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Inequitable Life

By P.G. Alistair Cammidge

"Iam sages est ubi Troyia fuit." (Now there are fields where once Troy was - Ovid)

For actuaries round the globe, the most distressing event of recent years was the collapse of Equitable Life—founded in London in 1762 as the Society for Equitable Assurances on Lives and Survivorship. The 'Old Equitable' was the first assurer established on sound actuarial principles. No actuarial textbook was complete without reference to how the Equitable did things in the beginning under its first actuary. The very designation 'actuary' was resurrected by the Equitable from antiquity. Names of senior actuaries at Equitable became familiar to actuarial students as authors of textbooks and seminal papers.

Old Equitable is a mutual company—owned by its policyholders and operated for their benefit.

Prior to the advent of the welfare state, mutual (with co-operative and not-for-profit) financial organizations were an essential part of the British social fabric, aiding their members through sickness and bereavement; helping them buy everything from a crib to a home to a funeral. Until recently, the small saver and home buyer turned not to a bank but to a mutual building society.

Worldwide, mutual financial firms have succumbed to cost pressures. In Britain, as elsewhere, most have demutualized; some have merged. Although a number of large mutual insurers converted to stock ownership in the 1990s, mutuals yet account for a significant proportion of U.K. life assurance. Demutualization has not been a panacea—in 2007 investors suffered a run on Northern Rock—then a bank, once a building society!

This is the story of a mutual life assurer that dared to grow—and grew beyond its strength. Though the insurer is British, its tale could easily have been told elsewhere. Indeed, Equitable sold policies in other European countries.

The African coast around Cape Town is littered with shipwrecks. How did so many master mariners come to grief on South African rocks when they had the limitless Southern Ocean to navigate in? The answer—they tried to cut a corner; some did so in kindly weather and succeeded—others were hit by storms then they hit unyielding Africa.

Equitable's modestly-remunerated actuarial management wrecked a fine ship—for which they have been whipped and pilloried. Corporate executives who have lost sums vaster by far are rewarded with mind-boggling retirement packages and suffer but a few 'tut-tut's from the press.

A significant cause of the Old Equitable's downfall was the failure of authorities—and judges—to understand the relationship between policyholders in such a company. One might suggest they did not want to understand what sort of ship a mutual insurer is!

An important difference between mutuals and proprietary companies is their ability to access capital. Proprietary companies have access to external sources of capital from the equity and the debt markets. Mutuals have no recourse to the equity markets and have only limited external debt, but instead rely largely on internal resources—the resources of their policyholders—to finance investments. The knowledge that capital cannot easily

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be replaced following significant losses ought to induce managers of mutual financial institutions to adopt a low-risk profile.

In addition to being a mutual, the Old Equitable was a standout in another important way—she did not pay commission to agents or brokers. Thus she remained—until the 1960s—a small, conservative life office. In 1969, her liabilities were a mere 39 million GBP (British pounds). She was heavily dependent upon the Federated Superannuation Scheme for Universities (FSSU) which accounted for more than half of her business. When the FSSU business went into decline in the early 1970s (under the impact of tax changes), the Equitable had to change.

The strategy adopted called for the opening of many branch offices and products aimed at a high net worth clientele. This approach was highly successful—liabilities grew to 34 billion GBP in 2000. Over a 40 year period, asset growth averaged 19 percent per annum.

Growth was fueled by a policy of distributing to policyholders as large a proportion as possible of the emerging surplus earned by them. Policyholders are the owners of a mutual insurer—but when a policyholder 'withdraws' (because of death or otherwise) his (or her) ownership interest terminates. Such a policyholder has no interest in passing on to succeeding policyholders any enduring 'estate' (accumulated surplus). By contrast, the owners of a proprietary insurer are its shareholders; when a shareholder no longer wishes to 'participate' he sells his shares to another, realizing the 'market value' of his share in the enduring estate.

The Society had explicitly held an estate until 1972. That estate was exhausted between 1973 and 1976. The Society deliberately re-built a significant estate by 1982 by withholding benefits from current policyholders. It was only in the middle to late 1980s that there came to be a positive assertion of a full distribution policy.

The Society's approach to bonus (dividend) distribution was one of 'equity'—fairness. This concept is impossible to define precisely but it aimed to provide a total bonus package to a with-profits (participating) policyholder based on the earnings of the business during his membership of the fund.

In addition to returning to each policyholder the return he had earned, Old Equitable sought to 'smooth' returns i.e., returning to policyholders withdrawing in times of low asset values more than a strict accounting could justify at the cost of returning less to those withdrawing in times of high asset values. Should low asset values persist, such an approach would deplete the company's reserves.

Policy values and hence claim values cannot consistently exceed the value of the underlying assets. Policy values might be managed so as to be very close to asset values with the volatility that

> "Actuarial navigators had sailed the ship too close to the rocks; a legal storm wrecked her."

such a course implies. Alternatively, a period of over-allocation must be followed by a period of under-allocation. Equitable should have set policy values at rather less than asset values after a period of strong asset value growth. In fact, smoothing was 'across the peaks' rather than 'through the middle'. On any view the policy was one of full, if not explicitly over-full, distribution.

