

RETURN TO AN ORDER OF THE  
HONOURABLE THE HOUSE OF COMMONS DATED  
8 MARCH 2004 FOR THE

# REPORT OF THE EQUITABLE LIFE INQUIRY

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THE RIGHT HONOURABLE  
LORD PENROSE

ORDERED BY THE HOUSE OF COMMONS TO BE  
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# THE EQUITABLE LIFE INQUIRY

Led by the Rt Hon Lord Penrose

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web-site: [www.equitablelife-inquiry.org](http://www.equitablelife-inquiry.org)

From the Rt Hon Lord Penrose

Ruth Kelly MP  
Financial Secretary to the Treasury  
1 Horseguards Road  
LONDON  
SW1A 2HQ

23 December 2003



I enclose the report of my inquiry into Equitable Life. You will recall that the terms of reference that you set me on 31 August 2001 were:

'To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers.'

In your letter of that date you drew attention to the general public concern over that situation, and in approaching the task I have been conscious of the potential significance of my findings.

2. You left it to me to determine how to proceed and what the focus of my inquiries should be. In a case as complex and as important as this one clearly is, I think it was essential that I should be able to approach the task with an open mind as to the main factors giving rise to the situation at Equitable, and how best these matters should be examined. The terms of reference were broad, and the time required to complete this report has inevitably reflected this breadth, as well as the extensive and detailed nature of the available evidence.

3. I was not set a deadline for completion of my inquiry, but I am conscious that the time it has taken has been a matter of frustration for many, not least the large number of policyholders and former policyholders of the Society, many of whom have contacted and contributed to the inquiry. I know that neither you nor I anticipated the required timescale in August 2001, but equally I know that you and your colleagues are as eager as anyone that the necessary lessons are well learnt. The fact that the issues raised are of such potential significance only increased the need for me to approach my task with considerable care. This I have tried to do. However, I regret that it was not possible for me to meet the aim that I set myself last year, and which I informed you and the select committee of last November, which was that I should report in the course of the Summer.

4. The conduct of the inquiry and the procedures I have adopted have reflected its inquisitorial nature and the inherent limitations of an inquiry that has no formal powers. It has also been necessary to avoid competing with the ordinary courts in matters that fall within their jurisdiction. Unfortunately there have been frequent misunderstandings of all of these points. Many of the witnesses, especially those who are engaged in concurrent court proceedings, have sought to treat the inquiry as if it were an adversarial forum, even though it was and could never have been equipped to conduct its proceedings in that way. Some have treated the inquiry as providing an opportunity for rehearsal of the issues that arise or may arise in those concurrent proceedings. Others have expressed frustration that this inquiry could not determine legal liability or adjudicate on the discharge of formal responsibilities. However, I have borne in mind at all times the scope of the litigation initiated by the Society against its former auditors and some of its former directors, as well as the possibility of other legal proceedings, including regulatory and disciplinary proceedings, and tried to maintain a strict focus on finding out and describing how the situation at Equitable came about, without straying into the proper domain of other tribunals that might have an interest.

5. In this last respect, and mindful as I am of the consideration you will be giving to the case for publication of the report, I should mention that I have informed the appropriate public prosecution authorities of aspects of the evidence and my emerging findings.

6. In your letter of 31 August 2001 you also asked me to give due consideration to the fact that the Society was an on-going business and asked me to avoid unnecessary disruption of its current

management. I have done my best to meet this request, subject to the over-riding objective of ensuring that I could properly describe the situation as at 31 August 2001 to which the terms of reference have directed my investigations.

