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Equitable Life U.K.: a Decade of Regulations and Restructuring

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Equitable Life U.K.: a Decade of Regulations and Restructuring

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The Geneva Association

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Executive Summary

The Equitable Life Assurance Society was a major U.K. life insurer that ran into severe financial difficulties in the late 1990s. It nearly went insolvent after a judgment in 2000 by the House of Lords concerning its pension policies with guaranteed annuity rates (GAR). The judgment led to an additional £1.5 billion in liabilities. The Society stopped taking new business in December 2000, reached a compromise agreement with its policyholders and began selling off its assets. Fifteen years later, Equitable Life is still running down its business. However, this 'run-off' was only one part of the Equitable Life's actions in response to the sudden and unexpected increase to its liabilities following the House of Lords judgement.

Equitable Life's products with guarantees: A mutual insurer founded in 1762, Equitable Life primarily sold with-profits policies (equivalent to participating policies in the U.S.), in which the Society's surplus was shared with its policyholders. The policies that led to the troubles were issued from 1957–1988 and contained a guaranteed annuity rate. These policies typically guaranteed that £100 cash at retirement could be converted into a £10 per annum annuity, regardless of external financial conditions at the time. The GAR was set at the time a policy was written (during times when interest rates were relatively high), with no special guarantee fee: it was the equivalent of a free guarantee. Furthermore, in its annual statements sent to policyholders, the Society did not distinguish between classes of policyholders, providing similar estimates of benefits to both GAR and non-GAR policyholders. While Equitable Life stopped offering GAR policies in 1988, this product would have financial implications for years to come. In 2000, 20 per cent of the Society's liabilities were on policies with a GAR.

How a GAR policy worked: At retirement, a GAR policyholder used the cash sum, including bonuses awarded, to buy an annuity that provided either the market rate or the guaranteed rate, whichever was higher. Thus, when the GAR exceeded the market annuity rate, policyholders selecting the GAR required more outlay of annuity amounts from the Society.

Equitable's deteriorating capital condition: Equitable Life did not have the reserves to pay the additional costs for guarantees that were over the prevailing market interest rates. A policy of overly generous annual bonuses, which had attracted customers and contributed to the Society's growth, depleted its surplus. The cost of the GAR annuity over what was available at market rates had to be met by the Society from its capital.

Attempted solutions: In 1993 when annuity rates fell below the GAR, Equitable Life sought to resolve the problem by cutting the terminal bonus allocated to GAR policyholders, thereby reducing the cash value of their pensions at retirement and establishing a 'differential terminal bonus' practice between GAR and non-GAR policyholders.

Policyholders protested. While the bonus portions of their policies were not guaranteed, the Society's annual notices to its members had led them to expect a cash value based on these bonuses at retirement. Thus, it was argued that the notices created an expectation even though they were not part of the contract.

Equitable Life loses court case: After GAR policyholders challenged the 'differential terminal bonus' practice, the Society funded a court test case, Equitable v. Hyman, to examine the merits of its practice. The U.K. High Court initially sided with Equitable Life, but the decision was reversed on appeal. In July 2000, the House of Lords, the U.K.'s highest court, ruled against Equitable Life by noting that the Society's directors did not have discretion to apply a lower bonus to policyholders who chose to use the GAR compared to those who did not. They found that Equitable Life, through its annual notices to members, had led both GAR and non-GAR policyholders to expect a certain bonus level.

The House of Lords' decision in total added £1.5 billion to the Society's liabilities. Although Equitable Life had assets of £34 billion and met minimum capital requirements, it was very weak financially. Excessive bonuses added to policies during the 1980s and 1990s meant that the Society was paying out nearly all of its yearly earnings. It should be noted that this policy of distributing most of its surplus as bonuses was not typical of U.K. mutual insurers at the time. Equitable Life pursued an aggressive growth strategy that was largely successful for many years. The Society's underlying weakness was not apparent from its published accounts or in the reports of returns submitted to regulators. In addition, the Society used 'valuation practices of dubious actuarial merit', (the term used by Lord Penrose in his report to the Government in 2004)[1] and failed to include a liability for GARs until 1998 (***see Table II***).

1 In this study, we make frequent reference to reports of investigations of the Equitable Life case. Most often cited is the lengthy 'Penrose Report,' a high-profile public inquiry commissioned by HM Treasury in 2001 and published in 2004.

Table I:
Overall findings: Equitable Life Assurance Society Case

	PRODUCTS CHARACTERISTICS	MAIN CAUSES OF 'INSOLVENCY'	GOVERNMENT AND INDUSTRY ACTIONS	LESSONS-LEARNED FOR 'RESOLUTION'—POSSIBLE ACTIONS
EQUITABLE LIFE ASSURANCE	• Individual and group pension products: primarily with-profits policies (participating policies) • Guaranteed annuity rate (GAR) policies sold between 1957 and 1988 • No additional premium charged for the GAR • Offered more generous and flexible GAR policies than most competitors • Mutual insurer	• Equitable Life did not plan for potential GAR risk. Starting in 1993, falling interest rates brought market annuity rates below the GAR • Equitable Life reduced the cash payout at retirement (by reducing the terminal bonus) for policyholders who used GAR rather than market annuity rates • The House of Lords ruled against Equitable Life's 'differential terminal bonus' policy in Equitable v. Hyman, (2000) • Judgment added additional £1.5bn to Equitable Life's liabilities • Equitable life found it difficult to absorb additional liabilities due to underlying financial weakness, resulting from history of poor financial and risk management and weak governance • Lack of appropriate supervision	• Equitable Life stopped writing new policies in December 2000 and entered into a voluntary run-off • Equitable Life was never declared insolvent and did not access industry guarantee funds • The Society reached a compromise agreement with its policyholders limiting future GAR liabilities, sold off administrative infrastructure and subsidiaries, and transferred some liabilities to other insurers • Because the Parliamentary and Health Service Ombudsman's Report (2008) found that U.K. insurance regulators failed to adequately supervise Equitable Life, Parliament passed the Equitable Life (Payments) Act in 2010, providing full compensation (based on 'relative losses') for with-profits annuitants, and £775m for other policyholders (covering 22.4% of their losses)	• The Equitable Life case revealed the importance of the following, all of which were subsequently addressed by U.K. regulators and/or legislation i) Inadequate product pricing ii) Lack of transparency iii) Corporate governance problems iv) Inadequate capital to meet risks (both operational and legal) • Resolution of a life insurer, or dealing with one that has severe weakness can take a long time and involve multiple phases; problems can linger for a long time

Voluntary run-off, new management, and reduced benefits: Following the House of Lords' ruling, Equitable Life tried to find a buyer. When this failed, the Society stopped accepting new business in December 2000 and entered into a voluntary run-off process. A new board in 2001 worked to improve Equitable Life's financial and risk management. It controlled the Society's exposure to low returns by switching out of investment in equities and into bonds. In addition, it implemented a 'compromise scheme' whereby policyholders gave up GARs in exchange for a 17.5 per cent increase in their cash benefits. Subsidiary companies were sold off, as was the Society's administrative infrastructure, and some liabilities were transferred to other insurers. By the end of 2014, Equitable Life's policyholder liabilities were £7 billion, down from £32 billion in 2000.

