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## 2 Corporate Review

The Society's Chairman, Vanni Treves and Chief Executive, Charles Thomson, on behalf of the Board, review 2003



**Dear Members,**

**In the Annual Report last year, your Board expressed cautious optimism about the Society's prospects.**

**We are pleased to report that this judgement was not misplaced. 2003 was a year of steady progress and improving stability, building on the foundations laid in the previous year.**

**The Society is solvent and more than satisfies the minimum capital requirements of the Financial Services Authority (FSA).**

The key measure of solvency at the Society, the Fund for Future Appropriations, stands at £542 million. As a proportion of the with-profits fund it now stands at its highest level since early 2002.

The Society has experienced a major reduction of both maturities and surrenders, particularly in the second half of 2003.

It is no comfort to see other life and pensions companies making drastic reductions in payouts, but it does serve to illustrate how challenging the economic climate has been in the last few years. It also explains why your Board, inheriting a company in a fragile financial condition, needed to act in ways that have now been followed by much of the industry.

### **The Penrose Report**

Since we last wrote to you in the Interim Accounts in November, the Government published, as recently as 8 March, the report by Lord Penrose. We are pleased the report was published in full and we continue, where appropriate, to consider its contents very carefully.

However, it is clear that Lord Penrose's report is no whitewash. He is direct and forthright in his condemnation of the past, particularly in expressing his views of the actions, inactions and omissions of the regulators and former management alike.

The report highlights a litany of failure by the regulatory regime and Lord Penrose pulls no punches in saying so. He stresses regulation was "inappropriate", that Government departments "failed", that the Treasury was "wholly passive" and Government actuaries "complacent".

The new Board believes the former directors made serious errors in the management of the Society. That is why we are pursuing a claim against them, as well as a claim against the Society's former auditors, Ernst & Young.

The Board is working with its legal advisers to see if the Society has a cost-effective and sustainable legal case against any regulatory regime. This would cover action the Society could take, action policyholders could mount and whether there are any effective challenges through the UK or European courts. The legal hurdles are very high, the costs would be enormous and it would take years to come to trial – consider the BCCI action in court now following its closure in 1991. However, if (but only if) there is such a case, we will pursue it.

We have called on the Parliamentary Ombudsman to reopen her inquiry into

The Board has assessed the probability of further claims arising from the publication of Lord Penrose's report and, on the basis of current information and having taken legal and actuarial advice, our view is that his report has not raised new issues which will result in any material adverse financial consequences for the Society.

the regulation of the Society now that she has access to Lord Penrose's report. We have also suggested that the Parliamentary Ombudsman seeks to involve Lord Penrose to assist in her investigation. The Ombudsman's original inquiry only covered the period after 1 January 1999 (when the FSA took over regulation) and concluded that by that time the "die was cast" and it was too late for the FSA to influence events significantly. This serves to focus attention on the earlier period of regulation, which Lord Penrose has studied in depth.

The Parliamentary Ombudsman is an important channel for this work for four significant reasons:

- She can investigate whether there was maladministration by regulatory bodies criticised in Lord Penrose's report including the Department of Trade and Industry and the Treasury. Her remit should also be extended to include the Government Actuary's Department;
- She has the statutory power to recommend Government compensation without establishing blame to the standards required by the courts;
- She is likely to reach a conclusion in a fraction of the time any legal action would take;
- Her investigation does not cost the Society or its policyholders any money.

Above all, whether or not any compensation is payable, the Parliamentary Ombudsman could bring independence and finality to the matter.

#### Other issues

Allegations of fraud have been made from time to time although no proceedings have been issued. This is not a new concern. As we have previously stated your Board has found no evidence that could lead to a sustainable case of fraud in relation to those allegations against the Society. In the event that any proceedings were issued, they would be defended vigorously. Both Lord Penrose and the Treasury have asked the Serious Fraud Office (SFO) to look at certain issues in Lord Penrose's report. We will co-operate fully with the SFO.