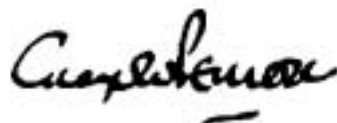
7. It is an inevitable consequence of the nature of this inquiry that the report includes a range of material from a number of different sources. Some of the material is subject to statutory restrictions on its disclosure. In respect of some other material, I have received representations that there may be constraints on its further disclosure owing to subsisting duties of confidence or its commercial sensitivity. These have tended to be at a level of generality that has made identification of specific issues difficult. No clear indication has been given to me of specific information in respect of which a duty of confidence is asserted to subsist. However, throughout the inquiry I have been conscious of the generally confidential nature of much of the material I have recovered. I have given undertakings to some of those providing material that I would have regard to claims of confidentiality, while always making it clear to all parties to the inquiry that the ultimate objective of the inquiry was the submission of a report to Ministers, and that this report would need to fulfil my terms of reference.

8. It is, of course, for Treasury Ministers to determine whether the report should be published in the public interest, notwithstanding any duties of confidence that may subsist in the information contained in it. However, I think that it is important to point out that I have not included material in the report that I do not consider to be necessary to a proper understanding of the evidence and the conclusions that I have drawn from that evidence. Throughout, I have borne in mind the need to take into account and to balance the interests of those with a stake in the report, as well as the various duties and obligations to which I have been subject. I have sought to fulfil the terms of my remit fairly, effectively, and with such expedition as the circumstances permitted. With that in mind, I have sought to include in the report only the information necessary to support the conclusions and the lessons to be learnt.

9. Those that are the subject of criticism have been informed of the gist of the criticism and given the opportunity to make representations in response. I have carefully considered the representations received and taken them into account in finalising my report.

10. As for the findings themselves, I do not wish to add anything to what I have said in the report, and in particular in the last two chapters. Suffice it to say that the issues I have sought to address are complex, and resolving them within the constraints of an inquiry such as this one has not been straightforward. The picture that emerges is of a Society that had deep-seated financial and management problems that pre-dated the emergence of the annuity guarantee problem (though not perhaps its origin). The judgment of the House of Lords in *Hyman* precipitated a crisis, but was not solely responsible for it. The lessons that emerge are broad, and relate to the responsibilities of all the main parties concerned, directors, management, auditors and regulators, but also highlight some important points about the nature of a mutual with-profits fund. There are no simple answers to questions of who lost and who is to blame, as I make clear in my postscript to chapter 20, but it is clear that the situation that was allowed to develop at Equitable has led to hardship and distress to many innocent parties.

11. It is important to provide the necessary powers and remedies to avoid the sort of widespread adverse impact that this case has had, and I am hopeful that many of the proposals being developed by the FSA are addressed towards the right issues. But a clear message from the report should be that it is also important to ensure that the continued relevance of the regulatory tools is regularly assessed in light of a constantly developing industry, and to ensure that those tools are diligently and intelligently applied. The task of regulation must not be allowed to obscure its aim, as appears to me to have happened in this case.



Lord Penrose

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## FOREWORD

1. At the end of 1993 the Equitable Life Assurance Society put into effect what was to become known as the differential terminal bonus policy. Annuity guarantees incorporated in certain products written before 1 July 1988 had become valuable relative to the current rates available on comparable later products. The differential terminal bonus policy was applied when the policyholder claimed the benefit of the contractual guarantee, and operated to relate the annuity provided to the higher of the equivalent current annuity and the guaranteed rate applied to aggregate guaranteed 'cash fund' benefits.

2. On 20 July 2000 the House of Lords held that the differential terminal bonus policy was unlawful. The directors immediately announced that they were putting the 240 year old mutual society up for sale. The independence and mutual status of the Society, proudly claimed to be the world's oldest mutual life assurance society<sup>1</sup>, had previously been vigorously defended by the Board. The decision to bring it to an end reflected a major set-back for the Board. The Board immediately suspended final bonus pending a review of rates.

3. On 2 August 2000, it was intimated that no growth would be allocated on with-profits policies for the first seven months of 2000, to retain within the fund the approximate cost of £1½ billion then estimated to reflect the aggregate value of policyholders' annuity guarantee rights. A financial adjustment, related to final bonus, but representing approximately 5% of policy values, for non-contractual termination of with-profits policies, previously an occasional and discretionary adjustment, was introduced generally<sup>2</sup>.