Regulatory maladministration: Equitable Life policyholders were dissatisfied with the outcome of less-than-expected amounts at retirement—leading to calls for governmental compensation. In 2008, an investigation by the Parliamentary and Health Service Ombudsman (PHSO) found that U.K. insurance regulators had failed to monitor and challenge Equitable Life in accordance with the rules and supervisory responsibilities in place at the time; and that this amounted to 'maladministration'.[2] Due to regulatory lack of warnings, those individuals buying Equitable Life policies were unaware of the Society's true risks and weakness. In 2010 Parliament passed the Equitable Life (Payments) Act, providing compensation to policyholders, but while compensation for with-profits annuitants was to be paid in full, other eligible policyholders were limited to a total amount to £775m, meaning they only received 22.4 per cent of their relative loss.

The events at Equitable Life resolution : There are two distinct parts to what happened at Equitable Life from 2000 onwards. First, the Society went into run-off following the House of Lords' decision and the failure of the Society to find a buyer: which illustrated the legal risk the Society was exposed to. The Society underwent a major restructure to enable it to cope with its weakened financial position. However, Equitable Life was never declared insolvent and thus never came under the auspices of the Policyholders Protection Board (PPB)—the U.K. guarantee fund at the time.[3] There was therefore no resolution in the accepted sense. Second, we explain the payment of compensation from HM Treasury to policyholders, due to the failure of regulators to adequately supervise Equitable Life.

Regulatory Changes: Since Equitable Life's troubles, U.K. insurance regulations have been strengthened considerably. Awareness of shortcomings in the rules themselves was a reason that the Financial Services Authority (FSA) began a review of insurance regulation in 2001 and, by 2005, had implemented some significant changes. Some were focused on with-profits business, for example, new rules on capital requirements, 'realistic' financial reporting, transparency and governance; others covered the whole of the market, including directors' capital assessments and risk management.

For the sake of completeness, we mention that there have been further regulatory changes following the global financial crisis, leading to the Financial Services Act of 2012. Taking effect in 2013, this legislation replaced the FSA with two agencies, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The PRA focuses on the financial soundness of insurers, ensuring that firms can pay valid claims if and when they fall due, while the FCA focuses on the fair treatment of customers. Further regulatory changes have taken place with the introduction of the new Solvency II regime in 2016, which addresses governance, risk management, financial reporting and capital requirements.

Finally, the U.K. pension market is in the midst of significant changes, with new regulations, which took effect in April 2015. Previously, policyholders reaching retirement could only receive 25 per cent of their personal pension lump sum as tax-free cash. They had to use the rest to buy an annuity. Today they can take the entire proceeds as cash, paying a tax on the remaining 75 per cent. Sales of annuities have therefore fallen sharply.

2 We use 'maladministration' here because it is the term used by the Parliamentary and Health Service Ombudsman in her reports to the government on Equitable Life (2003, 2008). In the U.K., ombudsmen are charged with investigating allegations of government maladministration at various levels. For more details on the PHSO's finding, see Section 4.

3 The Policyholder Protection Board (PPB) was charged with administering the U.K. insurance industry's compensation scheme for failed insurers from 1975–2001. In December 2001, the responsibility of policyholder protection was transferred to the Financial Services Compensation Scheme (FSCS).

Policyholders' actions: Fifteen years after Equitable Life's implosion, frustrated policyholders continue to protest their level of compensation. The Equitable Members Action Group (EMAG) has held numerous demonstrations, including protests outside Parliament.[4] Equitable Life's policyholders have received the payments guaranteed by their policies, but have been disappointed by their share of profits, which were not guaranteed, but which annual notices had led them to expect.

It is difficult to illustrate the extent to which claims to policyholders have been less than they may have expected. One possibility is to recognise that the compensation to policyholders, excluding with-profits annuitants, of £775 million is only 22.4 per cent of what could have been justified, i.e. implying that £2,685 million have been 'missed'. If we consider the position of the Society at the end of 2000, when its policy liabilities were £31.2 billion, this means that policyholders only received an estimated 93 per cent of the total value of their claims. However, it is accepted that several other calculations could be made and this is but one approximation.

Insights: In many ways, the Equitable Life case was unique among insurance company 'failures' and subsequent resolutions. Our detailed study of the case offers the following insights:

- ***Restructuring of a weak insurer without a formal resolution process***—Equitable Life's financial troubles did not result in insolvency and a formal liquidation process. However, the compromise agreement referred to below was a formal process involving the courts, while regulators monitored management's restructuring. Policyholders have continued to demonstrate their dissatisfaction with the outcome. However, we would not suggest that a formal liquidation process in connection with an insolvency would have led to greater satisfaction, and there is no reason to think that policyholders would have been better off.

- ***Pricing and guarantees implications***—Inadequate pricing lay at the heart of Equitable Life's problems. The Society's aggressive pricing model could not be sustained under external changes such as a reduction in interest rates. A lack of financial prudence also contributed. Equitable Life's desire to be competitive and grow led to 'over-bonusing', i.e. deciding on rates of bonus that led to paying retiring policyholders more than their premiums had earned, after expenses.

- ***Implied contracts:*** The Society issued annual notices of account values to policyholders that led to reasonable expectations of what they would receive at retirement, but without this being recognised by the Society as a potential liability, i.e. legal risks.

- ***Mutuality and monitoring:*** Because the Society was a mutual, there were no shareholders monitoring it and little scrutiny from analysts (or from insurance brokers, given that the Society did not pay commissions). Equitable Life's non-executive directors (NEDs) were criticised for lacking knowledge; from the early 1980s onwards none of them had relevant life insurance experience or related qualifications.[5]

- ***Transparency***—Equitable Life's financial weakness was not properly reflected in the financial statements of the Society. Policyholders (the Society's owners) were unaware of the Society's true financial position. As discussed above, subsequent regulatory changes in the U.K., however, have since addressed this issue.

- ***Corporate governance***—As a mutual insurer, without separate owners to challenge management actions, Equitable Life was particularly vulnerable to corporate governance problems. Regulators have since addressed these issues too.

- ***Risks and capital***—A major concern with Equitable Life was that it was not well prepared for the risk that interest rates would decline, much less for the legal and regulatory risks that followed. Today, such deficiencies in insurers' risk management are much less likely due to greater regulatory scrutiny and strengthened capital requirements better aligned with risks.