There exists the possibility that further claims could be made against the Society, alleging mis-selling not already addressed, or otherwise seeking compensation from the Society. In particular, such claims could be made following the publication of Lord Penrose's report, or as a result of criticism of the historic conduct of the Society, or of former management and advisers, following any FSA investigations or disciplinary or other reviews by the actuarial and accounting professions. This includes possible claims following Lord Penrose's suggestion that over-allocation of bonus during the 1990s led to the policy value reductions in July 2001. The Board

notes that Lord Penrose acknowledges that his work in this area was "necessarily crude". In fact, these policy value reductions were very largely a response to events in 2000 and 2001 including market falls.

In his own 'postscript', having considered claims put to him by policyholders, Lord Penrose refers to "potential problems of entitlement to compensation and quantification of loss, where loss was recoverable, of considerable complexity." Lord Penrose's remit was not to apportion blame or to consider the issue of compensation and he makes it very clear that his report "has not provided answers to two questions; who is at fault? ... and who deserves redress ...?"

The Society is currently advised that it has very substantial defences to further claims that might be asserted and, indeed, that any such claims would be, as Lord Penrose indicated, complex and would be enormously difficult to litigate.

The Board has assessed the probability of further claims arising from the publication of Lord Penrose's report and, on the basis of current information and having taken legal and actuarial advice, our view is that his report has not raised new issues which will result in any material adverse financial consequences for the Society.

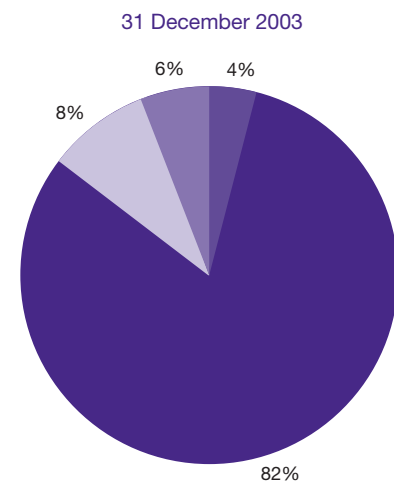
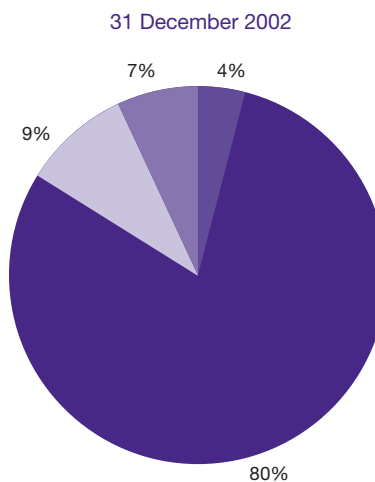
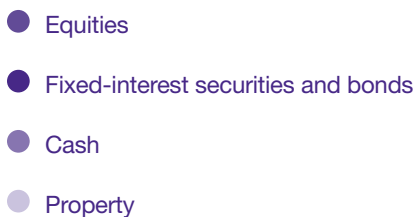
The Government's response has been, so far, to reject calls to consider compensation. Instead, it encourages policyholders, who think they may have

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### The picture today

#### Asset Mix



a compensation claim, to go to the Financial Ombudsman Service (FOS) or to the courts.

Your Board rejects the Government's attempts to deflect attention away from itself and on to the Society. In the interests of continuing policyholders, the Board will actively challenge any claims or decisions by the FOS which it considers to be wrong. We are keenly aware that it is the continuing policyholders – not those who have left – who must bear the financial burden of any successful claims.

The Society has come through a series of tough challenges in the past three years and, although not financially strong, it is still standing, is stabilising and is solvent. We must keep it that way. We have made appropriate provisions to

cover claims we know about. Any unsubstantiated new claim against the fund will be challenged with vigour.

#### Strategic objectives

The Society's business objectives continue to be to:

- Resolve outstanding claims against the fund;
- Stabilise the with-profits fund to ensure its continued solvency;
- Ensure we meet the guarantees provided to policyholders by pursuing an appropriate investment strategy;
- Reduce expenses and restore an efficient business model.

