B.A.J. **10**, V, 1047-1070 (2004)

THE PENROSE REPORT

A Discussion Meeting

[Held by the Institute of Actuaries, in Birmingham, 24 May 2004]

The 'Report of the Equitable Life Enquiry', by The Right Honourable Lord Penrose, was delivered to Treasury Ministers on 23 December 2003, and was published on 8 March 2004 by The Stationary Office (also at www.hm-treasury.gov.uk).

Members were encouraged to read the report in advance of the meeting, in particular Chapters 19 and 20; Lord Penrose's evidence to the Treasury Select Committee on 16 March 2004; and the statement issued jointly by the Presidents of the Faculty of Actuaries and the Institute of Actuaries, which appeared on page 4 of the April 2004 copy of *The Actuary*.

ABSTRACT OF THE DISCUSSION

The President (Mr J. Goford, F.I.A.) (opening the discussion with a presentation)**:** We have a couple of special guests, namely two members of the Morris review team: Paul Kennedy, who is known to many of you; and David Hobson, who is on secondment from his management consulting firm to the Treasury for the duration of the review.

The purpose of this meeting is to discuss what we, as a profession, can learn from the review of Lord Penrose of what happened at the Equitable Life (Penrose, 2004). What can we do differently? Can we take more actions? This discussion is to be forward looking, it is not about making direct criticisms of individuals, and actuaries should heed their duties under the Professional Conduct Standard; and it is not about trying to explain where you think Lord Penrose got it wrong or blaming others. The discussion is about the future of the Profession and regulation, and about constructive criticism, so that we can produce a better Profession for ourselves for the future.

In his report, Lord Penrose made several criticisms relating to the Actuarial Profession. First, regulation was based on over-reliance on the Appointed Actuary; that the Appointed Actuary could be the Chief Executive as well as having regulatory responsibilities made that role rather difficult. Our guidance at the time prohibited criticism of the Appointed Actuary. That has now been removed.

Another criticism was that new policyholders, those without guaranteed annuity rates, were exposed to the cost of guarantees in the policies started before then in one pot. The opportunity was not taken to create a new bonus series, or a separate long-term sub-fund, when policies were issued without guaranteed annuity rates. The main lesson for us here is that we must ensure that the legal onus of costs and benefits are well understood and defined, and this should now come out in the Principles and Practice of Financial Management.

There was no persistent attempt to reflect policyholders' reasonable expectations (PRE) in the liabilities. If there is one overriding message from the Penrose Report, it is that there was an absolute presumption by Lord Penrose that what should be reflected in the balance sheet was what the reasonable expectations of policyholders might be as defined in the dictionary, rather than as defined in terms of asset shares. His whole premise was that, if you send bonus notices to individuals with numbers in them, then it is reasonable to add these up and compare them with the assets. So, each policy value paid in excess of asset shares weakened the fund; the effect, disguised as the (larger) terminal bonus, was not reflected in the liabilities. He also had criticism of the use of the quite normal practices of hidden reserves, future profits, subordinated debt and financial reinsurance. He said that the Hymans' litigation on the guaranteed annuity options was only the trigger, and that the seeds of misfortune were sown in the 'over-bonusing' in pursuit of growth in new business. Also, the way in which the zero free asset, or very low free asset, situation was maintained was by varying the gap between the bonus rate and the discount rate, which, in his view, was inconsistent with best actuarial practice. The use of a quasi-zillmer adjustment, designed for regular premium policies, being applied to recurrent single premium policies was, also, in his view, inconsistent with sound and prudent actuarial practice.

However, at all material times, the Appointed Actuary of the Society was able to claim that the Society's valuation practices were consistent with applicable professional standards, and indeed regulatory standards. The Appointed Actuary was part of the regulatory system, and the regulatory system only valued guarantees, with specific exclusion in our own guidance notes for valuing terminal bonus.

When the Penrose Report was published, Ruth Kelly, Financial Secretary to the Treasury, announced a wide ranging review of the Actuarial Profession, which, we understand, is not just to do with the life side of the profession, but also pensions, general insurance and investments, to be led by Sir Derek Morris. This will be broadly in three parts: the regulatory matters, which we were expecting; the efficiency of the market in actuarial advice, which will involve firms, as well as individual actuaries, and which we were not expecting; and a separate review of the Government Actuary's Department (GAD).

The Penrose Report gives rise to some questions, and here are some of them:

— Do persistently illustrated policy values in excess of asset shares become policyholders' reasonable expectations?
— Does that then mean that persistently illustrated policy values in excess of asset shares become valuation liabilities, (even before adding the cost of guarantees)?
— How far does that extend to illustrations, even on unit-linked products? A quotation from Penrose, to illustrate his thinking on this, is about the regulatory accounts: "Claims that the accounts demonstrated 'solvency' ... were meaningless without a clear and simple explanation that solvency for this purpose ... had no bearing on the ability ... to deliver ... benefits ... that might have appeared in illustrations." That statement brings home starkly his view of bringing policyholders' reasonable expectations straight into the balance sheet for solvency purposes.
— So, was the Equitable's a model that could have survived without over-bonusing; maybe with a separate sub-fund, and if it maintained aggregate quoted policy values less than assets?
— Does the realistic balance sheet treat accrued bonus 'better'? The realistic balance sheet is consistent with an accountant's view of provision. The latter includes, if you are intending to make a payment (such as of reversionary bonus or terminal bonus), a reasonable estimate of what that payment will be. Therefore, it will bring a best estimate of future reversionary bonus and future terminal bonus straight into the balance sheet. This estimate then becomes a deduction before arriving at surplus, and the surplus becomes the flow in and out of the free estate. So, it is a different accounting treatment from the one to which we have been used. In the new treatrment, one declares surplus out of the accruals within the provisions, as well as using some of the free estate, or building a free estate.

So, where is the Profession? We had our own Corley investigation, and we have changed some guidance in line with that. We now have a mandatory provision for the annual financial condition report. We have worked with the Financial Services Authority (FSA) on the change in the Appointed Actuary role and on the twin peaks valuation basis. We already have a new disciplinary scheme in place, from 1 January 2004, with greater independence. Lord Penrose was very complimentary on what we have done, using the word 'uniquely', characterised by the scale of independence which we have put into the new scheme.

We have plans under way for the establishment of the Actuarial Standards Board, and those of us who are keen on it would like as high a degree of independence as we have in the disciplinary scheme, but it does, of course, have to be approved by Councils and the membership. In the meantime, we have instigated an immediate review of existing standards against modern criteria.

We will be revising the practising certificates' process, so that, not only will we have the practising certificates for statutory roles, but will be introducing a practising certificate for everybody who qualifies, who then keeps his or her CPD up to date, and has done the new regulatory module course and examination. This will be renewable every three years.

We have instigated as much peer review as we can so far. On the life side, we have the Reviewing Actuary. The auditors are required to obtain an opinion from an actuary. On the pensions side we are making progress, with a guidance note out for consultation. In Lloyd's of London, I have to say that it has stalled. Lloyd's declines to want to incur the additional costs of peer review, so we must continue the dialogue there. Lord Penrose's view, in November 2003, was that peer review in the Actuarial Profession was 'discretion within discretion', and worth not much more than the paper that it is written on. His view is that peer review must be implemented against very tight independently determined standards.

We have the 2005 education syllabus coming in next year, with a much greater business orientation, starting off with attention to customers' needs and environmental influences. We have plans to introduce a process for revalidation of the competence of practising actuaries.

Is there more that we should be doing? One phrase, which we pondered on long and hard, is that the Profession should: "... accept responsibility for direct intervention where it was thought that the administration of life funds was likely to threaten the legitimate interests of policyholders.'' This is consistent with the positioning that Lord Penrose gave us when Tom Ross (President, the Faculty of Actuaries) and I went to see him in November 2003. His words to us then were: "In my view, the profession is the most non-conflicted, the most disinterested and independent body in financial services.'' We were not quite sure what the implications of that were, but he went on to say that he would expect the Profession to intervene where we thought that the administration of life funds was likely to threaten the legitimate interests of policyholders. We are not used to having that sort of power, and I am not sure that we want it; but, if we are to have that sort of influence, then we need some mechanisms through which to make that influence more greatly felt than we have at the moment. So, any comments on that would be valued.

In the Report, this statement was made in the context of discipline; in other words, direct intervention towards disciplining an actuary, if that actuary was involved in administration likely to threaten the legitimate interests. However, our impression, when we met Lord Penrose, was that he thought that the Profession could take its influence wider than that. That is something which I should like to discuss with the Morris Review team.

Should we be encouraging joint reviews? Lord Penrose suggested that, not only should the accounts be audited, but there should be a separate actuarial audit, jointly carried out with the auditors. However, he added that he would not be pushing that at the moment, because he was looking at the new developments of the reviewing actuary in the changes. His view was: "See how the new processes get on before pushing the joint review.''

Should we be initiating investigations when actuaries are criticised? Should we be actively monitoring compliance with guidance? Should we fill in the deficiencies of legislation? This is a thought from Mr Paul Sharma, of the FSA, at the last CILA meeting. He said that it has been quite legitimately something that the Profession has taken on itself to do with its guidance notes, beyond the requirements of legislation, to cover those deficiencies through actuaries. Mr Sharma's personal view is that it is up to the FSA to regulate firms, and it is up the Profession to regulate people.

Lord Penrose used the following words about the nature of standards: "independently produced; prescriptive; specific; objective; clear; no double negatives; and consistent.'' His main complaint about our standards is that they allow far too much judgement, and breadth of judgement, to individual actuaries when they are doing their work.