- ***No systemic risk*** arose in the case. Equitable Life was not subject to a serious 'run', there was no significant liquidity problem and there was no impact on investment markets or on other insurers. When the Society closed to new business, policyholders had plenty of other life insurers from whom they could purchase annuities.

4 See http://www.emag.org.uk/.

5 Penrose (2004), chapter 19.

Table II:
*Equitable Life financial position (statutory solvency valuation)**

	1997	1998	1999	2000
ASSETS	23,827	28,238	33,110	34,257
FUTURE PROFITS	371	840	925	1,000
LIABILITIES	22,076	26,254	31,175	33,625
MINIMUM CAPITAL REQUIREMENT	845	1,008	1,114	1,221
FREE ASSETS	1,277	1,506	2,746	411
GAR LIABILITIES INCLUDED ABOVE:				
GROSS	0	1,593	1,630	2,631
NET	0	784	551	1,823

Source: *Equitable Life Regulatory Returns. Note figs in £m.*
**This table appears as Table 1 on page 15 in the main text*

1. Background

The Equitable Life Assurance Society, a U.K. mutual insurer, was founded in London in 1762. Two centuries later, its primary business was individual and group pensions, most of which were sold within the highly competitive U.K. market. From the 1960s onward, the Society grew rapidly. By 2000—the year it stopped taking new business—Equitable Life managed close to £34 billion in funds. With around 1.5 million policyholders, premium income that year was £3.5 billion (it had peaked in 1998 at £3.7 billion), representing about 5 per cent of the U.K. life insurance market.

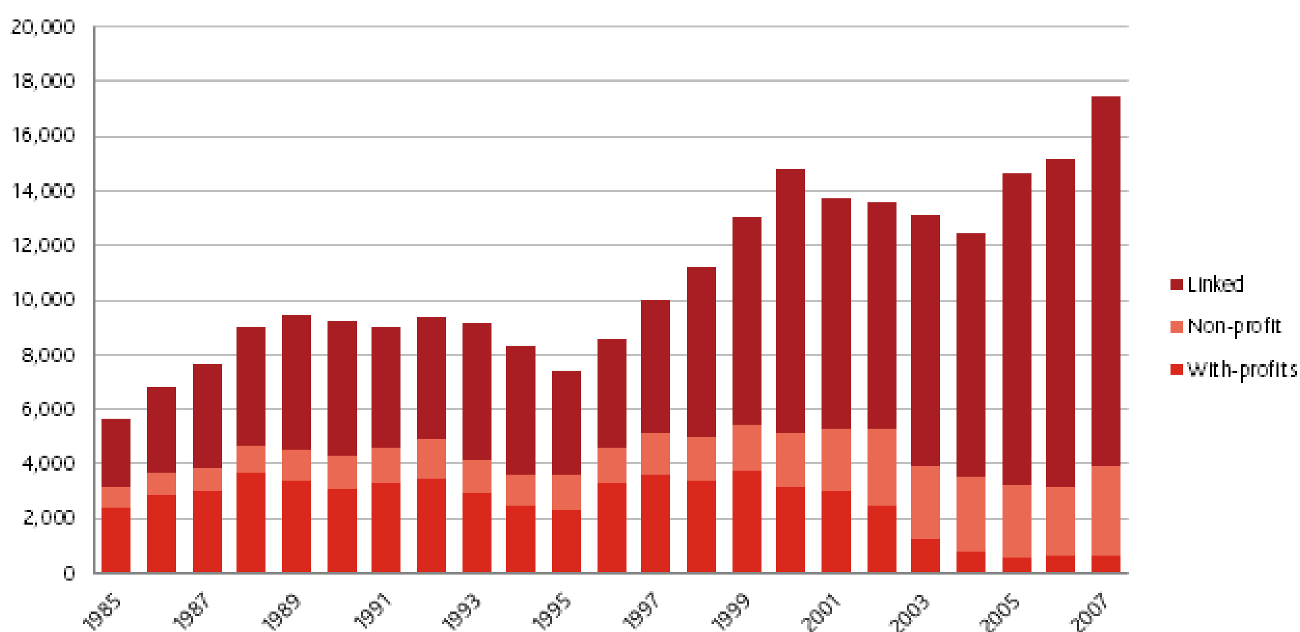
As a mutual insurer, Equitable Life had no shareholders. Instead, its policyholders were 'members' of the Society, sharing in its profits. In 2000, Equitable Life was one of 17 mutual life insurance companies in the U.K. market. As the Society expanded, it used its mutuality as a selling point, emphasising that, as a mutual, it did not have to allocate profits to shareholders, but instead gave them to the policyholders, who were the owners. This was more than just marketing: being a mutual was a core part of the Society's identity, influencing what types of policies it sold.

With-profits pensions

Most of Equitable Life's policies (91 per cent in 1995) were with-profits policies (known as participating policies in the U.S.), which provided a guaranteed cash fund at retirement. This lump sum payment was typically used to purchase an annuity. During the accumulation phase of a policy, the guaranteed cash fund grew each year when the Society added an 'annual bonus', based on its profits (surplus), as disclosed in the appointed actuary's valuation of Equitable Life's assets and liabilities. When a policyholder reached retirement, the Society also added a 'terminal bonus' to ensure that the policy provided a fair return. Thus, at retirement, the payout would be the guaranteed benefit, including annual bonuses plus the additional 'terminal bonus '.

Equitable Life had a practice of notifying policyholders annually of their 'policy value' which, although not guaranteed, helped them track the progress of their investment and led them to expect a certain sum at retirement. Since

Figure 1:
New business Annual Premium Equivalent (2007 prices)



Source: *O'Brien (2009)*

the policy values effectively included the terminal bonus accrued to date (although this was not identified separately), policyholders' expectations were being created for amounts in excess of what was formally guaranteed.

During the 1980s and 90s, Equitable Life continued to sell mostly with-profits pensions, even as other insurers began to shift their business towards unit-linked policies, a type of pension where the investment risk is borne by the policyholder. In the U.K., by the late 1990s, unit-linked pensions were far more common than with-profits pensions (***see Figure 1***). However, for Equitable Life, with-profits policies reflected its tradition as a mutual, where its members shared the profits. Equitable Life wrote more new with-profits business than any other insurer in each of 1995–1997.

Mutuality may also have contributed to one of the more unusual features of the Society—its practice of 'full distribution of surplus', emphasising—and this was made clear in its annual report and accounts—that it returned to policyholders the full value from the premiums they had paid, and did not hold back profits for future generations. In retrospect, this was not prudent behaviour, especially for a mutual company, which had limited access to additional capital.

