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LESSONS FROM THE EQUITABLE

Discussion Meeting, Edinburgh, 29 November 2001

Following the publication of the Report of the Corley Committee of Inquiry (2001) regarding The Equitable Life Assurance Society, the Faculty of Actuaries' Meetings Committee arranged a discussion meeting on 'Lessons from the Equitable', which was held in Edinburgh on 29 November 2001. The meeting was chaired by Mr Ralph Garden.

Mr Mike Shelley had been asked to open the meeting by giving a presentation summarising the events leading up to and subsequent to the Equitable's closure to new business in December 2000. He likened these events to a Greek tragedy, and said that the central character in such tragedies makes "a fatal judgement ... because of his arrogance and ... his belief that he can challenge the Gods. Of course, as a result, he is destroyed. But ... we feel sympathy and not revulsion for the central character, and come away thinking that could very easily have been me."

Mr Shelley said that the Equitable was somewhat unusual, in that it operated without any significant free assets. He remarked that everyone to whom he had spoken in another office told him that the House of Lords' judgment took account of the particular circumstances of the Equitable, that the Equitable was quite different from other offices, and therefore that the judgment did not affect their own office. He pointed out what he termed a series of 'fatal mistakes' made by the Equitable (issuing policies with guaranteed annuity options (GAOs)), by the regulator (saying in 1998 that terminal bonuses for contracts with GAOs could be lower than for contracts without these options), and by the actuarial profession (issuing a position statement in 1999, which suggested that it was comfortable with the Equitable's approach).

In his summary of events since the Equitable closed to new business, Mr Shelley mentioned an internal review being conducted within the Financial Services Authority (FSA), which, he suggested, might result in the regulation of insurance moving closer to the system for banking.

Following Mr Shelley's presentation, the Chairman asked for contributions from the floor. He said that the names of contributors would not be included in the report on the meeting. In total, there were ten speakers, and the Chairman read out one written contribution.

Three speakers talked about the need to charge and reserve for GAOs. The first said that he was astonished that, as far as he knew, this topic had not been seriously discussed at any actuarial forum. He said that any charge should be fixed at the outset of the policy, and not depend on the cost of the guarantee when the pension became payable. He went on to describe some

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work that he and his colleagues had been doing in this area. One approach that they had used was similar to that adopted by the Maturity Guarantees Working Party in their Report (1980), i.e. using a stochastic asset model to simulate the liabilities, and then determining reserves so that, with some specified probability, these reserves would be sufficient. They had also investigated how to hedge GAOs. In a subsequent contribution, this speaker talked about the problem of running down a closed with-profits fund. He made some suggestions, and then said that a technical discussion of this problem was needed within the profession at some time. The second speaker on this theme discussed the Equitable's policy of paying out broadly full asset shares. He agreed with this approach, but disagreed with how the Equitable had calculated asset shares. In his view, the asset shares should have been reduced to allow for the GAOs, much as asset shares for survivors are reduced to pay for guaranteed death benefits in conventional business. The fund built up in years when the GAOs did not bite could then be used to pay for the guarantee in years in which they did bite. The third speaker on this theme agreed with the previous point, but indicated the practical difficulties that would result from the build up of large reserves, particularly since the reserve would be used to equalise benefits between different generations of policyholders.

One speaker made a series of suggestions, which included more protection for whistle-blowers, a more pro-active approach by the Faculty and Institute with regard to possible breaches of our professional guidance and best practice, and actuaries having direct responsibility for the integrity and compliance of a life office's sales force.

The Corley Committee made some recommendations concerning Guidance Notes. Two speakers commented on this. One said that he thought there was nothing wrong with the Notes, but they were not being followed by the appropriate people. The other said that an Appointed Actuary has a duty to consider all liabilities which may occur in the future, and that Guidance Notes could not cover every eventuality.

One speaker expressed the view that the actuarial profession, itself, could suffer as a result of the difficulties experienced by the Equitable. He contrasted the profession's response to the problems caused by maturity guarantees in the 1970s (setting up a Working Party to establish a reserving methodology) with its apparent current lack of action with regard to reserving for GAOs. He also said that, if the profession showed itself unable or unwilling to address this problem, other professionals who were able and willing to do so would move into what we would like to regard as a core area of actuarial work.

The next speaker agreed that the actuarial profession had been very seriously damaged. He did not like the Appointed Actuary system, arguing that an independent reporting actuary should be appointed, not by the directors, but by the shareholders or policyholders. He referred to

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policyholders' reasonable expectations as a 'curse on the profession'. He expressed the view that the managers of the Equitable had a reasonable expectation that interest rates would stay above 7% p.a. When they fell below this level, he thought that the managers should have been free to take any action they chose. He also said that the Equitable had been close to safety, and could have been helped by its managers having more business awareness. He suggested that, instead of declaring a lower terminal bonus rate for those policyholders who exercised their GAO, the company would have been better advised to declare a uniformly lower bonus rate for all policyholders, with a higher rate for those who did not exercise their GAO. The next speaker had some sympathy with these views, although they were firmly condemned by a subsequent speaker, and went on to discuss asset shares. He thought that the Equitable case had "let the asset share genie out of the bottle", and that there was now a general perception of entitlement to asset share as a minimum. He saw this as a challenge to the with-profits industry and to those actuaries involved in it.

The final speaker referred to the paper 'With Profits Without Mystery' (1989). He said that, at the time when this paper was discussed at an Institute Sessional Meeting, there were people who did not agree with the authors' approach to running a with-profits office and did not regard it as equally valid as the more conventional approach, i.e. having an estate. He wondered why the profession had allowed such a strong minority view to remain unchallenged for so long. He put in a plea for actuaries to increase their technical knowledge, particularly in the area of financial economics, saying that we need to learn about these things to "uphold the good name of the profession".

The one written contribution read out at the meeting by the Chairman covered several points. The author asked whether the profession should have a robust mechanism for initiating investigations where sensible outsiders had expressed real concern about how an organisation was being run. He quoted a conclusion of the Scott report on unit-linked business, that policies should be linked only to assets that were available and easily realisable in the market, and wondered what the effect of such a restriction would be on guarantees attached to life policies. In common with several speakers, he suggested that guarantees should be paid for in advance of the guarantee date. One way to do this would be to make a regular deduction of an expected cost from asset shares. He made some suggestions for items that should be included in a Financial Condition Report, as proposed by the Corley Committee of Inquiry, and discussed the conflicts of interest that surround the operation of a with-profits fund.

In his closing statement, the Chairman summarised a few of the main points of the discussion. In particular, he mentioned Guidance Notes and charging for guarantees. On Guidance Notes, he said that views were divided. Taking Guidance Notes into micro detail, and attempting to deal

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with every situation, was almost bound to fail. On the other hand, there was much more support for having sensible Guidance Notes than there was opposition to this. On charging, he said that, even as far back as the 1980s, it should have been clear that large reserves were needed to back the guarantees. That such reserves were not set up indicated that the offices did not know what they were doing. He suspected that the Equitable was by no means the only life company in that situation.

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