He suggested that you cannot be prescriptive on absolutely everything, so not everything can be rules-based; but where it is not and principles can be laid down, the actuary should first of all write down how he or she is going to apply that principle to a particular situation, and then do a route map of rules for that situation. So, when the actuary is reviewed, the first question would be: "Was the route map a reasonable way of getting from the principle to what the actuary was going to do, and then, did he actually follow it?" Then there should be better comparability between the work of different actuaries; disclosure of alternatives; reliances and limitations; and the work should be auditable.

Dealing with the aftermath of the Penrose Report, when going through it, we have to distinguish between those findings which are relevant to the Profession, those which are relevant to individual actuaries, and those which are relevant to the regulator. We are given a briefing to be more proactive in avoiding scandals.

We have to make sure that we produce adequate pricing, especially of guarantees, and that we are clear as, and when, those prices are charged; to create only reasonable expectations; to go along fully with new realistic balance sheet reserving, making sure that the prudence is mainly in the internal capital assessment, rather than putting it into the realistic balance sheet reserves. Of course, it is now up to directors and management to decide what the reserves are, and we must be careful, as actuaries advising them, to identify what conservatism, if any, is in the realistic balance sheet and the realistic liabilities. We have to make sure that the distribution is within the principles and practices of financial management, and oversee fair claims handling.

We have to watch customers' developing expectations, as they are developed in the press or in the statements of the company. I suspect that we are going to get to the point where we have to monitor what customers' developing expectations are, and, maybe, even ask them what their expectations are, so that, if they are changing from the original intention, they can be guided back to what was intended and reasonable.

The view of Lord Penrose is that change is possible, but you must tell people. We should monitor criticism of practices and methodology. We should keep methodologies up-to-date and relevant. We should work with other professionals. His view, also, was that there should be more limited scope for judgement to within more reasonable bounds. That was his main criticism of us. For that we need a different relationship with the FSA.

What is this world of new 'pure advisers' about? There is this strong distinction between the actuaries who advise management and the directors who decide. In my view, this makes advising a much more responsible role than we had before. Not only do we have to communicate to the decision makers in a joined up way, but we have to make sure that, when management and directors make decisions, they are truly and properly equipped to make them. I also put in here, as a reminder, the impact of illustrations and policy values on liabilities.

We must watch the following: "Where is the inhibition on recommending over-conservative reserves?" It is the directors' decision. Can we see directors going through our recommended reserves with a fine tooth comb and saying: "No, I do not think that that bit of conservatism is necessary?" Also, what are the auditors going to do about spotting conservatism in the realistic liabilities?

Finally, are we thinking enough about the customers? This is something that you will find familiar from me:

— Are we looking from individual customers' expectations right through to the backing assets and the capital of the organisation, including the 'what-if' scenarios?
— Can we identify any lack of communication in the chain between customer expectations and the assets and the balance sheet, and correct misunderstandings immediately?

We should be focusing far more on this first part of the chain — what is happening between the customer and the adviser — and we need to make sure that, if the adviser disappears and there are orphans, providers pick up that responsibility.

Reference

Penrose, The Right Honourable Lord (2004). Report of the Equitable Life inquiry. H.M. Treasury. www.hm-treasury.gov.uk

Mr R. B. Colbran, F.I.A.: The President has asked to what extent projections raised PRE. Certainly the way in which Equitable Life presented its bonus notices, in my view, did that, because they showed the value of benefits, as at each 31 December, with-profits and unit-linked, side by side. In the case of the unit-linked, of course, there were assets corresponding fully to the values, whereas, in the case of the with-profits, there were not. Any reasonable policyholder would have expected there to be assets there as well.

The President then asked whether the model could have survived without the over-bonusing and other adverse effects. It seemed to us, at the time, that it was sound; and a great many consultants recommended Equitable Life. Presumably, therefore, there was a large body of opinion which thought that it was sound. It is clear from Penrose that, to produce competitive results, they had to over-bonus. That says to me that the over-bonusing by other offices was going on to such an extent that the Equitable Life could not match it without over-distributing. Whether the others were paying out of reserves, and, therefore, able to give away more than their performance, I do not know, but it seems likely, whereas Equitable Life had no reserves from which to do this.

When I read in the Penrose Report how, so often, the bonus decisions were governed by the needs of the market, I was taken back to about 30 years ago, when I was a senior actuary in the pensions division of a major life office. We were always under strong pressure from the outside staff, the pensions specialists, to give them concessions to make their job easier. One day one of them said to me that, although they pressed us so hard, they were absolutely sure that the actuaries would never concede anything that was not sound and prudent, however hard they pressed. I should like to think that the Profession, one day, could get back to having that level of respect.

Mr M. Iqbal, F.I.A.: The Penrose Report lays bare the actuarial management of one company. I am not sure how many companies' decision making in a fast moving environment would be completely beyond reproach when accorded the glare of leisurely hindsight. It may be that, in the future, everyone should work on the assumption that all decisions would be in the public domain.

I restrict myself to four points:

(1) In Chapter 3 of the report, there are expressions such as: "Marketing considerations lay at the root of the (bonus) distribution policies pursued at the time", and the "practice of setting bonus levels to meet objectives rather than allowing them to emerge from calculated surplus." We all know that marketing considerations are an important aspect of management's responsibilities, and that not all cohorts might have been dealt with with as much care as those that are routinely monitored for competitive reasons. What management do is their business, but I would be very concerned if such recommendations formed the substance of the Appointed Actuary's report, to the exclusion of a more orthodox appraisal. The implied criticism is serious enough for the profession to conduct a review to ascertain whether this was a more widespread problem during the 1990s.

(2) Chapter 3 also talks of reversionary bonus rates being set having regard to current gilt yields, even though the company invested extensively in equities. Such a mis-match risk is by no means uncommon, and has recently come into the public domain with at least one other major company. In this, and in other things, the Life Board suffers from being dominated by life actuaries. In order to achieve detached objectivity, the Life Board should be chaired by someone with a pension consultancy background, somebody such as the incoming President, and the Pensions Board by someone with a life company background, such as the present President.

(3) Section 30 of Chapter 20 talks of "sweeping actuarial footprints from the snow", on the general absence of reconciliations between successive valuations. It is 20 years since the President wrote a paper on the Control Cycle, but I suspect that such analysis is uncommon, even today. Many companies will have submitted their PPFMs on the basis of a revised bonus and asset allocation philosophy for separate cohorts. Have they taken steps to institute relevant system changes and MI systems to operate them? If not, what allowance will they make for operational failure in their ICA?
(4) We have, of course, pre-emptively changed the constitution and membership of the Disciplinary Board. However, in the current climate it would be very useful if Appointed Actuaries of high profile companies which have run into difficulties were put through the process. They may come through it unblemished, but the process needs to be gone through to win public confidence in the system.

Mr N. H. Taylor, F.I.A.: My comments are under three broad headings: regulatory governance; actuarial governance; and corporate governance.

Regulatory Governance

The GAD and the Department of Trade and Industry (DTI) are criticised for leaving investigations incomplete. At the same time, the profession is criticised for making it difficult to disagree with Appointed Actuaries.

The latter was used to good effect by Equitable Life when there were disagreements between their Appointed Actuary and the GAD over their annual returns. The reasons do not come out too clearly in the Penrose Report, which is rather unfair on the GAD. I hope that the investigation by Sir Derek Morris, and any investigation by the Parliamentary Ombudsman, will make public what was actually the cause of some of the investigations being left undone by both the GAD and, in similar cases, by the DTI.

The President has said that we have changed the guidance. I had never thought that there had been problems challenging other actuaries, but we must make sure that that is absolutely so. We must always have the ability to challenge another actuary, and, with the new actuarial functions of with-profits actuaries, any director who is an actuary must be able to challenge them, be they an executive director or a non-executive director.

Actuarial Governance

We have been criticised for not being tight enough in our professional guidance. We also need to be very tight in giving out practising certificates.

As an example, I was struck, at the CILA Conference, by our approach to giving out certificates under the new actuarial function holder regime, including with-profits actuaries and reviewing actuaries. We will use the same basic standards as now. That is fine. If there is with-profits business, we will require three years' experience of this in the last ten. However, we apparently intend to grandfather in Appointed Actuaries, even if they do not have such experience. We cannot do that if we are trying to be above criticism in maintaining high standards. There is no problem in providing mentors, be they in-house or be they consulting actuaries. We want to look at other examples of that sort of thing, and make sure that our standards are high.

Corporate Governance

This is the most important matter that comes out of the Penrose Report. Whether it is Maxwell, Enron, Shell or Equitable Life, everything points to problems with corporate governance, particularly the role of non-executive directors.

On paper, the non-executive directors of Equitable Life seemed well qualified. If you went back ten years and looked at the board, you would say that it was a widely experienced board. They were well respected business people. Yet, they failed to ask the right actuarial questions.

Now that life office boards are to become wholly responsible for the actuarial aspects of their offices under the new FSA rules, it is vital to have properly qualified non-executive directors, who can challenge the work of the actuaries, as well as all the other aspects of the operation. As much as I would like to see an actuary on every life board, there are plenty of other well qualified people who can be encouraged to serve, such as former non-actuary chief executives and finance directors of life offices.

In addition, boards must demand proper training programmes, which could be provided either by the Profession or by consultants, because boards need to understand the actuarial aspects, and they clearly do not at the moment. They must also demand clear, comprehensive papers from their actuaries. I note that one of the criticisms in the Penrose Report was that the Equitable Life board received their actuarial papers in various chunks, which made it difficult for them to form an overall view.