Growth strategy

Equitable Life's philosophy of providing a 'full and fair' return to policyholders helped to attract customers in a highly competitive market. The U.K. pensions market was growing rapidly from the 1970s, and the Society embarked on a new strategy of active marketing of its pension products, focused on high net worth individuals. (Parliamentary Ombudsman, 2008, pp. 10–12). There was a particular boost arising from new legislation, allowing members of employer-sponsored pension schemes to opt out of the scheme and purchase a personal pension policy with an insurer instead. The Society's 1985 annual report and accounts predicted that this pension reform would '…provide a new opportunity in the field of personal pensions where the Society is a market leader' (Equitable Life, 2005, p. 5). After the new rules came into effect, the Society's 1988 report and accounts reported, '…growth in premium income directed towards individual pensions has confirmed the Society's pre-eminent position in that area ', and its having over 50 per cent of the market for additional voluntary contributions to pension schemes (Equitable Life 2008 pp. 3, 5).

Equitable Life pursued a competitive low-pricing strategy. It did not pay commissions to intermediaries, relying on its own specialised sales force instead. It had well-respected administration systems, operating at a low cost. As depicted in its annual reports and accounts, the ratio of the Society's expenses to premiums was lower than the average for U.K. life insurers. For example, the cost of expense to premium ratio was 6.6 per cent, compared to 18.5 per cent for the industry in 1992. Being a mutual, it also did not have to allocate profits to shareholders; all belonged to the with-profits policyholders.

Equitable Life's aggressive pursuit of growth eventually took on a life of its own. The Penrose Report concluded that 'sustained growth became an independent objective pursued with something approaching missionary zeal'. This meant that the Society's policies had to be attractive, and they were when it came to bonuses (Penrose, 2004, pp. 69, 78).

But, Equitable Life's aggressive pursuit of growth came at the expense of its financial and risk management objectives. The Society's competitive rates and generous bonuses masked severe weakness. Its mutuality, too, left it vulnerable. When something went wrong, the Society had no outside shareholders to fall back on.

2. Guaranteed Annuity Rates

Equitable Life's problems can be directly linked to problems with pension policies written by the Society from 1957 to 1988, that contained a guaranteed annuity rate (GAR) option. As explained in the previous section, most of Equitable Life's pensions were with-profits policies that produced a cash fund at retirement, most of which had to be taken in the form of an annuity. Equitable Life's GAR policies guaranteed that each £100 in cash funds could be converted into an annuity, typically providing £10 per annum (10 per cent). As long as market rates exceeded the guaranteed rate, policyholders would be expected to purchase a market-rate annuity. When the GAR exceeded current annuity rates, policyholders would choose to use the guaranteed rate. The Society would then have to provide an annuity at that rate.

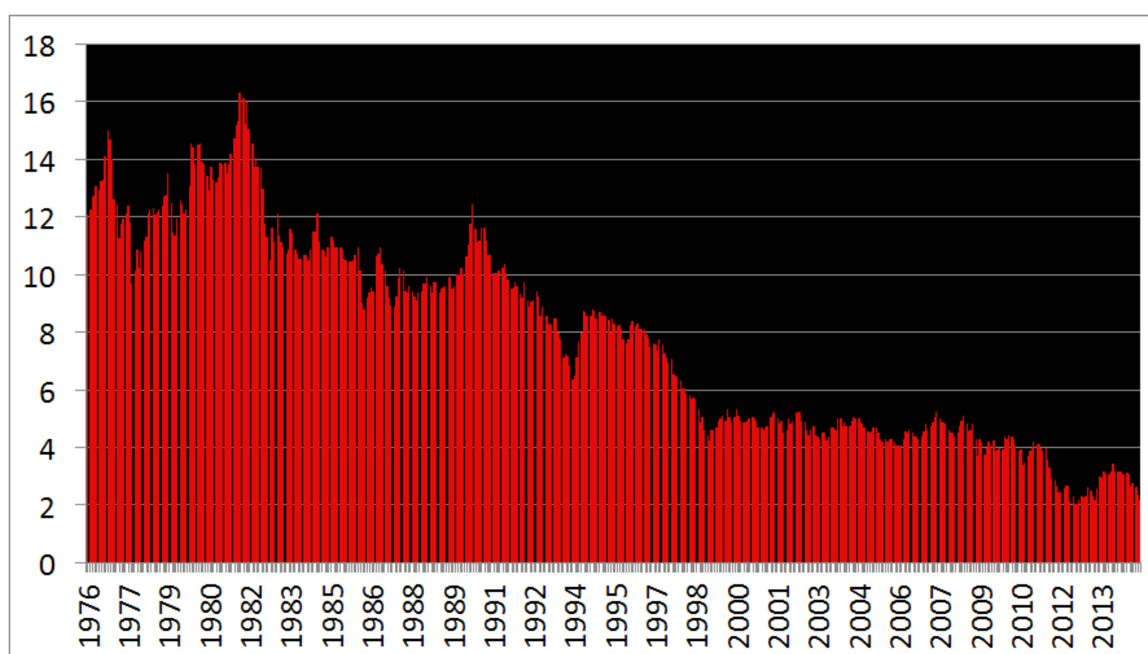
The Society's GARs were, compared with those offered by other insurers, more generous and flexible (allowing the guarantee to be exercised over a wide range of ages, not just age 65) and included the option for the policyholder to pay additional amounts to increase the 'fund value at retirement' and enjoy the GAR on the added funds as well. Unlike some other insurers, Equitable Life did not charge extra for the GAR (Parliamentary Ombudsman, 2008, p. 12).

When Equitable Life redesigned its pension product in 1988, GARs were no longer included. However, the volume of GAR business already sold meant that, by the end of 1999, the value of with-profits policies with a GAR was still as high as £6.7 billion, compared with £20.1 billion on non-GAR with-profits policies (Penrose, 2004, p. 181).

Falling interest rates

The GARs became a problem from 1993 onwards. As U.K. interest rates fell (***Figure 2***), annuity rates on the open market dipped below the GAR. Falling mortality rates also contributed to lower annuity payments as the life expectancy of a 65-year-old male annuitant increased from 14.9 years in 1975 to 17.6 years in 2000.

Figure 2:
Yields on British government bonds 1976-2014 (%)



Source: *Heriot-Watt/ Institute and Faculty of Actuaries Gilt Database*

For example, consider a policy, which provided a cash fund, including annual bonuses during the accumulation phase, of £80,000 and a terminal bonus of £20,000. The cash fund at retirement (when the distribution phase began) would be £100,000. If open market annuity rates were 9 per cent, the resulting annuity would be £100,000 x 9% = £9,000 p.a. The problem for Equitable Life was that, if the policyholder chose to use the GAR (in this case 10 per cent), then, with the full fund of £100,000, the annuity would have provided £100,000 x 10% = £10,000 p.a. Given the then current annuity rate of 9 per cent, the implied outlay of cash would be £111,111 to provide the promised £10,000 p.a. (£10,000/9% = £111,111.) But, as the cash value of the policy was only £100,000, the Society would have had to dip into its reserves or capital to make up the £11,111 deficit.