The important progress we have made towards these objectives is reported in this Review and the Financial Review.

#### 2003 bonus declaration

During the last 12 months significant progress has been made to meet the new regulatory requirements of the "realistic" balance sheet reporting framework. This is part of the new regulatory solvency reporting requirements which are expected to be formally introduced for 2004. The likely general effect is to increase the capital requirements for a with-profits fund. For this reason, we are holding back a margin of 1% per annum from the investment return in order to meet the cost of guarantees and provide some additional risk capital. If future experience allows, it will be possible to gradually release some or all of the margin back to with-profits policyholders and to increase policy values at a faster rate.

Significant progress has been made to meet the new regulatory requirements of the “realistic” balance sheet reporting framework.

The Financial Review details the issues the Board considered in reaching its bonus decision, which included balancing the changing regulatory requirements with the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of policies as fairly as possible.

In determining the amounts payable under with-profits policies the Board aims to treat all with-profits investors fairly, taking account of the returns earned on the underlying investments and also the requirement to honour guarantees already granted to policyholders.

The Society has announced the following bonus decisions:

- For 2003, there is no reversionary bonus. However, guaranteed benefits will be increased for those policies containing a Guaranteed Investment Return (GIR) at the rate set out in the policy conditions.
- Policy values (or their equivalents) will be increased for all UK with-profits pensions policies at an accrual rate of 2% per annum (p.a.) for the whole of 2003 (1.5% p.a. for UK life policies). This applies equally to GIR and non-GIR policies. The effect is a slightly lower return than the interim rate of 3.5% p.a. which applied from 1 April 2003.
- From 1 January 2004 until further notice, a non-guaranteed interim

bonus will be added to policy values (or their equivalents) at the overall rate of 2% p.a. for UK with-profits pensions policies (1.5% p.a. for UK life policies).

With-profits annuitants have been reminded that the Society is still in the process of recovering their share of the Guaranteed Annuity Rates (GAR) cost from them, by withholding 1.5% of final bonus for two more years. However, the Board is able on this occasion to defer this recovery for this year. This means that all with-profits annuitants will get the benefit of the 2% award for 2003.

#### **GAR Rectification Scheme and Managed Pension Review**

This time last year the Board announced that we had decided to withdraw the original GAR Rectification Scheme. That scheme was launched by the Society's former Board, to compensate holders of GAR policies who retired before the House of Lords' ruling in 2000. However, it had proved to be too slow, too complex and potentially unfair to continuing members.

The new Rectification Scheme was launched last November and over a thousand offers have already been made. This scheme is on course to complete this year. The version of the scheme designed for group pension schemes is nearing completion and details will be sent to trustees shortly.

The review of the sale of managed pensions (also known as income

drawdown policies) is progressing and we expect to have completed most cases by the end of the year.

The progress now being made in these projects represents an important step towards stability. The large provisions for these schemes in our accounts are based on forecasts that are inevitably uncertain and that uncertainty can only be completely removed by the completion of the reviews.

#### **Complaints by former non-GAR policyholders**

During 2003, the Society wrote to former non-GAR policyholders, representing 16,000 policies, inviting them to let us know if they felt they had a valid complaint against the Society in relation to the GAR issue. Good progress has been made in dealing with those former policyholders who have responded to the Society and the financial uncertainties have been significantly reduced.

With respect to the complaints at the Financial Ombudsman Service, the Society has received a preliminary view from the FOS that it is considering a different approach to redress from that of the Society for some cases. The Society has made representations to the FOS that the appropriate approach to assessing compensation in cases such as these should be based on the Society's own legal opinion, which is consistent with the published legal advice obtained by the FSA. We have

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made representations to the FOS, but it could be many months before the matter is finally resolved, particularly if the matter ultimately requires resolution by the courts.