However, that said, in the current environment — and I do not make any criticism here of Equitable Life — where Equitable Life are suing their directors, it is a wonder whether anybody will want to serve in that role. As a profession, we are well qualified to do so. Some of us are prepared to take the risks involved. I put a caveat in here, which some of you might not realise if you are asked to do the job. The advice that I now have from my solicitor is that, if I am sued, either in my consulting career or as a non-executive director, it is best to be a man of straw — not a happy situation.

The President (Mr J. Goford, F.I.A.): On that last point, for the FSA to say that you have to pay your own fines personally, rather than using your directors' and officers' cover, is singling out non-executive directors of life assurance companies for very special treatment, which I find very odd.

Mr A. J. Sanders, F.I.A.: It is necessary to examine Lord Penrose's conclusions critically, in order to learn lessons for the future.

Lord Penrose did a good job in the circumstances. However, there are areas where his conclusions can be challenged, and, in particular, where we need to be careful before making decisions that depend upon the conclusions.

I was disappointed, though not surprised, that Lord Penrose ducked the issue of whether the House of Lords judgment was sound. Many respected commentators, both within and outside of the legal profession, have cast considerable doubt about that. If it was a maverick judgment, then Lord Penrose's conclusions should be different; but, understandably, he refuses to be drawn, though he does insist that the judgment was not a decision beyond reasonable contemplation.

It seems a matter of some concern if billions of pounds of damage can be inflicted on industries by judgments which depend too heavily on chance rather than on reasoned argument. One might conclude that the civil justice system is a more serious cause for enquiry than some of the other areas which have been put under scrutiny. Equally, it makes planning and risk management much more difficult if courts give unpredictable decisions.

One controversial area is his view that Equitable Life consistently paid bonuses in excess of what could be afforded, and that this was a more significant cause of their difficulties than the House of Lords judgment. This conclusion was challenged pre-publication, but Lord Penrose retained his view. It seems to me that his analysis was largely done with the benefit of hindsight, which he admits at one point. It ignores important elements of value, such as the in-force business and unrecouped expenses, and also relies, to some extent, on his view of the flexibility, or lack of flexibility, that could be applied to Equitable Life's terminal bonus. He has a point, but he carries it much too far.

A related area where he can be challenged is the criticism made about the reserving approach to terminal bonus. This depends heavily on his view that Equitable Life did not have the flexibility to change or remove terminal bonus that it (and the rest of the industry) thought it did have. If you do not accept that view, or that that view was reasonable at the time, then the flexibility in reserving is a consequence of the flexibility inherent in the with-profits contract itself — and the criticisms of the reserving approach have less validity.

The FSA, in its principles and practice of financial management proposals, CP207, and other initiatives, is trying to limit that flexibility; but a consequence of the removal of the flexibility is the de-risking of contracts, and the likelihood of poorer average returns.

On PRE, Lord Penrose seems to contradict himself by, quite rightly, criticising actuaries for trying to resolve essentially legal matters, whilst, at the same time, suggesting that we could have done more to help to define PRE.

So, what should the actuarial profession learn from this? One of the most difficult questions is that of guidance. When should we give guidance and when should we not? We are getting conflicting messages here. On the one hand, we should not be too permissive in guidance — we should be definitive. However, on the other hand, we should not assume responsibilities that do not lie with us. We must not give guidance that changes, or extends, law or FSA rules. We have tried to be the regulator, and we have been told quite firmly that we should not be. We must be wary of trying to fill the gaps that are being created by others, either in legislation or in FSA rules and guidance, such as nebulous concepts like PRE. It is not for us to say what constitutes prudence — that, ultimately, is a case for the FSA or the courts. Nor is it for us, as a profession, to say how much capital an insurance company should hold. That is for the company and the FSA. However, we can give guidance on appropriate techniques. We should, therefore, be very careful about the guidance which we give. We should enable a healthy debate and discussion on key issues, and we should draw attention to deficiencies in practice or regulation; but we should also insist that the FSA, or the Government, assumes what is, ultimately, their responsibility.

Mr R. K. Sloan, F.F.A.: As one who, since 1996, has taken an interest in the situation at Equitable Life, I am not surprised at any of the major conclusions arrived at by Lord Penrose. I made critical comments about Equitable Life's flawed bonus distribution approach at the discussion of the 'Transparent With-Profits' paper in Edinburgh in March 2001 (Clay *et al.*, 2001), where I included a table illustrating their over and under declarations of bonus since 1989, effectively a simplified version of Lord Penrose's financial Table D, at the end of his report.

We then also had a discussion on lessons from the Equitable Life in November 2001, following publication of the Corley Report. My remarks covered a range of topics, including whistleblowers, intervention by the Actuarial Profession, peer pressure, advertising, sales supervision, compliance, PRE and corporate governance. I propose only to re-address corporate governance, which Mr Taylor has already addressed to some extent.

Principal A.3 of the Combined Code of Good Governance and Best Practices, which came out in 2000, states: "The Board should include a balance of executive and non-executive directors, and, in particular, independent non-executive directors, such that no individual or small group of individuals can dominate the Board's decision taking."

Given that none of Equitable Life's non-executive directors was an actuary, and that most of the executive directors were, it is difficult to see how, in the complex environment of a life office, this requirement can reasonably be met without at least one independent actuary amongst the non-executive directors. I would, therefore, like to see this adopted by every life office.

Returning now to Lord Penrose, he explained, on page 739, how critical risk management in actuarial functions of Equitable Life were not subject to effective scrutiny or challenge. This was mainly because the Equitable Life's non-executive directors were so wholly dependent on actuarial input from the executive directors that they were largely incapable of exercising any influence on the actual management of the society. He further described Equitable Life's board as a self-perpetuating oligarchy. Later, he referred to the importance of the FSA addressing the problem of unbalanced, or ineffective, boards, and suggested that there appears to be no alternative to the FSA exercising powers to refuse an appointment, where this does not fill a gap in a board's range of skills and experience.

Given the introduction of the Combined Code of Corporate Governance, that I quoted back in 2000, which has recently been reviewed and remains unchanged in that regard, and despite the repeated public pleas of many commentators, I am surprised that some mutual life offices still have no actuaries amongst their non-executive directors. It was thus virtually inevitable, albeit highly regrettable, that the Treasury should now find it necessary to institute the Myners Review of the Governance of Mutual Life Offices. As with all issues of corporate ethics and probity, if the parties concerned will not put their own houses in order, then someone else will eventually feel compelled to do it for them. This is a lesson that the life assurance industry, coupled with the Actuarial Profession, should have learnt long before now, and which could have avoided the embarrassment of the imposition of yet another external review. I am not talking about Morris here, but Myners.

Reference

Clay, G.D., Frankland, R., Horn, A.D., Hylands, J.F., Johnson, C.M., Kerry, R.A., Lister, J.R. & Loseby, R.L. (2001). Transparent with-profits — freedom with publicity. *British Actuarial Journal*, **7**, 365-465 and 725-746.

Mr C. D. Daykin, C.B., F.I.A., Hon.F.F.A.: It is appropriate that the focus of the discussion should be on the implications looking forward, and the lessons that we can learn for the future. I want to preface my remarks with a couple of brief reflections on the report from the regulatory perspective, although I should emphasise that I was never personally involved in the supervision of Equitable Life, since I was a policyholder. The GAD was not the regulator, but only gave actuarial advice to the regulator.

Lord Penrose appears to be pretty liberal with his criticisms of all and sundry in the report. One should note that he carefully avoids making any critique of the insurance supervisors against the backdrop of the law and of the regulatory system which was actually in place at the time in question. His apparent criticisms of the supervisors were carefully crafted against the yardstick of a hypothetical regulatory system, which he personally would have liked to have seen in place, although it was not, and with a generous helping of hindsight in interpreting what was known at different times over the period. Unfortunately, this conveys the impression of being critical, while not actually identifying genuine points of criticism relative to the regulatory law at the time. The shortcomings, which he perceives, essentially amount to a critique of the European Union directives and the United Kingdom insurance law and regulations.

Furthermore, Lord Penrose did not think through very carefully the consequences of his ideas in relation to the rest of the industry. Some of the things that he proposes had been considered and rejected earlier, because of their widespread repercussions. Fortunately, Lord Penrose did not apply quite the same approach to the Profession. He was quite soft on the Actuarial Profession, itself, relative to his treatment of both the company and the regulators. However, he did imply that the Profession could have responded more positively to the challenge of reserving for guaranteed annuity options, could have set standards, which were more of a restraint on actuaries' behaviour, and could have played a more proactive role in counselling members who were not in line with mainstream thinking.

Looking forward, one of the key lessons which the Profession has to learn from the Equitable Life saga, including the House of Lords judgment and the report of the inquiry, is that we have to be more attuned to the changing views of society. Actuaries thought that they could set the agenda for what was meant by PRE. It was an actuarial turn of phrase, which actuaries invented; but it turned out to be a 'Pandora's box', over which the Profession had no control. Lord Penrose had a completely different view of PRE from the Profession, and from the way in which the regulators had dealt with PRE.

Another area is the management of conflict of interest. The Profession believed that the Appointed Actuary, as a professional operating under standards of practice, could be relied upon to manage the conflicts of interest which were inherent in the role. Lord Penrose did not agree with this, nor did the FSA, when they decided that the Appointed Actuary should be replaced by the three actuary system, in order to bring the conflicts directly to the board of directors of the company for resolution.

We also need to be concerned about how we, as a profession, maintain and assure the quality of the work of actuaries. With the benefit of hindsight, we might well have moved much earlier to introduce effective peer review requirements. The Morris Review may strengthen the hand of the profession to bring these in. I like to think that the Morris Review is an opportunity for the Profession to move forward in areas in which we would like to move forward, but which have been difficult to progress in the past.