The 'differential terminal bonus rate' policy

In 1993, the board adopted a 'differential terminal bonus rate' policy, meaning that, if policyholders chose to use the GAR in their policy, their terminal bonus would be lowered, reducing the cash fund at retirement. This action was meant to equalise the amount received by GAR policyholders, regardless of whether they chose to use the GAR or market rate to purchase an annuity. Moreover, Equitable Life's leadership believed that the Society's articles of association gave its directors the discretion to lower bonus payments in this way.[1]

Under the 'differential terminal bonus' regime, if the policyholders described above chose to exercise the 10 per cent GAR option, they would see the terminal bonus cut from £20,000 to £10,000, resulting in a cash value at retirement of only £90,000. An annuity at 10 per cent would now produce only £9,000 p.a. (£90,000 x 10% = £9,000 p.a.), the same amount the policyholders would receive if they had not chosen to use the GAR. Hence, the GAR gave the policyholder nothing extra.

This differential terminal bonus policy was not properly explained to policyholders, who expected the same fund value at retirement regardless of annuity rates at distribution time. In 2000, the House of Lords would rule the 'differential terminal bonus' practice illegal due to implied terms within Equitable Life's contracts.

1 In many countries, what are referred to in the UK as bonuses are called dividends elsewhere; hence lowering the terminal bonus would have had the same impact as lowering dividends.

3. Underlying Problems

The Society's management of its GAR risks (or failure to do so) was emblematic of its poor risk management—and of its governance in general. Many of the inquiries into Equitable Life looked at problems in its corporate governance. One issue highlighted was the dual role held by Roy Ranson, the appointed actuary of the Society from 1982 to 1997. Ranson also served as chief executive from 1991 to 1997. The appointed actuary had a professional role to ensure, inter alia, that product pricing and reserving were appropriate and adequate, which required a degree of independence from the executive management. Thus, Ranson's dual role became a problem, especially as, according to Penrose, he was an idiosyncratic and autocratic individual (Penrose, 2004, p. 741).

Equitable Life's non-executive directors (NEDs) were also singled out for blame. Because the Society was a mutual, there were no shareholders monitoring it and little scrutiny from analysts (or from insurance brokers, given that the Society did not pay commissions). The NEDs were criticised for lacking appropriate knowledge; from the early 1980s onwards none of them had relevant life insurance experience or related qualifications. The NEDs that Penrose interviewed had a poor understanding of the Society's true financial position and the risks to which it was exposed.

Lack of controls at the Society was another problem. Penrose reported that Ernst & Young, the Society's auditors, noted in 1997 'a long-standing concern regarding the absence of traditional internal audit '. He also drew attention to the absence of controls over the actuarial function (Penrose, pp. 312, 329).

Financial prudence was also wanting. Equitable Life's desire to be competitive and grow led to 'over-bonusing', i.e. deciding on rates of bonus that led to paying retiring policyholders more than their premiums had earned, after expenses (the 'asset share'). Consequently, the Society's surplus was depleted (Penrose, pp. 353, 689).

In addition, the accrued terminal bonus, included in the policy value notified annually to a policyholder, was out of line with and often higher than the asset share. The outcome was that the total of policy values reported to policyholders exceeded the available assets. At the end of 2000, they were £28.9 billion and £25.8 billion respectively.

Another problem was risk management: Ernst & Young thought that the Society's approach was not sufficiently robust. Further, the appointed actuary did not produce an annual financial condition report, as recommended by the Institute of Actuaries, which could have highlighted the financial risks from low interest rates and increasing longevity. There were associated concerns about governance: Peter Davis, a NED, expressed a concern that the board was being prevented from understanding what risks the business faced and how these were being managed and controlled (Penrose, pp. 299, 312).

Equitable Life was very focused on its customers, at the expense of the long-term stability of the organisation. Its decision to manage the GAR risk by reducing bonus rates to policyholders choosing a GAR was inconsistent with its policy of satisfying and attracting customers with high bonuses and was bound to lead to complaints. Financing the risk was inevitably difficult due to the Society's practice of 'full distribution of surplus', meaning that there was limited surplus to draw on in adverse circumstances. Further, as a mutual, it could not raise share capital. These adverse circumstances were to arise when the House of Lords ruling on differential terminal bonuses led to additional liabilities.

Investment strategy and reinsurance

A formal risk assessment would have established that Equitable Life's investment strategy was risky. The Society was more generous in its guarantees than most of its competitors, as regards both the guaranteed cash fund on retirement and the GAR, and it did not have sufficient bonds or derivatives to match the interest rate risk in its liabilities. Furthermore, its substantial equity portfolio meant that the value of its investments was volatile, leaving its solvency insecure.

Equitable Life had no reinsurance in place to protect its GAR liabilities until it effected a treaty with Irish European Reinsurance Company Limited in 1999. The main purpose of this treaty, however, seemed to be to give the Society credit for the end-1998 valuation and thus improve its surplus by £809 million. The reinsurance had limited value however, because of provisions indicating that it would not be effective if the Society changed its terminal bonus practice. Further, it was found in 2001 that the Society's appointed actuary had written a side letter to the reinsurer,

not disclosed to the FSA, indicating that the treaty would be cancelled if claims exceeded £100 million: this would have significantly limited the value of the reinsurance.

Accounting

One of the problems identified by Penrose was that the published accounts of life insurers transacting with-profits business were unsatisfactory. The then applied accounting standards for life insurers did not appropriately reflect the economic reality of the liabilities of the insurer. This meant that policyholders reading the annual report and accounts in the 1990s were unaware of the financial difficulties of the Society. Penrose noted problems arising from the different approaches to valuation of liabilities in the accounts and the regulatory returns. This inconsistency was also a concern of the Select Committee of the Treasury, who, in their 2001 report, concluded that policyholders could not easily establish the true position of the Society. In addition, there were inadequacies in the auditing arrangements for both the accounts and the regulatory returns.

Weak financial position

Equitable Life's continuous 'full distribution of surplus' policy had a direct and deliberate consequence: its financial position was weak. A life insurer's excess of assets over liabilities was known as the 'estate', but as Ranson and Headdon wrote in their 1989 paper 'With Profits Without Mystery,' 'We do not believe in the concept of an estate in the sense of a body of assets passed from generation to generation and which belongs to no-one' (Ranson and Headdon, 1989). In other words, they felt it appropriate to run the Society without a buffer of excess assets that might be needed in adverse conditions .