4. Five months later, on 8 December 2000 the Society announced that it had not succeeded in finding a buyer and was closing to new business<sup>3</sup>. The non-executive directors announced their intentions to resign when replacements had been appointed. It was announced that the loss of growth for the first 7 months of 2001 was unlikely to be restored. The financial adjustment was raised to 10% of policy values. It was subsequently raised to 15%.

5. Seven months after that, on 16 July 2001, a new Board announced a 16% cut in the value of with-profits pension policies (14% for with-profits life assurance policies), and in addition intimated that, with the exception of contractual guarantees, no growth would be allocated for the period from 1 January to 30 June 2001. The financial adjustment was reduced to 7½%. The cut in policy values was necessary, and could not be delayed, because, as the Board explained the position, maturity values significantly exceeded the value of the investments underlying maturing policies at the time, stock markets had fallen heavily over the last eighteen months, and a large number of policyholders were taking their benefits.

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<sup>1</sup> The Scottish Churches and Universities Widows' and Orphans Fund, established in terms of 17 Geo II cap 11 in 1743 may have a prior claim to that honour: *The Scottish Ministers' Widows' Fund 1743 – 1993 ed. Rev A Ian Funlop*.

<sup>2</sup> In January 1995 the Society imposed a financial adjustment of 15% of policy values at 31 December 1994 on non-contractual surrenders and transfers at a time when there was a major discrepancy between policy values and underlying assets and a risk of transactions indicating selection against the fund. In August 1995 the rate was reduced to 10%. In June 1996 the adjustment was changed in form to a deduction from terminal bonus. The last occasion on which that adjustment was used was March 1997. On 26 July 2000 following the House of Lords' decision in *Hyman* an effective rate of 5% was imposed, increasing to 10% on 8 December that year. On 16 March 2001 the rate rose to 15%. It was reduced to 7.5% on 16 July when the policy value cut was imposed. On 13 September 2001 it rose to 10%.

<sup>3</sup> The Society subsequently announced on 5 February 2001 that Halifax plc had agreed to acquire the operating assets, sales force and non-with-profits parts of the business. Aspects of that deal are discussed in chapter 5.

6. These major events, taking place over a traumatic year for Equitable Life and its policyholders, represent the immediate background to the setting up of this inquiry. The widely debated issue was what had brought this venerable financial institution, with assets of over £30 billion, to a position where it had had to close to new business, put itself up for sale, apply significant market value adjustments, and reduce the apparent value of its in-force policies by just under £5 billion. The inquiry was launched on 31 August 2001 by the then Economic Secretary to the Treasury, Ruth Kelly MP, with the following terms of reference:

“To enquire into the circumstances leading to the current situation of the Equitable Life Assurance Society, taking account of relevant life market background; to identify any lessons to be learnt for the conduct, administration and regulation of life assurance business; and to give a report thereon to Treasury Ministers.”

7. It was made clear in the letter the Minister sent to me on that day (and published on the Treasury and the inquiry websites) that it was for me to determine how to conduct the inquiry and which particular matters warranted examination. The terms of reference were broad, and I understood that they had been deliberately made so in order not to prejudge the issues under inquiry. However, the Minister also rightly made clear that it would be inappropriate for me to seek to review the decisions taken in the *Hyman* case or in any other way to assume the proper functions of the courts. I was also asked to be mindful of the fact that the Society was an on-going business and that the inquiry should avoid unnecessary disruption of its current management.

8. It was inevitable that hindsight would instruct much of the inquiry’s work and many of its findings. I was asked to discover what had led to the situation of the Society at 31 August 2001. In some cases what individuals had understood, what individuals had anticipated, and what individuals had done might form part of that history. But my terms of reference did not require me to form and express views on what ought to have been understood or ought to have been foreseen, or ought to have been done or omitted, either in absolute terms or relative to the performance or failure to perform duties as director, executive, auditor or professional adviser. I had to have regard to market background where that was material. But it was not for me to measure any person’s actions against accepted standards of conduct defining the legal duties of other people performing comparable duties in other organisations and other similar circumstances.