I am not aware that the U.K. actuarial profession has ever given much thought to the issue of competition within the profession, although, clearly, firms will have given thought to this in relation to their own competitiveness. Sir Derek Morris, coming from the Competition Commission, will see this as one of his main areas to look at, and it will be interesting to see how that emerges. I do not think that there is any doubt that the Profession, itself, operates in a competitive marketplace, and that we are subject to competition from other professions and other specialisms. We need to respond to these if we are going to survive, and thrive as a profession.

One of the greatest challenges which faces the profession at the moment is to be taken seriously as a major player in relation to the development of risk management within financial institutions. We thought that actuaries were doing this, but it is becoming clear that most people do not see actuaries as the primary risk manager. The more important this subject seems to be becoming from regulatory and other perspectives, the less influence actuaries seem to be having in its development. We need to address this urgently.

The profession has taken a fair amount of buffeting in the last year or two, compared to what we are used to. Nevertheless, we have much to be proud of as a profession, and we need to strive to set, implement and maintain the highest professional standards. In addition, we need to resist the idea, which Lord Penrose seemed to have, of turning standard setting into detailed regulation and control, which would give us a 'tick box' mentality, and could be severely detrimental to professionalism.

We need to promote thought leadership in the wider financial sector, and show ourselves to be particularly sensitive to the interests of the consumer. We might consider how we could develop a further strand to our activities, which falls between standard setting and discipline. This would be more of a process of counselling and encouragement to do the right thing, as has already been successfully implemented in the United States of America, through the counselling element of the Actuarial Board for Counselling and Discipline.

Mr T. J. Gordon, F.I.A.: I am unimpressed by the negative response to the Penrose Report, despite the President's suggestion that we do not revisit that old ground. There were two things which were very plain. One, there was significant unease in the profession about what was going on at Equitable Life before it all fell apart. Two, it is obvious that, if you do not hedge guarantees, then they are going to come back and bite you, sooner or later. If it had not been Equitable Life, it would have been another company.

Many of the points made by Lord Penrose have a strong resonance on the pensions side. You could drive a coach and horses through our current pensions guidance, and this needs fixing. We are doing something about that. We need to rein in the freedom for so-called judgement.

If I were looking for a market in actuarial advice, one exercise that I might carry out would be to plot the ratio of the strength of average pension scheme funding bases over the actual cost of securing pension scheme liabilities over time. Given that the level of guarantees and the relative value of these to members has increased, you might expect this ratio to increase with time; but I suspect that there will actually be a line sloping downwards, indicating a good deal of efficiency, but probably not of the right sort.

Mr A. K. Gupta, F.F.A.: I have been the Appointed Actuary of a substantial insurance company with a substantial with-profits fund. I always found the role uncomfortable.

Many actuaries have fulfilled the role extremely well, with great integrity, professionalism and, indeed, courage. The role of Appointed Actuary is no longer tenable, and I am pleased to see it passing. In normal circumstances, the actuary has been in a position where he was effectively personally taking responsibility for things which are of great commercial significance, and are really board issues. At times of great turbulence, like takeovers or demutualisations, I was entirely sceptical of the ability of the actuary to withstand the intense commercial pressures that could result. This is particularly true for mutuals, where Lord Penrose has highlighted the key issue of board accountability. The absence of a clear process, where boards of a mutual are accountable to their shareholders, places the actuary and the Profession in a no-win situation. That is something to which we should respond. The passing of the role and the passing of the responsibilities for policyholder benefits direct to the board are significant improvements. We, as a Profession, need to take the opportunity that the Morris review has given us to realign ourselves and to regain the confidence of the public and the business community.

However, we believe that we have fulfilled our role in recent years. I do not believe that we have covered ourselves in glory. The Penrose Report makes some criticisms that we should think about very carefully. The opaqueness of actuarial methodology, the erosion of the industry's capital base, and the spectacular failure of the Equitable Life have all combined to reduce the country's confidence in the profession to an all-time low. I believe that we are at a watershed, and that we need to rebuild the industry's reputation. If we have any doubt about it, then the profession should carry out some market research. The actuarial profession needs to be less introverted.

Mr Daykin has mentioned the issue of PRE. That has become something which we never intended it to become. However, it is important what we, as a Profession, intended it to become, and it is important what our policyholders interpret it to be. Penrose, and new regulation, particularly CP 207, will increase the focus on PRE. That is a major challenge, which we have to rise to.

There are opportunities, like risk management, around. It would be great if we could take advantage of these. If we are going to do so, we need to rebuild our reputation and be prepared to take a stance on moral issues. We need to be prepared for the Profession to accept responsibility for direct intervention.

Mr J. A. Jenkins, F.I.A.: My first point relates to the proactive monitoring of guidance notes. We need to be very careful where, and how, we set guidance notes. However, having done that, we then need proactively to monitor against them. Waiting for somebody to make a complaint does not seem to be tenable. Whether it is peer review, or something along the lines of what the accountants do, I do not know, but we need to monitor proactively.

My second point relates to the proactiveness of the life side of our profession. In the late 1990s, the Philip Scott working party (Scott *et al.*, 1996) proposed that we should be responsible for calculating two numbers, a statutory solvency liability and a realistic liability. When it was discussed at Staple Inn, actuary after actuary effectively said: "Why bother?", on the realistic liability. They said there was no need for it. Yet, here we are now calculating realistic liabilities, as a result of an FSA initiative.

My last point relates to the Actuarial Standards Board. I have difficulty understanding how, if it is a very small body of independent people, they can possibly review properly the technical standards which are going to have to be produced to make sure that they are not woolly standards which allow you to do anything. I am not sure how that is going to work in practice, but I am in favour of the ASB in principle.

Reference

Scott, P.G., Elliott, S.F., Gray, L.J., Hewitson, T.W., Lechmere, D.J., Lewis, D. & Needleman, P.D. (1996). An alternative to the net premium valuation method for statutory reporting. *British Actuarial Journal*, **2**, 527-621.

Mr M. R. Kipling, F.I.A.: I agree with Mr Jenkins about the development of guidance at a reasonably detailed level. If we do not, we will end up with calculations being carried out on a fairly arbitrary basis.

For example, there is clear dichotomy in the choice of risk free rate of return. Should it be the rate of return generated from swaps or from fixed interest? It is important that the profession gives proper guidance on what is the generally accepted actuarial best practice in deriving the rate using stochastic modelling.

Another area of concern relates to the reasonableness of management actions. There is a reputational risk if actuaries make liability reducing assumptions about future management actions that will take place in certain circumstances, and those circumstances then come about and the management actions are not, or cannot be, taken. That could reflect badly on the profession, at some future time, if guidance is not given in a way which is reasonable and is as generally accepted as possible.

The second reason for needing to give detailed and specific guidance is that the FSA wants us to. The actuaries at the FSA, who are working on the Integrated Prudential Sourcebook, are aware that they have limited time and resources to develop the 300 or so rules relating to life capital and life reserves, and that what they produce will not necessarily be perfect. In particular, they will not reflect all the nuances of different life funds. The profession could direct more resources to discussing and refining guidance than the FSA possibly can. The FSA is also aware that, if it makes rules which are imperfect, and the profession does not act to fill these gaps or to clarify the intention of the rules, then, inevitably, these shortcomings will be exploited by companies to minimise the capital which they need to hold.

Thirdly, the actuaries who will be advising the auditors require standards against which to challenge the actuaries advising companies. We have to be aware that we are moving into a more adversarial environment. We will no longer have an Appointed Actuary, who is a bit of a conscience on behalf of the policyholder, as well as acting on behalf of the company. The new 'actuarial function' is purely a function advising the company. It cannot even set its own valuation bases. The actuary advising the auditor needs some backbone of guidance, over and above the FSA rules, to enable him, or her, successfully to challenge inappropriate practices.

Detailed guidance works overseas. In some countries, the Actuarial Profession, working more closely than we do here with the regulators, produced joint guidance, in detail, on matters such as the tail thickness of equity stochastic models. North America is an example of this.

We need to take the opportunity that the next few months will give us to reassert our skills, as a profession, in assessing liabilities, and to develop newer skills, assessing adequate capital to run life insurance companies in the challenging circumstances of the next few years.

Mr J. Instance, F.I.A.: I support Mr Kipling about the need for strong standards. The Penrose Report criticised the insurance industry for not having decent accounting standards for with-profits business. Ruth Kelly has said that there is a third report, which is due by the end of this year, on accounting for with-profits business. Therefore, the accountants are moving fast. Maybe they have to. Should we be moving just as fast to assert our influence over accounting for insurance business, going forward?

The Report emphasised the need for good, open, complete communication. Part of the problem was that actuaries were not communicating in a consistent way with their boards of directors. Strong standards help that, because it gives people the ability to communicate against those standards.

The report stated the need to acknowledge the limits of our competence. Mr Daykin said that PRE means something to actuaries. It meant something very different to Lord Penrose, and he criticised actuaries for making assumptions about what PRE really meant. His was a much more straightforward view, and it had nothing much to do with asset shares.

So, maybe we have to think about these issues and work with other professions, such as accountants and lawyers, to develop something that is meaningful.

Mr P. M. Greenwood, F.I.A.: Any financial product, if it is going to avoid scandals, needs to have three elements in line: the consumer understanding; the legal position; and the financial backing. In my own arena of pensions, final salary schemes are now in scandal, because the Government accidentally increased the level of guarantees. That agreed with the consumer understanding, but the financial manner in which they were established did not reflect those guarantees. With precipice bonds, the consumer did not understand the risk element that was involved. With Equitable Life's communication of its bonuses, it created a guaranteed expectation. I admit, as a consultant, that I advised Equitable Life on the basis that terminal bonus could only be cut back.