### Litigation by the Society

In February 2003, the High Court accepted Ernst & Young's application to have part of the Society's claim against them struck out. In July 2003, the Court of Appeal overturned that decision, substantially reinstating our claim.

In October 2003, the High Court rejected the application by the former non-executive directors to strike out the claim against them and permitted the Society's case to go forward against the whole group of 15 former directors.

The Society was awarded costs in both cases and the decisions have vindicated your Board's action to pursue this important litigation in the interest of policyholders. The trial of both claims is due to commence in April 2005.

Your Board decided to act on these claims only after a careful assessment with our legal advisers of the likely financial rewards and the chances of success. These actions are expensive and in 2003 the litigation costs amounted to £7.9m. The Board regularly reviews with its legal team the progress and cost justification of the claims and we remain of the view that we have strong and substantial claims to assert. Any compensation the Society receives will be added to the with-profits fund for

the benefit of continuing with-profits policyholders.

### With-profits annuity payments

With-profits annuitants were issued with a letter in January 2004 explaining the second stage in the process to bring them into line with the Society's other with-profits policies. Once completed, the only remaining adjustment would be to recoup the remaining 3% related to the House of Lords' judgment. As noted earlier the adjustment has been deferred for this year.

The amount of future with-profits annuity payments depends on the performance of the with-profits fund and the 'anticipated bonus rate' chosen when the policy started. Broadly, each year the income level reduces at the anticipated bonus rate and increases by the bonus added. Policyholders generally chose the anticipated bonus rate at a time of higher inflation and higher expected investment returns. With lower inflation and low investment returns, many with-profit annuitants will see further falls in their income when the increase in bonus falls below their anticipated bonus rate.

### Investments

The Society's investment strategy continues to be to hold very little in equities in order to minimise the risk to solvency from volatile equity markets. The asset mix in percentage terms has changed little over the year. This has been the result of careful management of

asset sales in anticipation of the reduction in the size of the fund. That has been more straightforward in 2003 as the amount of funds withdrawn by policyholders has fallen considerably.

### Customer service

Members will be only too aware of the impact the last few years have had on customer service.

Customer service has improved a great deal but has not fully recovered to the levels which we believe are appropriate. However, progress has been made and the Society continues to work with HBOS – to whom our administration is outsourced – to make improvements.

### Expenses

Last year we reported on the high levels being experienced in both exceptional and non-exceptional expenses. Total expenses have been significantly reduced in 2003, but the assumed future expenses incorporated into the provisions are expected to remain at a high level for some time. This is an area on which we continue to focus, in line with our objectives.

### Board changes

We must take this opportunity to put on record our thanks to Sir Philip Otton, deputy chairman and former Lord Justice of Appeal, who retired at the end of 2003, aged 70. Sir Philip was the senior independent non-executive Director, chairman of the Legal Audit

We still have many issues to resolve – clearly many uncertainties still remain – but we hope and believe the dark clouds overhanging the business are slowly drifting away.

Committee and chairman of the Remuneration Committee. We are grateful to him for all his efforts on behalf of members to lead us through many of our legal challenges to calmer, clearer waters.

Sir Philip has been replaced by Peter Smith as the senior independent non-executive Director, by Fred Shedden as chairman of the Legal Audit Committee and by Jean Wood as chairman of the Remuneration Committee.

### Looking ahead

The past two years have been very difficult and challenging. The enormous benefits of the Compromise Scheme were obscured by the turbulent economic conditions. Your Board fought hard to steady matters and this gave us the confidence to express cautious optimism early in 2003.

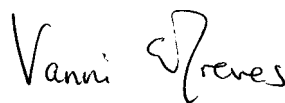
That cautious optimism was not misplaced. 2003 has been another testing year but also a year of steady progress and relative stability.

The Society had already gained a great deal of knowledge of the issues facing the Society. Lord Penrose has restated some of those, but, having taken advice, the Board does not believe that he has identified any new issue which will have a materially adverse effect on the Society.