In their report for the Institute of Actuaries, Roger Corley et al. commented that, 'the absence of free reserves meant that the company lacked a potentially valuable instrument to cope with unforeseen financial problems as compared with other mutual life insurance companies which had built up free reserves ' (Corley et al., 2001, p. 24). The Select Committee found that the Society's 'risky decision in 1993 not to build up a reserve to cover the cost of GAR liabilities was a crucial turning point '. But, over-bonusing took priority, weakening the Society to the point where the £1.5 billion GAR cost was enough to cripple it.

This weak position is reflected in the financial position of the Society in the statutory solvency valuation as reported in the regulatory returns (***see Table 1***). At the end of 2000, the position was dire.

Equitable Life did not include a liability for GARs until 1998, under pressure from the regulators. It had argued (wrongly) that, since it negated the GAR by reducing the terminal bonus rate if a policyholder chose the GAR, it did not have to include any liability.

Therefore, the regulatory returns before 1998 presented an unduly favourable picture. In addition, the Society used 'a series of particular valuation practices of dubious actuarial merit', which reduced the liabilities as reported (Penrose, p. 727).

Regulatory Weakness

Insurers were subject to the European Union's Solvency I regime, and the Insurance Companies Act in effect in the U.K., which required a valuation of assets and liabilities and set minimum capital requirements, was responsible for implementation. The valuation, intended to be prudent, was not always so in practice. Furthermore, it failed to ensure that policyholders' reasonable expectations were protected; for example, the regulations did not require a liability for terminal bonus to be included. Further, the minimum capital requirement was not sufficiently sensitive to the risks insurers were running.

In addition to deficiencies in the regulations, supervision of Equitable Life was inadequate. The Society was supervised by the Department of Trade and Industry (DTI), advised by the Government Actuary's Department (GAD), until responsibility passed to HM Treasury in 1998 and to the Financial Services Authority (FSA) in 1999. The inadequacies in supervision were to become clear when the Parliamentary and Health Services Ombudsman (PHSO) presented her report in 2008, finding 'maladministration' by the regulators, for which policyholders deserved compensation (See Section 4).

Insurers were also subject to ordinary company legislation, including the need to issue an annual report and accounts in accordance with the Companies Act of 1985. This required a valuation of asset and liabilities, not identical to that for the statutory solvency valuation. There was a requirement for insurers' accounts to be 'true and fair' from 1994, but, in the absence of agreement on what that meant, a number of different practices remained.

There were particular difficulties in accounting for with-profits business, where liabilities to policyholders were unclear when payouts depended on the discretion of management.

Table 1:
Equitable Life financial position (statutory solvency valuation)

	1997	1998	1999	2000
ASSETS	23,827	28,238	33,110	34,257
FUTURE PROFITS	371	840	925	1,000
LIABILITIES	22,076	26,254	31,175	33,625
MINIMUM CAPITAL REQUIREMENT	845	1,008	1,114	1,221
FREE ASSETS	1,277	1,506	2,746	411
GAR LIABILITIES INCLUDED ABOVE:				
GROSS	0	1,593	1,630	2,631
NET	0	784	551	1,823

Source: *Equitable Life Regulatory Returns. Note figs in £m.*

4. Crisis and Action Taken

Equitable Life's financial weakness became known as the result of the House of Lords' ruling in 2000. After 1993, as U.K. interest rates continued to decline. Equitable Life's GAR policyholders discovered that the GAR did not provide a true benefit. Subsequently, a number of GAR policyholders filed complaints with the office of the Personal Investment Authority Ombudsman.

Judgment

The policyholder challenges eventually led Equitable Life to seek a declaratory judgment before the U.K. High Court of Justice, by funding an action by a representative GAR policyholder, Mr. David Hyman. On 9 September 1999, the High Court ruled in the Society's favour, affirming the validity of its directors' decision to apply differential bonuses.

On 21 January 2000, the Court of Appeal overturned the verdict. The ruling was completely unexpected. In addition, if it held, the Society faced more than £1 billion in additional liabilities. Hoping to overturn the ruling entirely, Equitable Life brought an appeal to the House of Lords, the U.K.'s highest court.

On 20 July 2000, the House of Lords affirmed the Court of Appeal judgment that Equitable Life directors had exceeded their discretion. The Lords' ruling went even further, however, rejecting both the differential bonus policy and the use of 'ring-fencing' to pay GAR policyholders smaller terminal bonuses. The decision was a huge shock to the Society and to the U.K. insurance industry.

The restructure process

Following the House of Lords' ruling, Equitable Life's additional liabilities were estimated at £1.5 billion. Lacking the reserves or reinsurance to cover this sum, the Society immediately put itself up for sale, expecting to find a buyer quickly. While several companies seemed interested, all expressed concerns about the Society's financial position. One by one, bidders pulled out. By early December 2000, it was clear that no one would buy the entire operation outright. With no buyer in sight and because of its debt, Equitable was downgraded from A+ to BBB, stopped writing new business on 8 Dec 2000 and entered into a voluntary run-off process.

In February 2001, the Halifax Group agreed to buy Equitable Life's non-profit (non-participating) policies, while the Society's sales force was transferred to the Halifax Group (to sell Halifax policies). This rescue package gave the Society an immediate cash infusion of £500 million, plus a further £500 million if the Society's policyholders agreed to a compromise , capping the GAR liabilities and if new business and profitability targets were met by the Society's sales force. The compromise, proposed by the Society in September 2001, offered GAR policyholders a 17.5 per cent increase in their policy value, in exchange for giving up their rights to a guaranteed annuity rate. Non-GAR policyholders were offered an additional 2.5 per cent, in exchange for giving up any legal claims against the Society. The agreement covered some 70,000 GAR and 415,000 non-GAR policyholders. The FSA endorsed the scheme in December 2001. In January 2002, 98 per cent of policyholders accepted it.

A new board worked to improve Equitable Life's financial and risk management situation. It controlled the Society's exposure to low interest rates by switching out of equities into bonds. Subsidiary companies were sold off, and some liabilities were transferred to other insurers, with the approval of the High Court. In February 2007, £4.6 billion of non-profit pension annuities (approximately 130,000 policies) were transferred to Canada Life. At the same time, Equitable Life's University Life subsidiary (with £30 million in assets and fewer than 2,000 policyholders) was sold to Reliance Mutual. In January 2008, a sale to Prudential was completed, transferring £1.8 billion of with-profits annuity liabilities (62,000 policies) from Equitable Life to Prudential. By the end of 2014, Equitable Life's policy liabilities were £7.3 billion, down from £32 billion in 2000; its assets were £8.0 billion.