You may ask why a mutual society should seek growth - providing the best return to its policyholders is its aim. Growth imposes new business strain—new business costs money before it earns money. The answer lay in keeping down—indeed, reducing—unit costs. Labour costs skyrocketed; computer costs were astronomical. In those days of 'big iron' (large mainframes) necessary computer investments could only be justified by a big business base. Following the loss of its FSSU business, the Equitable had not the option of graceful decline into a tiny company. Such a company never could provide her policyholders with a half-decent return.

1957 the Equitable started selling retirement annuity (savings) policies. These had to be written as deferred annuities but were structured as with-profit (participating) endowments with a guaranteed annuity rate ("GAR"). The policy included a GAR at 4 percent—later 7 percent—interest to convert the accumulated single premiums to an annuity. Premiums were on a recurrent single premium basis and future single premiums would receive the same guaranteed terms. Guaranteed annuity rates applied not only to past premiums—but to future premiums, too. Both premium payments and retirement dates were flexible. Excess returns in deferment were distributed by way of reversionary bonuses. The guaranteed annuity rates appeared conservative and Equitable introduced a terminal (final) bonus which was applied at retirement to align the annuity with that which would be obtained from (better) current annuity rates ("CARs").

In 1993 guarantees were exposed by improving annuitant mortality and falling interest rates.

Recurrent single premiums proved a strong marketing feature for the Equitable as they gave policyholders flexibility compared with regular annual premiums; retirement dates were flexible, too. The Society came to be heavily dependent upon retirement annuities.

In July 1988 retirement annuity policies were withdrawn and replaced by Personal Pensions. Existing policies could continue to receive single premiums on the same terms and conditions as the original policy. Personal Pension policies did not include a GAR.

Subsequently, there was no differentiation between the policy classes in the level of bonuses declared despite changes in policy terms and dropping guarantees. The guarantees were neither charged for nor properly reserved for.

1990 saw UK inflation and interest rates decline significantly. In October 1993, as a result of falling interest rates, the annuity rates in the GAR policies began to exceed current annuity rates. This situation reversed in May 1994. But from April 1995 onwards GARs were increasingly more favourable than CARs. Equitable had introduced what came to be known as the Differential Terminal Bonus Policy (DTBP) whereby terminal bonus would depend on the form in which benefits were taken. In particular, where benefits were to be taken in GAR form, the terminal bonus was reduced in recognition of the additional cost of GARs over CARs.

The Society thought it inequitable for policyholders to take more out of the fund than their premiums had earned, i.e., their 'asset share'. Equitable

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therefore reduced the terminal bonus for policyholders exercising the GAR, until the annuities which their maturity values supported were at the same level as those policies not exercising their GARs. Policies without GARs were awarded the full terminal bonus but annuity rates applied were lower market rates.

Asset shares are the accumulation of premiums less expenses, allowing for the investment return earned for a group of similar policies. In making the calculations, the asset share would normally be charged for the cost of accruing guarantees, life cover etc.

Frequently explaining to policyholders that the policy proceeds would be based on asset shares, Old Equitable believed policyholders understood and accepted the need for differential bonuses.

Not all did! Dissident policyholders argued the final bonus should be the same whether the policyholder took the benefits in guaranteed annuity form or otherwise, and should not be reduced to reflect the cost of providing the guarantee. This reasoning regards a guarantee as an additional amount—not a floor. Yet no extra premium had been paid for the additional amount.

Dissident policyholders launched litigation in 1999. Finally, the case was argued before Britain's highest court - the Judicial Committee of the House of Lords—the Law Lords. Their Lordships ruled for the dissidents on July 20, 2000.

Who was to meet the cost of the award to the dissidents? Other policyholders are the only source of funds in a mutual. There being no estate, other policies must shoulder a burden of 1.5 billion GBP. Policies had to be reduced by 16 percent of the policy value as at December 31, 2000. In addition, there was to be no growth in policy values for the following six months.

The Law Lords' exercise of their powers was inequitable—indeed, irresponsible—they had no concern for other policyholders. More for some meant less for others. Is robbing Peter to pay Paul equitable? By legal fiat, Equitable Life became Inequitable Life. Actuarial navigators had sailed the ship too close to the rocks; a legal storm wrecked her.

The Old Equitable closed her doors to new business on December 8, 2000.

Equity had conflicted with Law—and Equity lost.

POSTSCRIPT:

The dissident GAR policyholders had shot themselves in the head.

Think of the Equitable as a tube of Smarties (iced chocolate). The teacher promises a group of children four each. But the tube is smaller than the teacher thought and, when the sweets are shared between the whole class, there are only enough for three each. The disappointed group demands the promise be kept. The only way to get the extra Smarties is by grabbing them from their classmates. After a scrap, nothing remains but mushy chocolate and broken icing.

R.I.P ☐