The danger that we have now, even if we have strong standards, is that, both on the pensions side and on the life side, the guarantees issued, or understood, by the consumer, at the moment, may not be supported by the macro-economics. The supply side of the economy cannot provide that total level guaranteed cash flow income from economic activity.

We have to be very careful on how far we go with standards before we understand what the supply side can do. Hence, we may have to cut back the guarantees and balance with discretionary elements. As well as strong standards, to get that balance between guaranteed and discretionary back, we need to communicate to the Government that, overall, if there are too many guarantees around in what the public thinks that it has got, there will be economic damage in the long term.

As a profession, we can do our bit on standards, but we need to be getting the politicians to help us to deliver on the consumer expectations. This is not happening at the moment, for example, what the Government has done on trying to restore the Pension Protection Fund retrospectively. I would argue that the capital value of what is needed to restore full security to final salary pension schemes currently in wind up is probably of the order of £200 billion to £300 billion, but the Government is trying to argue that it is £300 million per annum.

There are two sides to this. The Profession can correct only one part of it; we need to get political support for correcting the other parts.

The President (Mr J. Goford, F.I.A.): I find this perception of guarantees absolutely fascinating. When you see that the market has fallen, interest rates have fallen and we have increased longevity, yet you also see that all guarantees have been paid, bar Oak Life and Nation Life. However, all you get is: "But my constituents are disappointed." So, what do you do with that? On the presentation of realistic liabilities, I have the makings of an agreement with John Tiner and David Strachan that, whenever a realistic liability is stated as a number, it must always have alongside it: "of which so much is in respect of guaranteed liabilities". Otherwise, we are in danger of presenting the realistic liability, which is a mix of guaranteed and non-guaranteed benefits, as if it is all the same thing.

Mr D. J. McLean, F.I.A.: The profession has two types of problem which should be addressed going forward. It may be that we are more successfully addressing one type than the other. We want to avoid looking backwards, and looking at the individual case of Equitable Life; but, at whichever case we look, I would like to divide the problem into: "Was somebody doing something that was different?" and: "If we had written down what should have been done, would that particular approach have been caught?" Also: "Was there any collective blind spot that now, with the benefit of hindsight, we can see?"

I now take two of the things that we are discussing here: "What does PRE mean?" and "How do we hedge for guarantees?" With the benefit of hindsight, we might regard both of these as being collective blind spots, rather than things that were peculiar to any one institution. If we go about setting out more and more detailed standards, we are perhaps likely to reduce the likelihood of the one-off aberrant actuary firm doing something strange. However, I have not heard very much yet that allows us to address what I would regard as the collective blind spot. If anything, the more that we try to sort out the one-off difficulty, the more we make that likely, because we just have a common view of life. We all do the same thing, and, from time to time, it may turn out that all of us doing the same thing was wrong.

Peer review may actually make this worse, not better. I fear that, in a number of areas, the way in which we will do peer review will focus more and more responsibility on the few people who are experts in that field, and the few people who are experts in any particular field tend to be those people with the greatest vested interest in it.

Mr D. B. Martin, F.F.A.: We have a big challenge, as a profession, because we are quite used to the idea of having academic type debates. People will come up with a particular view, and others will oppose it. In the end, we make our own decisions and go about our work in the way that we think best. Our standards, to date, have very often reflected that.

An example from my own area, which is pensions, is the requirements for calculating transfer values, which have been the subject of huge debate over the years. In the end, we have a standard where people who subscribe to one approach can use that and those who subscribe to the other can use the other. We have not really decided which of the approaches is right. With an Actuarial Standards Board, somebody is going to have to bite the bullet and make those kind of decisions which some actuaries will not like.

To follow on the point that has just been made, we will have a remit to listen to all the academic discussions which will presumably continue within the actuarial profession. The Actuarial Standards Board will have some independents, and they will have a duty to listen and to be prepared to shift those standards as thinking develops. As with all sciences, new ideas come forward, and it may be proved that what we did before may not have been quite right. The standards must, therefore, not be set in stone, as they must be capable of change and modification.

In summary, the Actuarial Standards Board will have a very difficult and responsible task, and the rest of us need to accept that and to respond accordingly.

Mr D. G. R. Ferguson, F.I.A.: My remarks are about PRE. When I first read the Penrose Report, I bridled at the criticism that actuaries have taken upon themselves the role of equating PRE with asset shares. I thought that that was a little harsh. I recall that, when the phrase was first introduced into legislation in the Insurance Companies (Amendment) Act of 1973, the Profession was greatly disturbed that it was not a defined phrase. It was introduced to give the Secretary of State power to intervene in the affairs of an insurance company if he judged it "to be desirable for protecting policyholders, or potential policyholders, of the company against the risk that the company may be unable to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of the policyholders or potential policyholders." So, that is where the phrase came in. It was designed to give the Secretary of State powers, particularly to deal with perceived asset strippers.

The profession was left with the implications of that phrase, and was somewhat disturbed to have it ill-defined. We recognised, at the time, that it needed to be defined by the courts, and we also recognised that it was extremely unlikely that that would happen. We regretted, but were not surprised, that it did not happen. We had to make the best interpretation of PRE that we could. We regret that one of the first cases to address PRE, the House of Lords judgment in the Hyman case, raises as many questions as it answers. I was not surprised by the House of Lords judgment, although I have not studied the case in detail. Often, when a court case gets to the House of Lords, it does come back to a common sense judgment, and it does appear that there were two promises given: that funds would be built up to retirement; and that there was a minimum guarantee on retirement, and that it was reasonable for policyholders to interpret it in that way.

Gerald Barrow and I wrote a paper in 1984 on the subject of reasonable expectations (Barrow & Ferguson, 1984). At that time we made a distinction between what we called contractual expectations and equitable expectations. We debated the extent to which it was proper for the regulator to deal with those two expectations, and we came down on the side of thinking that the regulator should concentrate on the contractual expectations. Clearly, that was not the intention. The intention was that the regulatory authorities should require offices to demonstrate that they were being conducted in such a manner as to ensure, as far as possible, their ability to fulfil all policyholders' expectations, equitable as well as contractual.

In recent years, it is clear that the regulators are taking that aspect of their work extremely seriously. That is to be applauded, and I support the Treating Consumers Fairly (TCF) initiative, as an example.

Starting from the point where the profession has been judged harshly, it is important for us, as individuals, whether non-executives on boards or in an influential position in management, to continue to ask the question: "What are PRE, and how can we meet them?" Even more so with TCF, but we need to recognise that it is not just actuaries who have to do this.

I hope that, in the debates which the profession has with Sir Derek Morris and others, we will make the point that we should be getting more help and more input, particularly from the legal profession, so that we can play our substantial and leading part in meeting PRE.

Reference

Barrow, G.E. & Ferguson, D.G.R. (1984). A review of the law relating to insolvent life assurance companies and proposals for reform. *Journal of the Institute of Actuaries*, **111**, 229-278.

Mr N. B. Masters, F.I.A.: I want to pick up some of the comments that have been made during the debate, and to look at ways forward over the next 12 or 24 months:

(1) We have an opportunity to revisit the membership of the Life Board. I propose an experiment in having some lay members join the Board.
(2) We need to get auditing firms to have procedures around what is the right level of solvency and prudential capital. The auditing profession does not have any principles as to the amount of capital. Many of us will be subject to audit discipline going forward, as many life companies have to work with their auditors to confirm solvency. The Actuarial Profession must lead in setting the standards that should imply.
(3) I believe that intervention by the Profession in the affairs of individual organisations, or, indeed, possibly even in the practices of individual actuaries in a commercial setting, is not the role of the Profession. It is very much the role of the Profession, where there are specific methodologies and specific practices that seem suspect, and where we can provide an independent assessment of the conceptual validity of those. I should like to see us being much more proactive and much more hands on.
(4) We might want to learn some of the lessons that industry, in general, has suffered from Sarbanes-Oxley. We should find out how we can get some of the undoubted governance benefits that come from the focus on process that Sarbanes-Oxley requires, but without expensive and bureaucratic overheads.

Mr I. J. Kenna, A.I.A. (in a contribution that was read to the meeting)**:** The Equitable Life was an actuary-led office. The actuary was the managing director under the Articles of Association.

Our discussion of the Penrose Report must take account of the discussion paper 'With Profits Without Mystery' (Ranson & Headdon, 1989), by two leading Equitable Life actuaries, one being the Appointed Actuary.

The Equitable Life had no proprietary shareholders. The authors of the paper dismissed the need for an estate and for financial strength. Mr Ranson put it succinctly in his reply to the discussion: "We take the savings from the current generation, we earn what we can on those savings, and pay it out to the current generation."

At a later date, through not having reserved for certain guaranteed annuity options, the Equitable Life was unable to meet its obligations to its policyholders. Without the cushion offered by financial strength, an estate and shareholders' funds, the Equitable Life ran into difficulties. The current generation of policyholders suffered.

Coming to the Penrose Report, it is clear that the Equitable Life lived from hand to mouth for many years. A turning point was reached in 1989, when there was a good return and the Equitable Life deliberately distributed a high proportion of the available return for market related reasons, and, accordingly, entered the 1990s with a negative estate. There was a dependence on capital appreciation to sustain distribution policy.

There was an enormous non-guaranteed final bonus in 1996. In 1997 the Equitable Life experienced an average year on the market, with an overall investment return of 17.2% (including an income yield of 5%).

Payouts depended largely on inflated capital appreciation. Lord Penrose does not appear to understand that inflated capital appreciation now leads to reduced yields in the future. Reduced yields in the future lead to a situation where guaranteed annuity options begin to bite. The Equitable Life paid out money in final bonuses which should have been used to reserve for guaranteed annuity options.