Equitable Life also attempted to raise money by suing its auditors and former directors.

In April 2005, the Society started a £2 billion High Court action against auditors Ernst & Young (reduced three months later to £0.7 billion), claiming the auditors had failed to inform the board of the seriousness of the Society's position. Described by Ernst & Young as 'ill conceived', the case was eventually dropped. Simultaneously, Equitable Life started a £3.3 billion claim against its former directors, claiming that they failed in their duties to policyholders. This claim was soon abandoned as well. Altogether, the two cases cost the Society around £40 million.

Costs to policyholders

Equitable Life may have avoided a formal insolvency, but its policyholders paid a price nonetheless. In 2000, the Society had approximately 1.7 million policyholders, 1.5 million of whom held with-profits policies. Although policyholders received their guaranteed benefits, the weakness of the Society meant that they did not receive the share of profits that they were expecting. Some saw the value of their pensions cut by as much as 30 per cent. Total damages to policyholders would later be estimated at between £3 and £5 billion.

The House of Lords' ruling was not the only factor that led to a weakening of the Society's finances in 2000. It was also hit by falling stock markets, which lasted until early 2003. What the Society could do was reduce surrender values on its policies. It implemented a 5 per cent early termination fee (surrender charge) for all its with-profits policies after the Lords ruling, the early withdrawal penalty soon being increased to 10 per cent. In May 2001, the Society reduced policy values by 16 per cent compared to the end of 2000, citing adverse stock market conditions. The compromise agreement reached early in 2002 had increased the cash benefits paid to GAR policyholders by 17.5 per cent, in exchange for giving up the GARs, but further reductions subsequently eroded the gains as stock markets continued to decline.

Investigations

Several enquiries attempted to analyse the case of Equitable Life from different perspectives. In 2001, the parliamentary Select Committee of the Treasury highlighted a number of issues. These included the lack of reserves for GARs; the role of the regulator; the need for greater transparency in presenting information on a life insurer's financial position; the discretion used by with-profits life insurers; and the auditing arrangements for life insurers.

A committee established by the Faculty and Institute of Actuaries commented critically on the lack of a substantial estate in Equitable Life and its high concentration on pension products.

A 2001 enquiry reviewed the performance of the FSA and concluded that, in particular, there was a need for market-consistent financial reporting and a risk-based approach to minimum capital requirements. It also found that there were shortcomings in the way the supervision had been carried out (Baird, 2001).

Lord Penrose was the author of a lengthy 2004 report requested by the Government. He claimed that, superficially, GAR claims of £1.5 billion should not have brought down an insurer with assets of £32 billion. A crucial point he established was that the single most important contributor to the situation at Equitable Life was the weakness of the fund that developed from the late 1980s. He highlighted the way in which the Society declared bonuses meant policy values advised to policyholders exceeded the assets of the Society, and Equitable Life used a range of mechanisms that meant the fundamental weakness of the Society was not made clear. This was possible partly because the regulations governing life insurers were inadequate, and also because the regulators were not acting effectively.

A 2007 report by a committee of enquiry of the European Parliament further drew attention to concerns about regulators' failings, concerning the potential impact of GAR policies on the financial stability of Equitable Life (European Parliament, 2007).

Regulatory failure

Policyholders were unable to receive monies from the Policyholder Protection Scheme as Equitable was never insolvent. However, it is not unexpected that policyholders who were receiving payments from their insurer that did not meet their expectations should complain, and some complaints reached the Parliamentary and Health Services Ombudsman (PHSO), alleging shortcomings by regulators (who were meant to protect policyholders' interests). The PHSO investigated several complaints that the DTI, HM Treasury, FSA and GAD failed to exercise their regulatory functions properly in respect of the Society during the period up to its run-off. The PHSO substantiated many of these claims and found other instances of maladministration, including a failure to evaluate the Society's exposure to the potential effect of GARs on its solvency in a context where market annuity rates were falling and on reserving relating to GARs and the reinsurance arrangement.

The PHSO established that there were 10 findings of maladministration, six of which involved injustice, and recommended a further investigation to determine what compensation should be paid, while recognising the arguments for and against compensation in such circumstances.

The government asked Sir John Chadwick to report on how compensation could be arranged. His report referred to the loss that Equitable Life policyholders had suffered compared to effecting a policy with another insurer: the 'external relative loss', reckoned to be about £4–4.8 billion in total.

The Coalition Government that was subsequently elected decided that fairness to taxpayers at a time of difficulties for public finances meant that, while compensation for with-profits annuitants would be paid in full, a limit of £775m would apply to others, which meant that they would receive only 22.4% of their relative loss. An Independent Commission reported on how to arrange that while maintaining fairness between policyholder groups The dissatisfaction among members of the Society, some of whom were excluded from the scheme, is evident from the website of the Equitable Members Action Group (http://www.emag.org.uk/).

5. Conditions and Rules in 2015 and Insights

In this study we discuss the circumstances that led to Equitable Life U.K.'s voluntary runoff and its implications for policyholders, regulators, and legislative action. Our purpose is to illuminate a unique situation of an insurer that created an aggressive model to increase market share in the annuity market based on unreasonable guarantees and ended up in trouble.

In 2015, 15 years into its 'run-off', the Society still managed the assets of 480,000 policyholders (165,000 individual with-profit, 170,000 group with-profit, and 145,000 unit-linked). With approximately 5 per cent of the business maturing each year, the run-off is expected to take another 20 years to complete. Equitable Life's remaining annuity business—31,000 annuities worth £875 million at the end of 2014—could stretch this period out even longer. In March 2015, however, the Society reached an agreement to transfer its annuities business to Canada Life.[2]

The Government compensation scheme also continued to make payments to policyholders. By the end of September 2015, over £1 billion had been paid out to 915,453 policyholders (this included over £300m to with-profits annuitants). About 125,000 policyholders had not been paid. The compensation scheme was closed to new claims at the end of 2015. The policyholder group—the Equitable Members Action Group (EMAG)—continues to protest and lobby the U.K. government for greater compensation.

Recent U.K. pension reforms along with record-low annuity rates have greatly reduced the appeal of annuity products for retirees. Likewise, many of the conditions that led to Equitable Life's collapse have largely disappeared. Regulatory changes in the years since Equitable's troubles make a similar occurrence less likely.

U.K. regulatory changes since 2000

The U.K. has overhauled insurance regulation since 2000. The Financial Services Authority addressed several of the concerns arising from the Equitable case in the changes it introduced at the end of 2004. In particular, financial reporting for most with-profits life insurers had to be 'realistic', requiring market-consistency and including expected future bonuses as a liability. Further, the capital requirements for insurers were more closely related to the risks they were running. For all life insurers, new governance arrangements meant that the appointed actuary role was abolished, the directors taking full responsibility for the insurer; and a requirement for the directors to prepare, annually, an 'Individual Capital Assessment' report, setting out the risks to which the insurer was exposed and the capital the business required.