9. I have received representations in the course of the ‘maxwellisation’ process that has been undertaken that it is unfair, even “grotesquely” unfair, to make criticisms of actions and decisions without comparison with contemporary practice of other institutions or individuals<sup>4</sup>. If I had been required to determine whether any person’s conduct was in breach of an obligation owed at the time to the Society or to its policyholders or any class of them, some of the comments I have received from or on behalf of former directors and executives of the Society might have had some substance: I would not have been entitled to form a view whether an act or omission was or involved a breach of duty without taking evidence from others active at the time as to the general scope of the relevant duty and the allegation, from whatever source, that the act or omission was in breach of that duty in the circumstances. However, that was not the remit of my inquiry, as the Economic Secretary’s letter made clear. Breach of duty, and the financial consequences of breach, are properly matters for the established courts of justice and for other appropriate tribunals in the financial sector, to be dealt with in accordance with rules of procedure that take account of the interests of parties, typically as focused in adversarial terms.

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<sup>4</sup> Comments to this effect have been received from individual directors, and, more generally from Allen & Overy on behalf of five directors who refused to co-operate with the inquiry by attending for interview. Allen & Overy’s representations were familiar: they essentially reflected their clients’ defence in the Society’s action that has been sent for trial. These representations have been adopted by others, for whom the solicitors do not appear to act, according to the information provided to me.

10. It would have been unthinkable for an inquiry such as this to have embarked on such a process. I had no powers to compel the production of documents or the attendance of witnesses. I had access to witnesses only by their agreement. The inquiry was not adversarial. There was no mechanism that could have been devised, and put into effect within a time scale that would have had regard to the wider public interest in obtaining the account of the developments of the Society's position, that could have accommodated in parallel the investigation and resolution of disputed contentions of conformity or non-conformity with generally accepted norms of practice in any of the fields that would have been relevant. In the event, co-operation with the inquiry was at best patchy. Several former directors refused to co-operate in any way. Others were constrained by their interests in concurrent litigation from full co-operation. Those who did co-operate could not be subjected to full and searching cross-examination of their comments, even where reliability was questionable because of the witness's focus on making self-serving statements clearly designed to support a position in another forum. The production of documents became a long drawn-out and stressful process as parties' legal advisers sought to protect interests in relation to litigation or threatened litigation and disciplinary proceedings. I am satisfied that I have been able to provide an account of what happened, and in some cases to identify individuals or bodies involved in the events. I am not in a position to adjudicate on whether the events involved breach of duty on the part of directors and other officers of the Society.

11. It follows that it is no more appropriate for me to form or express views on representations by industry sources and other third parties that have sought to distinguish the actions and omissions of Equitable's management from practices in other parts of the life industry and to suggest that the Society adopted practices that did not conform to industry norms and were in some respects unique. I have received representations that indicate that accepted practice in the industry would have been a contentious issue in several areas. There will be those who were active in the industry over the material period, and those who currently represent industry interests, who will continue to argue that Equitable's practices were unique. But the competing contentions are irrelevant to what I have been asked to do. Lessons may be learnt alike from unique or idiosyncratic practices tolerated by a system, on the one hand, and from universally accepted practices that hindsight has undermined on the other. I have interpreted the remit and the Economic Secretary's letter as requiring me to focus on the events that explain the Society's fate. It will be for others to consider in an appropriate forum, and in the context of the facts found according to the practice of that forum, whether fault occurred if that should become or, in the case of current litigation, remain a matter of controversy.

12. In considering the approach to adopt to those who have been concerned with the management and regulation of the Society over time, I have had to balance their sensitivity to critical comment, or comment that might imply criticism, against the interests of another constituency: the very large numbers of members of the public who committed their funds to investment in Equitable products. The complaints of those who have alleged that the inquiry's procedures have been unfair, in refusing for example an opportunity for textual review of the draft report, have to be weighed against the interests of the policyholders in learning what has been found by the inquiry.