I am disappointed by the report's 'Lessons for the Future', in Chapter 20, which deal largely with regulatory matters. Lord Penrose does not appear to see the need for an estate. He hardly comments on the need for the reform of life office practice generally. It is not true to say that life offices take people's savings, earn what they can on those savings and pay them out again. Payouts to departing policyholders come from cash contributed by new and existing policyholders plus investment income. Shares are not generally sold to make payouts. New policyholders are attracted by the size of the payouts to departing policyholders.

The Equitable Life had a series of misfortunes. A stubborn actuarial management; inflated payouts; guaranteed annuity options; no admission of the need for an estate or for financial strength; the lack of shareholders' funds; and an unfortunate House of Lords judgment.

However, the Equitable Life was not alone. Life offices, generally, are paying cash claims out of cash income, that is out of contributions and investment income. A large proportion of life office funds is invested in shares. The market price of shares goes up and remains high, because life offices have got net cash income available for investment in shares, and because the demand for shares exceeds the supply.

Nobody knows the true value of shares except for the fact that it is less than the market value. It may be that life offices have discovered the secret of continued, indefinite and successful pyramid selling. Disinvestment of shares to pay claims may never be necessary, or it may be that the Equitable Life was simply the unfortunate tip of an iceberg.

Life offices can only ensure a soft landing by ceasing the practice of pyramid selling. Claims in respect of departing policyholders must be met out of investment income and the selling of shares; not out of the contributions of new and continuing policyholders.

Ms F. J. Morrison, F.I.A.: I want to make two brief comments. The first one relates to compliance review. The President commented that we are making progress in the pensions' area, but in the Lloyd's area it has stalled. When I chaired the exposure meetings on the Pensions Compliance Review Guidance Note, in March 2004, I started a session by saying that we were not there to debate whether, or not, we were going to have it; we were there to debate the proposal which was in front of us. It was encouraging, at the second meeting in London, which was after the Penrose Report had been published, that people were saying: "This is not going far enough.''

One point made by the President was: "Do we fill in deficiencies in legislation?'' Many people have commented on the difficulty in trying to establish what PRE were, because there was a void in legislation. I see parallels on the pensions' side, where we may be getting deficient legislation with the new Pensions Bill. We are very good at coming into those vacuums. We will be judged with the benefit of hindsight, and it is not for us to make the political decisions. The model which I would see us following is much more what was said in the four Presidents' letter — the two Presidents and the two incoming Presidents wrote an open letter about the proposed Pensions Protection Fund. That is how we, as a profession, can fill these vacuums in legislation and government policy, point out where they are weak, make sure that the public is aware of them, and then, if the Government still manages to leave deficient legislation, we know where we stand.

I wonder whether, if we establish an independent Actuarial Standards Board, and see that these standards are not keeping up to date, the Profession may say: "The standards set by the Standards Board are not up to it. There is a vacuum."

The President (Mr J. Goford, F.I.A.): It may be that there are some seeds in what Ms Morrison was suggesting. If we see a vacuum, we should come up with, say, draft standards, publicise them, and say: "This is what should be happening, but these should be taken on by the Government or the regulators, not taken on by the Profession."

Mr C. D. O'Brien, F.I.A.: I should like to pursue the theme of the Actuarial Standards Board, and the dangers that the standards are not very good or are out of date. Maybe there is an opportunity, with an Actuarial Standards Board, that has some impetus and responsibility to sort out some of the issues which have been bugging us for some while. Maybe we should pursue the idea of an 'urgent issues task force' or a 'critical issues task force'. When there are problems, such as deciding the transfer value basis for a pension scheme, maybe this 'critical issues task force', reporting to the Standards Board, would have to address the issue, and have some kind of independence and authority to try to resolve it.

There are all sorts of other issues around that we do not seem to have addressed and come to a conclusion on, for example longevity assumptions, not just in life insurance offices, but in pension schemes. We clearly have a mis-match between what the different sides of the profession are doing.

I am not sure that auditors are good at 'true and fair'. Why have we got a working party looking to accounting for with-profits life insurance? We have ducked the issues. There have been vested interests. Maybe a 'critical issues task force', that complements an Actuarial Standards Board, will do some good and resolve some of the current problems.

Mr P. A. C. Seymour, F.I.A.: We need to be proportionate in solving the problems which we face. The President said that there are three actuaries involved. I could make that four by adding the with-profits function.

We may have too many actuaries in the pie. That might be good for us as a profession, but it is very expensive. I wonder whether we are not in a situation now where the board, quite properly, is totally responsible for the management of the business. It is advised by the actuarial function. That is fine. It can take its own advice if it wishes, and the auditors are going to have a look at what the board decides.

That leaves the question of whether we still need peer review. I know that we came up with it initially, but I wonder if it needs to be reconsidered.

Mr Gordon: I want to pick up on Mr McLean's comment about collective blind spots. It is part of life that there will be things that you do not know which are going to come out and hit you. The example he gave of unhedged guarantees was curious. It may have been a collective blind spot for actuaries, but there were lots of expertise outside the profession on this subject, and it has been developed since the early 1970s.

Failings in the profession, therefore, have not just been around governance, or standards issues, but there have also been some intellectual issues that need to be addressed, going forward. We need to take expertise where we can find it: academia, the City or investment banks.

Mr M. A. Pomery, F.I.A. (closing the discussion)**:** Reading through the Penrose Report, it would appear to be all about a life insurance company, but there are many parallels and lessons to be learnt by pensions actuaries. In a sense, what happened at Equitable Life was a failure in the system.

We have a system failure in pensions now, which is very much in the news — some 60,000 people are not getting the pensions which they were expecting to get. The Government has come up with a £400 million rescue fund, which is coming from taxpayers' money.

You could argue that, since there are nine million members of final salary pension schemes in this country, there are 8,940,000 who have not been adversely affected by what is going on. That should not be a cause for complacency.

Back in May 2000, as Chairman of the Pensions Board, I gave a talk at the National Association of Pension Funds (NAPF) conference. The market was still very high. I talked about the possibility of pension fund failures. I said that, if a major company's pension fund failed, there would be serious repercussions for everybody who works in pensions. The actuarial profession would not escape criticism in that situation.

We have been extraordinarily lucky that there has not been a major failure of a pension fund so far, but there may be one day, and we are going to be in serious trouble if it happens. Part of the reason why we would be in trouble — and this comes from the Penrose Report and looking at parallels in pensions — is that we have not emphasised enough the difference between funding and solvency. If you think that that is not a fair criticism, how often have you seen, in an annual report from trustees to members, the sentence that goes something like this: "This year we had our triennial valuation, and I am pleased to tell you that our actuary has confirmed that our scheme is fully funded.'' I have seen it dozens of times in my career. I ask myself now: "What reasonable expectations does that sentence create in the mind of somebody who reads it?''

The changes which the Pensions Board has just brought in to GN9 have gone a long way to improving our communication of solvency to trustees; but there is no reason to suppose that that would necessarily get passed on to the members of schemes. A couple of years ago, the Department of Work and Pensions (DWP) set up a consultation panel to get ideas from pensions experts on the replacement for the Minimum Funding Requirement. Ms Beaver and I sat on that panel. The DWP was determined to have what they called scheme specific funding. They rejected MFR, because it was 'one size fits all'.

I described this scheme specific funding regulation as freedom with disclosure, and Ms Beaver and I pushed very hard both for the statement of funding principles to be agreed between the employer and the trustees and, more importantly, for the disclosure to members, on a regular basis, of the wind up position. The reason for this was quite simple. If the employer remains solvent, in business and continues to pay contributions to the pension fund, the members will get their benefits; but if the employer becomes insolvent, then there is a severe risk that the members will not get the full benefits which they are expecting. So, this information, if you are not having a Minimum Funding Standard, but are allowing a free for all on funding, has to be given to members on a regular basis.

We eventually won the panel and the DWP over. To their credit, the DWP then went out and employed a company to do some market research. This was very interesting. They produced a mock up of what an annual disclosure might look like, circulated it to a group of about 30 or 40 people, and then had in-depth interviews with each one of them. What they discovered, on the issue of telling people what would happen if their pension scheme wound up and their employer was insolvent, was the following. First, everybody was totally shocked, because they had no idea that their benefits were not 100% secure. Second, gratifyingly, they all said that it was actually information which they would like to have.

So, looking at that brief history, we could, as a profession, have some modest claims to have recognised some of these issues, and to have tried to influence regulation in a positive way. I would conclude that we still have much more to do.

Turning, now, to the discussion, Mr Colbran and Mr Iqbal mentioned the commercial pressures and the push coming from the marketing side, and the impact of that on actuaries. However, that sympathy soon disappeared. Mr Taylor and Mr Sloan raised the question of corporate governance and the role of non-executives. Mr Taylor talked about corporate governance as being the most important part of the Penrose Report. Now that life boards are going to be fully responsible for decisions without an Appointed Actuary, there is a greater than ever need for good non-executives and for proper training for boards. Both Mr Taylor and Mr Sloan suggested that there was a role for independent actuaries sitting as non-executives. Mr Taylor had a bit of advice for them as well: they should minimise their personal assets.

I noted some positive suggestions from Mr Daykin as to what the profession could do. We should be more attuned to the changing views of society, for instance, in relation to PRE. We need better management of conflicts of interest. We need to maintain the quality of actuarial work. There was a role for actuaries in risk management, and we need to establish our influence there. He suggested, interestingly, that there was a position midway between discipline and standards, which he called counselling, and recommended what was going on in the U.S.A.