The 2012 Financial Services Act abolished the Financial Services Authority, replacing it with the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).[3] A 2013 memorandum of understanding describes how the two regulators operate together (FCA, 2013). The FCA is largely responsible for fair treatment of with-profits policyholders, while the PRA is charged with ensuring that this is achieved in a way that maintains a sound financial position. It also takes risk into account, with 'higher standards of risk mitigation' expected 'from insurers posing greater risks to its objectives' (PRA, 2014, p. 22).

The next stage in insurance regulation, Solvency II, took effect 1 January 2016.

This new regime for the European Union is concerned with improving policyholders' protection and creating a safer and more resilient sector. Solvency II retains the general approaches introduced by the Financial Services Authority that addressed Equitable's issues. It prescribes an actuarial function and ensures this is under the control of the directors (as distinct from having an appointed actuary with separate professional responsibilities). It has a market-consistent valuation of liabilities, including GARs, and sets a capital requirement related to risks in a more complex fashion than previously and with the potential for an insurer to use an internal model (appropriate to its business and risks) instead.

2 Equitable Life and Canada Life press release, 3 March 2015

3 The statutory objectives of the Prudential Regulation Authority are as follows. First is to promote the safety and soundness of the firms it regulates. There is then an objective, specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders. Last is a secondary objective to facilitate effective competition. The Financial Conduct Authority is charged with securing an appropriate degree of protection for consumers; protect and enhance the integrity of the U.K. financial system; and promote effective competition in the interests of consumers.

Finally, the U.K. pension market is in the midst of significant changes due to new regulations that took effect in April 2015 (Taxation of Pensions Act, 2014.) Previously, policyholders reaching retirement could only receive 25 per cent of their pension policy proceeds in the form of tax-free cash. They were required to use the rest to buy an annuity. Now, however, they can take the entire proceeds as cash, paying a tax on the remaining 75 per cent. Sales of annuities have therefore fallen sharply.

Final insights

While improved regulatory framework and supervision make another Equitable unlikely, the larger lessons of the case still remain relevant.

It is useful to note three particular features of Equitable Life's business which have consequences for regulators and which had to be addressed during the resolution process.

An insurer has a business model that differs from other financial services providers. It has significant guarantees and/or options and its policies involve the firm exercising considerable discretion on matters such as bonus rates and investment strategy.

- The business model of Equitable Life was quite different from its competitors. Its profits allocation to policyholders left little room for adverse contingencies which was an approach that senior management felt appropriate and indeed publicised, but it did not gain acceptance elsewhere in the industry.

- Equitable was never declared insolvent, and following the House of Lords decision and the Society's inability to find a buyer for what was a very weak business, it went into a voluntary run-off and carried out a restructuring, with policyholders agreeing to new and potentially inferior conditions. This is truly in line with other cases, as we featured in our January 2015 report U.S. and Japan Life Insurers Insolvencies Case Studies: Lessons Learned from Resolution .

- In our April 2016 Observations on the U.S. Resolution System for Property/Casualty Insolvent Insurers: The Lumbermens Mutual Group Case Study, we followed the full course of the Lumbermens resolution process from discovery of troubles through liquidation, a process involving 10 years of run-off before formal declaration of insolvency. Equitable, unlike Lumbermens, never reached the final stage of the resolution process. However, the process of restructure and payment of compensation also took over 10 years.

- There is a lesson about the nature of the insurance business model. Equitable was not officially declared insolvent, and never taken over by liquidators under formal actions. Under the run-off process, there was no regulatory take-over. Instead, new directors made changes to the way in which profits were allocated among policyholders. They restructured the business and ensured that a buffer was maintained that could be drawn upon if circumstances made this necessary . Hence the nature of the insurance business model, at least as seen in this case, is such that, in response to a shock event – here, the House of Lords decision – there is time to take actions, and indeed a range of actions, to mitigate the problems.

- In the years since the Equitable debacle, U.K. regulators have taken a variety of corrective actions. The Equitable case showed that regulators should be alert to the risks involved when a firm's business model deviates dramatically from its competitors. There needs to be a middle ground where regulators can assess whether such deviations represent beneficial innovation that should not be stifled or just reckless business practices.

In the area of innovations, Equitable GAR was at the core of the crisis.

- Guarantees and options: Equitable Life provided significant guarantees and options (more so than other U.K. insurers). Further, unlike some other insurers, it made no charge for them. They became onerous when interest rates fell. Such external possibilities should never have been ignored in the risk management and accounting policies of the Society.

- Policyholders pay the price of unreasonable promises: As shown in Japan and U.S. insolvencies, overly generous and unsustainable guarantees on returns could not be met fully under changed market conditions. The resolution process of Equitable Life included

compromise agreements with the policyholders, whereby they gave up the guaranteed annuity options in return for higher guaranteed cash benefits. This meant that the Society was less exposed to future reductions in interest rates and mortality rates.

This case further points out to the need to be aware of legal as well as regulatory risks. In the restructure process, the directors had to determine bonuses on with-profits policies in accordance with the new terms decided by the House of Lords.

Regulators should be aware of the potential for courts to intervene in insurance contracts and, in particular, that courts may imply terms in policies never intended by the insurer that can make up a significant part of an insurer's liabilities.

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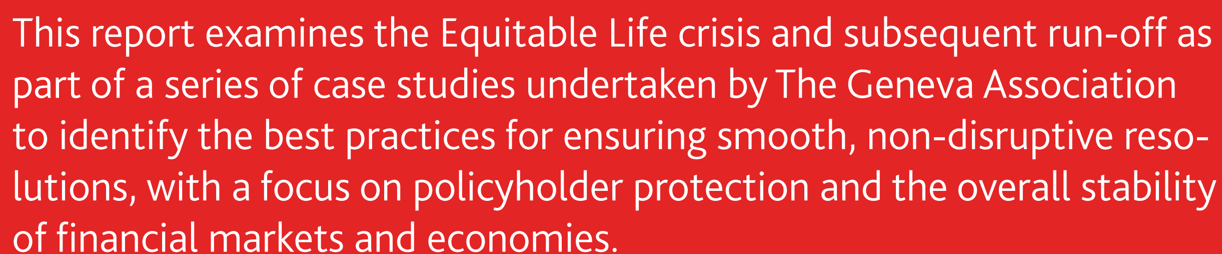

This report examines the Equitable Life crisis and subsequent run-off as part of a series of case studies undertaken by The Geneva Association to identify the best practices for ensuring smooth, non-disruptive resolutions, with a focus on policyholder protection and the overall stability of financial markets and economies.

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