13. I have received many representations from policyholders and former policyholders of the Society. I shall later comment on some of them. But it is appropriate at this stage to make some general comments on their position. There is a risk inherent in any analysis of the practices and procedures of a commercial organisation that one may understate the human impact of the events described. That would be a disservice to the many people who have written to their members of Parliament and the inquiry commenting on their experience and providing evidence of their own reactions. One letter will illustrate the position:

"I write to you in a desperate attempt to get a voice heard in Government to highlight the plight of my wife, myself, and thousands of other hard working,

honest, contributing members of society. I refer to the victims of the disgraceful EQUITABLE LIFE debacle. It is obvious that the only people who have suffered in this nightmare are the only ones who are innocent of any wrongdoing or negligence; the policy holders.

My wife and I thought that we had done everything right, we ran our own small business, long hours, hard work, put our two children through university all at our own expense and then looked forward to being able to slow down in our latter years.

All this is now in jeopardy.

I request that you please make your voice heard on behalf of all the policy holders and endeavour to see that justice is done, and that politics and blame shifting do not prevail to ruin the retirement hopes of thousands of people who were only trying to make provision for a financially secure and independent old age. After all, it is our money and not a state handout.”

14. I cannot adjudicate on the policyholders’ complaints and claims: that again is a matter for other proceedings, and the expectation that many have expressed that this report will provide my views on the validity of claims and their value will inevitably be disappointed. But policyholders have a legitimate interest in having as full an explanation as can reasonably be provided of the sequence of events that brought the Society, and them, to their position, and providing that explanation requires that in the presentation of the material I should not shrink from identifying those who were involved with significant decisions or from describing their roles so far as I have been able to identify them. Fairness implies at least giving appropriate weight to competing interests: it is not served by a predisposition to protect from adverse comment those who were involved in the decision-making processes at the time.

15. It was for the inquiry to establish what was the “current situation” as at 31 August 2001, and to identify the circumstances leading to that situation that required explanation, and it was for the inquiry to attempt to interpret those circumstances in order to provide as complete an explanation as possible of what had brought so venerable a British institution so low. Consideration of the current situation at the date of my appointment, and in particular the policy value cuts outlined above, had an immediate and profound impact on my assessment of the factors that were pertinent to this inquiry. Although the annuity guarantees and the differential terminal bonus policy clearly played a significant part in bringing the Equitable Life to the position it was in on 31 August 2001, it was apparent from the outset that annuity guarantees did not answer all the questions. A full consideration of the financial history of the Society going back over many years would be necessary. And as the inquiry has proceeded, I have noted that others have come to the same appreciation of the breadth of the issues involved.

16. However, in the aftermath of these events the annuity guarantee issue was the natural focus of concern, and it has remained the issue most widely believed to lie at the heart of a proper understanding of Equitable’s position. The actual position is more complicated, but the annuity guarantees and the *Hyman* case are nevertheless the obvious starting point for any discussion of Equitable’s position at 31 August 2001.

#### Note on Terminology

17. But before I describe how the annuity guarantee issue emerged and came before the Courts, it is necessary to comment on the terminology to be used in this report. As will become apparent from the first chapter, which deals with the origin of the annuity guarantees and the differential terminal bonus policy, the acronym ‘GAR’ has tended to be applied indiscriminately to all forms of contract. It has also been treated inconsistently, as if it had different meanings in different situations, and sometimes confusion has resulted.

18. The Corley Committee commented on a range of definitions used in its report<sup>5</sup> in relation to Equitable and defined five different terms in the appendix on annuity guarantees. Many of the references to GARs in the documents examined by the inquiry appear to refer to what Corley described as a GAR on a fund value, but in many others the references relate to none of the types described by Corley, but rather to the interest component implicit in the conversion rate applicable at contractual maturity in the Society's retirement annuity and other pre-July 1988 pensions contracts.