I picked up another positive suggestion from Mr Gupta, that we should carry out some market research to see what people think of actuaries. I could ask some of my journalist friends, but I do not think that I would like the answers!

My final point concerns standards and guidance. There seemed to be some conflicting views about just how detailed our guidance and standards should be in the future. Mr Daykin put forward the position that we should keep some professional freedom and not be too restrictive; whereas Mr Kipling and others were arguing for much more prescriptive guidance, and Mr Kipling gave a number of examples.

It seems to me, certainly from my days on Council and on the Pensions Board, that there is always a difficult balance required in setting guidance notes between those actuaries who want a great deal of professional freedom and an ability to exercise judgement, and so want the guidance to be as vague as possible, and those actuaries who want to be told exactly how they must carry out their work. Mr Martin talked about the need for flexibility. Also, Mr McLean made some interesting comments about collective blind spots. That set me thinking again about pensions.

In the pensions world, until the late 1990s, we carried out valuations using a discounted income approach to value the assets. That was pretty universal. People began to change their views about that following the paper by Exley *et al.* (1997), and the abolition of Advanced Corporation Tax in July 1997. Gradually, actuaries started moving over to doing valuations by starting with the market value of the assets and changing their method of valuing liabilities correspondingly. Now, most pensions actuaries are using market-based valuations.

How would we have coped with that if we had had an Actuarial Standards Board and detailed guidance? We would have waited, I suppose, until about 50% of the actuaries were chafing at the bit, saying: "I do not want to do it this way anymore, I want to do it a new way." Eventually, the Actuarial Standards Board would, one day, have come to, and said: "This is the new way. You all have to do it the new way." The other 50% would have been really unhappy at that stage.

However, what we actually got was a complete change for the Profession in a space of about five years. You might argue that that is far too slow, but, in the lifetime of a pension fund, five years is not very long.

Reference

Exley, C.J., Mehta, S.J.B. & Smith, A.D. (1997). The financial theory of defined benefit pension schemes. *British Actuarial Journal*, **3**, 835-966.

The President (Mr J. Goford, F.I.A.): I should like to thank all those who have contributed to the discussion, and, in particular, add my thanks to Mr Pomery for doing an excellent job, when suddenly asked to close the discussion.

I have always found that looking at life from the customer's end of the telescope makes life a lot easier. It is in the customers' interest that we keep their expectations consistent with what we intend to deliver. I deliberately put it that way round. It is not in the interests of customers to allow the press, or whoever, who transform what are supposed to be variable benefits into guaranteed benefits, because, otherwise, we will have to offer guaranteed benefits only, and they will get only a guaranteed return.

We have a responsibility to get proactive with customers, and to keep their expectations in line with what was originally intended.

WRITTEN CONTRIBUTIONS

Mr A. R. Armitage, F.I.A.: How should the current statutory valuation process be improved? The net premium method, though presented prospectively, was effectively a retrospective demonstration of solvency for non-profit whole life policies. All the bells and whistles in the world do not help us to determine a level of bonus to meet PRE, however defined. It is not surprising that, with such an artificial system, there will be occasions when the Appointed Actuary gets it wrong, e.g. the Equitable Life zillmerisation, but the greater concern must be that teams of valuation actuaries and staff could be more usefully employed preparing something more meaningful. It is certainly no disgrace that the limited resources at the GAD did not pick up anything sooner.

Therefore, I suggest that we should rethink the whole statutory valuation methodology. Let us ask ourselves the question: "What would we do if we had to start from here?" I leave it to others to answer this question. It could be quite a long paper, but let me make an observation. For a start, the bonus level needs to be justified. It should be demonstrated that the office can continue to pay at least current reversionary bonuses in current conditions, that terminal bonuses can be justified by capital appreciation, and that whatever counts for terminal bonus has not already been allocated as reversionary. Incidentally, this would be my definition of PRE.

As far as possible, I would expect the offices' existing internal methodology to be adapted, so the first step would be for Appointed Actuaries, their advisers, and the GAD to reach a consensus. Five years from now, I would wish to see a large volume of readily produced electronic data and calculations, based on the above, being made available to the GAD, plus additional similarly skilled actuaries. As a quid pro quo, I would suggest that the current paper returns should be minimised to the minimum required by primary legislation/European Union directives, with a view to their eventual abolition.

Mr D. O. Forfar, F.F.A.: The House of Lords' judgment in the Equitable Life case has been criticised, but it must be asked whether the judges were fully informed on all the issues concerned, and whether the lawyers involved were able to deploy the required depth of understanding of actuarial practice and the reasons for this, the concept of policyholders' reasonable expectations (PRE), of financial economics, and of the actions and influence of the Regulator and the Treasury.

It is crucial to determine what a reasonable policyholder had been led to expect from the policy's wording, from the bonus notices which had been sent to him, and from other literature sent to him by the life office.

In what follows, GAR means the guaranteed annuity rate, typically around 11% p.a., meaning that £100 of cash provides an annuity of £11.00 p.a. CAR is the annuity rate then current. FV is the fund value. For simplicity, only a single premium is assumed payable, and the smoothing of investment returns is ignored. FV is the accumulation of the single premium, less expenses, at the investment return achieved over the whole term of the policy. Equally, FV is equal to the initial fund (the fund bought by the single premium) plus guaranteed bonus on the initial fund plus (fund value) terminal bonuses. (Fund value) terminal bonus is based only on the value of £1 of cash, which is the same as basing the terminal bonus on the FV. GFV is the guaranteed fund value. FV *includes* terminal bonus while GFV *excludes* terminal bonus. Terminal bonus is not guaranteed.

Example

Assume that the fund value at maturity of the policy is £2,000, made up from £1,000 initial fund, £500 guaranteed bonuses additional to the initial fund, and £500 (fund value) terminal bonus additional to the initial fund. Assume maturity at age 65, and that the guaranteed annuity rate (GAR) at age 65 is 10.00% p.a. (meaning that £100 provides a pension for life of £10.00 p.a.) and the current annuity rate (CAR) is 8.00% p.a.

Two Types of Policyholders' Expectations on a With-Profits Policy (which may be termed Type A and Type B)

Type A

The expectation is that the pension payable will be the better of the fund value (FV) applied at CAR or the guaranteed fund value (GFV) applied at GAR; i.e. the pension payable will be the maximum of FV*CAR and GFV*GAR. Thus, a Type A expectation is that the minimum pension will be GFV*GAR – the (Type A) floor pension. In the example, the pension payable is £160.00 p.a. (2000*0.08), as it is greater than the (Type A) floor pension of £150.00 p.a. (1500*0.10).

Type B

The expectation is that the pension payable will be the fund value (FV) applied at the better of CAR and GAR; i.e. the pension payable will be the maximum of FV*CAR and FV*GAR. Thus, a Type B expectation is that the minimum pension will be FV*GAR – the (Type B) floor pension. In the example, the pension payable is £200.00 p.a. (2000*.10) and the (Type B) floor pension is also £200 p.a. (2000*0.10).

Unit-Linked Policies

In the case of a unit-linked policy, FV represents the value of the policyholder's units at the maturity of the policy. A unit-linked policy with a guaranteed annuity rate has to provide a pension payable of the maximum of FV*CAR and FV*GAR. In the case of a unit-linked policy, and taking the example given above, the pension payable is £200.00 p.a. Thus, a unit-linked policy with a guaranteed annuity rate has to have a Type B expectation; there is no choice.

Actuarial Profession

The life industry had long since withdrawn guaranteed annuity rates, and maturity guarantees, on unit-linked policies, as a result of work done in 1980 by the Maturity Guarantees Working Party of the Actuarial Profession. The Corley Report on the Equitable Life, by the Actuarial Profession, stated that Equitable Life had, in the mid-1980s, rejected a guaranteed annuity rate on its unit-linked policies because the guaranteed annuity rate on unit-linked policies, in contrast to with-profits policies, had to be 'stand-alone' (Corley Report, paragraph 58), and the policyholders' expectations, therefore, had to be of Type B.

In the 1980s, the Actuarial Profession had felt that it was dangerous to give a Type B expectation, as the life office was then exposed to four risks, without any way of controlling, or ameliorating, these risks. These risks were: (1) a decline in interest rates; (2) a strong stock market; (3) an increase in longevity; and (4) a guaranteed annuity rate applying whenever the policyholder chose to retire. It is understood that, because there was no terminal bonus on a unit-linked policy (and therefore no way of controlling or ameliorating these risks), the Actuarial Profession recommended that guaranteed annuity rates be dropped from unit-linked policies. The life industry took the advice of the Actuarial Profession. On the other hand, with-profits policies with annuity rate guarantees could be offered, provided that the life office was careful to give policyholders only a Type A expectation. The flexibility afforded by terminal bonuses under with-profits policies allowed the life office to exercise sufficient amelioration over these risks.

(*Annuity Value*) *Terminal Bonus*

The second type of terminal bonus, (annuity value) terminal bonus, is based on the higher value of: (a) £1 cash; and (b) an amount of annuity of £GAR p.a. When CARs are above GARs, (a) has the higher value, but, when CARs fall below GARs, (b) has the higher value. Thus, the (annuity value) terminal bonus reflects the fall in annuity rates, subject to the terminal bonus never being less than zero. Thus, the risks inherent in a Type A expectation can be controlled or ameliorated except to the extent that, if the (annuity value) terminal bonus would otherwise be less than zero, the (Type A) floor pension (see above) would 'cut in' and force the (annuity value) terminal bonus to be zero. That risk remains under a GAR policy with a Type A expectation, and the life office must bear it. A differential naturally arises from the difference between the (fund value) terminal bonus and the (annuity value) terminal bonus.

Equitable Life's Practice

Equitable Life advised policyholders, each year, of the (fund value) terminal bonus on their GAR policies. This was alien to the way in which each GAR policy had been written. It had been written in annuity form, i.e. to provide an annuity.

As far as I am aware, Equitable Life was unique, in, every year, advising its policyholders of their fund value (which contained the (fund value) terminal bonus).

This may have created, in the minds of Equitable Life's GAR policyholders, a Type B expectation.

Equitable Life's guaranteed annuity rate, set in 1975, was 11.72% p.a. at age 65, some 40% above annuity rates of 8.37% p.a. current at the time of the Law Lords' judgment in July 2000. It is estimated that the aggregate fund value of the GARs might amount to about £8bn at policy maturity. As a consequence, if the expectations of the non-GARs and WPAs were not to be infringed, meeting a Type B expectation for the GARs would force Equitable to find spare financial resources (estate) of £3.2bn (8*0.4). Equitable Life, as a mutual life office without shareholders, would immediately have been made insolvent, as its philosophy was to have no estate.

If current annuity rates at age 65 had fallen to 7.0% p.a., as they have now done, and therefore guaranteed annuity rates were to become some 67% better than current annuity rates, the necessary estate required to meet a Type B expectation for the GARs, without infringing the expectations of the non-GARs and WPAs, would have amounted to £5.4bn (8*0.67).

The Practice of Other With-Profits Offices

Since the introduction of terminal bonus on with-profits policies some 30 years ago, it was accepted practice, in the light of the 1970, 1971 and 1978 Finance Acts and related Inland Revenue practices, to allow the fund value of a policy with annuity guarantees (GARs) to be applied on current annuity rates, when current annuity rates were above guaranteed annuity rates.

Other offices (i.e. other than Equitable Life) had granted a reversionary bonus as an enhancement to the initial annuity, and ensured that the scale of terminal bonus (applicable to a given policy) was not announced until shortly before the policy's maturity date. They were careful to ensure that the scale of terminal bonus was based on whichever had the higher value of: (a) £1 of cash; or (b) an amount £GAR p.a. of pension, i.e. the terminal bonus was the (annuity value) terminal bonus. Other offices did not send to their policyholders, each year, a fund value containing the (fund value) terminal bonus, i.e. the terminal bonus based solely on the value of £1 of cash, ignoring the level of current annuity rates.

Thus, offices (apart from Equitable Life) had been careful to give to their policyholders only a Type A expectation on their with-profits GAR policies.

Finance Acts and Inland Revenue Practice

Guaranteed annuity rates (GARs) of the order of 11% p.a. (for a male aged 65) were introduced mainly in response to various Finance Acts (particularly the Finance Acts 1970, 1971 and 1978) and Inland Revenue practices. For example, the 1970 and 1971 Finance Acts introduced the facility that a part of the pension could be commuted to provide a cash lump sum, and the 1978 Finance Act introduced the facility of transferring the policy to another office under the so-called open market option. Pension scheme rules had a requirement to build in annuity rates, and 11.11% p.a. was the annuity rate automatically approved by the Revenue. The pension scale, in public service schemes, of three-eightieths cash lump sum and one-eightieth pension, is equivalent to one-sixtieth pension on the basis of an annuity rate of 11.11% p.a. It was, therefore, not surprising that a typical annuity rate guarantee was also 11.11% p.a. It would have been unfortunate, to say the least, if, in trying to satisfy legislation and Inland Revenue practice, the life industry had inadvertently created a Type B expectation on its with-profits GAR policies. This would have been so serious as to threaten the very existence of the life industry.

Reasonable Expectations (PRE)

In the 1980s, the Actuarial Profession recommended to the life industry that it should drop guaranteed annuity rates on unit-linked policies yet retain guaranteed annuity rates in respect of with-profits policies. This would have been illogical if policyholder expectations under a with-profits policy were exactly the same as the expectations under a unit-linked policy. On a unit-linked policy, a Type B expectation was the only expectation possible.

Every with-profits GAR policyholder may have liked to have been given a Type B expectation. This was not the expectation that could be given, and was not given by life offices, except that certain Equitable Life GAR policyholders felt that Equitable Life's practice (not shared by other life offices) had led them to this expectation.

The practice of most life offices was to base terminal bonus on whichever had the higher value of: (a) £1 of cash; or (b) an annuity amount of £GAR p.a. This practice led naturally to a Type A expectation, i.e. a (Type A) floor pension, below which the pension payable could not fall, no matter what might happen to the stock market or how expensive annuity rates might become.

In contrast, policies without annuity guarantees (non-GARs) were hostages to fortune as to how low current annuity rates might fall — they had no floor pension of any type, and could only expect a pension of FV*CAR.

In the late 1990s current annuity rates were falling steadily, and, in about 1997, fell below typical guaranteed annuity rates of around 11% p.a. (for a male aged 65). It would have been reckless with the solvency of the life industry if policyholders with with-profits policies had been given a Type B expectation. For example, if current annuity rates had fallen to 5.5% p.a., as in Japan (one half of a typical guaranteed annuity rate), the life industry in the U.K. would have been either severely disrupted or rendered insolvent, as no life office would have had the spare financial resources to meet, fairly, a Type B expectation on its with-profits policies. To operate PRE fairly for all policyholders, a Type B expectation for the GARs would either: (a) have required an estate of 100% of the aggregate fund value of the GARs; or (b) shareholders would have been required to meet this cost. Shareholders would have been very reluctant to meet an additional cost of this size.

Policyholders' Reasonable Expectations in the Equitable Life Case and Representation of the non-GARs and WPAs

There were three classes of with-profits pension policyholder, namely: those with an annuity rate guarantee (GARs); those without such rates (non-GARs) — both classes not yet in receipt of their pensions; and with-profits annuitants (WPAs) already in receipt of their pensions.

Lord Scott and Lord Morritt concluded that a differential terminal bonus did not infringe the GAR contract, so there were only the expectations of the GAR policyholders to consider against the expectations of the non-GARs and the WPAs.

Certain GAR policyholders considered that, because of Equitable Life's practices, they had been given a Type B expectation. On the other hand, the expectations of the non-GARs and WPAs was that their fund value would not be reduced to pay for the GARs. Both of these expectations could not be afforded, as the philosophy of Equitable Life was to have no estate.

The question was: "Was the Type B expectation (of certain Equitable Life GAR policyholders) reasonable?"

There were many arguments on both sides, so Equitable Life turned to the Courts to judge the issue. The public assumed that the judges had been well informed, by the lawyers involved, on all of the complex issues involved. They are now asking whether this was true?

As Equitable Life could not afford a Type B expectation for the GARs without damaging the reasonable expectations of the non-GARs and WPAs, the case involved competing policyholders' expectations (PRE). The non-GARs and the WPAs feel, therefore, that they should have been legally represented in one contemporaneous legal action, as there was only one 'cake' to divide, and the 'cake' could not be made any bigger (as Equitable Life had no estate). It should be pointed out that, leaving Equitable Life aside, any other life office could only meet a Type B expectation on its with-profits policies, while at the same time meeting the expectations of its other policyholders, if it had a large enough estate.

Application to other Life Offices of the Law Lords' Judgment in the Hyman's Litigation

Certain life offices, despite having given a Type A expectation on a with-profits GAR policy, have, in my view, unnecessarily implemented the Law Lords' judgment in the Hyman's litigation. They now give with-profits policyholders the expectation that the fund value (FV) will be applied on whichever is the better of GAR or CAR (i.e. a Type B expectation). These life offices seem, in my view unnecessarily, to be exposing their with-profits funds to the very risks which the Actuarial Profession felt, as early as 1980, to be too dangerous.

Mr C. D. Sharp, F.I.A.: The Penrose Report contains a useful summary of the origin of the phrase 'policyholders' reasonable expectations', but does not go to the heart of the matter, which is that this phrase is a 'value judgement', and, as such, calls for each individual to assess what he or she would consider to be 'reasonable' according to their particular 'values'. Now, the word 'values' lacks definition, but, having studied the subject for many years, I suggest that the best general definition is an 'individual's habits of thinking about ethical issues'. Specifically, our values largely determine the extent to which each of us is prepared to modify action in our own self interest to allow for what we consider the 'legitimate' interests of others.

The Law Lords drew attention, in their decision, that they could only rule on the specific questions put to them by Counsels representing the parties involved. By implication, this means that, if different questions involving wider issues had been put to them, their decisions could have differed. While they were only asked to decide what was 'right and just' in the request of the GAR policyholders, the reality was that they were implicitly involved in conflicting 'rights'. In restricting themselves to the PRE of the GAR policyholders, they automatically ignored the PRE, not only of all the other holders of with-profits policies, but also the tens of thousands of holders of non-profit pensions and other annuities.

This is because the Standard & Poor rating of the Equitable's financial standing, over the years, went from their top grading to ungradable!

If the holders of a contract with a GAR had been asked whether he considered it 'reasonable' for the Equitable Life directors to take all 'reasonable' steps to keep a 'fair' balance between their interests and the interests of all the other policyholders, some, at least, must have agreed. The directors, relying on specific powers given to them by the wording of their policies and their constitution (in a mutual company each policyholder automatically subscribes to that), decided to reduce the final bonus to the GAR policyholders. This was in accord with actuarial practice and legal opinion at the time. In their blinkered response, the Law Lords considered that PRE over-rode all other considerations.

Therefore, 'in the public interest', and with these factors in mind, if their attention had been drawn to them, the Law Lords could well have come to a different conclusion.

And that is the heart of the matter — we have legislation with which we are called to comply, which is obviously uncertain in its effect, and that must be the way to chaos. How then should we act?