19. In this report the general expression 'annuity guarantee' is used in discussion of policyholders' rights under their contracts. The expression 'GAR' is used here to describe the rate of conversion of a cash fund, however computed, into an annuity at maturity. The GAR in this usage invariably comprises two actuarial assumptions, an interest rate and a mortality factor, implicit in the specification of the policyholder's contractual rights from the outset. Quotations and other evidence that appear to ignore the mortality factor have to be treated with caution.

#### The annuity guarantee issue

20. Problems associated with annuity guarantees affected a wide range of pensions providers in the second half of the 1990s. But there were peculiarities of contractual provisions, implicit rates and other actuarial assumptions, as among providers. The volumes of business affected, both in terms of cash value and as components of the total in-force business of individual offices, varied and that had a bearing on the need to resolve issues and on the policyholder and public reaction to the emerging position. Individual offices varied in the approaches adopted to resolving the problems that arose for them. At one end of the range I have identified an office which had relatively low volumes of annuity guarantee business with implicit interest rates that were considerably lower than Equitable's rates. In common with others, that office implemented the guarantee provisions in full. At the other end of the range there was an office which adopted policies similar to those applied by Equitable in relation to problems of a similar scale. It has subsequently complied with the *Hyman* decision. Equitable's differential terminal bonus policy was identified and publicised by independent commentators, and became controversial. There was open debate in the financial press from the summer of 1998. From July 1998 there was a growing number of complaints to the PIA Ombudsman.

21. In Chapter 1, I shall describe the litigation process more fully. It had its origins in legal advice sought by the Society in September 1998, initially from its retained solicitors and thereafter from counsel, on the validity of the differential terminal bonus policy. The solicitors' initial advice was qualified, but as matters were explored with counsel the advice became more positive and assertive of the validity of the Society's position. Declaratory orders confirming the validity of the Society's policy were sought in the High Court. Alan Hyman was selected by the Society as representative defendant. The Society succeeded at first instance before the Vice Chancellor. The Court of Appeal reversed that decision by a majority. The Society appealed to the House of Lords. There the Society lost comprehensively. Not only was the differential terminal bonus policy held to be unlawful, but the Society's alternative approach, to limiting the consequences of an adverse decision by 'ring-fencing' the annuity guarantee liability so that the burden fell only on those classes of business that had the benefit of the guarantees, was rejected.

22. The issues focused in the originating summons in the *Hyman* case were the subject of protracted discussion between the Society and its legal advisers. There was a desire on the one hand to define the issue for the court as narrowly as possible, with a view to controlling the argument, and on the other hand to limit the risk of future challenge by closing off as many areas of dispute as possible on grounds of issue estoppel. So, ring-fencing was initially referred to in the managing director's affidavit at first instance, but it was not dealt with in the declaratory

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<sup>5</sup> Report of the Corley Committee of Inquiry, September 2001, appendix 2 paragraph 2.

orders sought. Once the issue had arisen in debate in the Court of Appeal it increased in importance. It became a significant issue in the House of Lords after counsel's intention to argue in that court primarily on grounds based on the fundamentals of mutuality was frustrated by her discovery that the Society's practices had been inconsistent with the argument she intended to advance.

23. There was nothing casual about the preparation of the pleadings and supporting evidence, nor about the specification of the issues for resolution by the court. The *Hyman* case was carefully planned. The restriction of the issues, and of the range of representative defendants, ultimately to a single individual, were decisions taken after debate. Similarly the restriction of the class of business to retirement annuity and similar contracts reflected a decision to avoid discussion of other product types that incorporated guarantees that the Society dealt with by the differential terminal bonus policy. I shall discuss the background more fully, but I wish to emphasise that, however one might disagree with the views expressed and conclusions reached, in my view the decision to embark on litigation is not open to criticism.