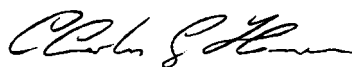
We still have many issues to resolve – clearly many uncertainties still remain – but we hope and believe the dark clouds overhanging the business are slowly drifting away. As we continue to achieve greater stability, we plan to develop further our ideas for the longer term future of the Society. We will share our proposals with members at the appropriate time when they have taken sufficient shape.

Meanwhile policyholders can be certain of this: that the Board's overriding objective is to act in their long-term interests, as it has done since taking office three years ago.

### Vanni Treves and Charles Thomson on behalf of the Society's Board of Directors.



Vanni Treves  
**Chairman**



Charles Thomson  
**Chief Executive**

## 8 Financial Review

### Fund for Future Appropriations and regulatory solvency

The Society's net resources, after allowing for its liabilities, are represented by the Fund for Future Appropriations (FFA). This amount is available to meet its non-guaranteed bonuses and any unforeseen liabilities or liabilities in excess of those provided for at the balance sheet date.

At 31 December 2003, the FFA balance was £542m, a reduction of £14m from the prior year.

The movement in the FFA during 2003 is shown in the following table:

	2003 £m	2002 £m
Opening balance	556	1,105
Increase in provisions and expenses	(179)	(242)
Changes in net asset values and valuation rates of interest	159	(80)
The effect on FFA of policy maturities and surrenders	20	(211)
Contractual cost of HBOS past service pension funding	5	(106)
Elimination of provision for future discretionary guaranteed bonus for non-Guaranteed Investment Returns (non-GIRs)	–	241
Change in mortality assumptions	–	(179)
Other movements	(19)	28
Closing balance	542	556

The principal changes in the FFA are explained in more detail in later sections of this Review.

The Society seeks to maintain the FFA balance at a level, which protects solvency whilst treating exiting policyholders fairly. Accordingly, it would be expected to fall over the longer term as the fund size reduces. The FFA balance at December 2003 represents 5.7% of with-profits reserves, which compares with 4.7% at December 2002. Whilst the balance of the FFA has fallen marginally over the year as a whole, it improved in the second half of the year. As the number and value of policies decline, the relative importance of the level of provisions and their related uncertainties increases in considering the adequacy of the FFA to address the risks facing the Society, unless they can be reduced proportionally.

When assessing solvency, it is the Society's ability to pay its guaranteed obligations to policyholders that is most significant. The guaranteed obligations



The Society aims to manage the run-off of the fund without building up excessive amounts of capital.

include reversionary bonuses on with-profits policies that have already been declared in respect of previous years. The guaranteed obligations do not include any allowance for non-guaranteed bonuses.

The policy value attributable to with-profits policies often includes an element of non-guaranteed final bonus accumulated to date. It is important to recognise that the estimated final bonus, sometimes referred to as the terminal bonus, included in the policy value is not guaranteed and is therefore not included in either the valuation of the long-term business technical provision or as part of the solvency calculations. In accordance with current actuarial and accounting guidance and industry practice, only guaranteed obligations are included in the valuation of the long-term business technical provisions included in the balance sheet.

In assessing the Society's ability to meet its obligations as they fall due, the FFA is a more relevant measure than the excess of net assets over the Required Minimum Margin (RMM), which forms part of the separate set of financial statements sent to the Financial Services Authority (FSA). The RMM is calculated by the application of specified factors to the policy reserves and acts as a minimum level of required capital. If the Society's net assets fall below RMM, the FSA has powers to require that certain information and plans be prepared to demonstrate how the Society would

The following table shows the interaction between the figures for the FFA and the excess of net assets over RMM for the Society:

	2003 £m	2002 £m
FFA	542	556
Subordinated debt (note 1)	312	346
Implicit item (note 2)	–	200
Reserving adjustments and disallowed assets (note 3)	(8)	(23)
Regulatory net assets	846	1,079
RMM	623	723
Excess of net assets over RMM	223	356

(1) For the purposes of RMM reporting, the subordinated debt can presently be treated as capital. This is achieved in practice by disregarding as a liability the inter-company loan from Equitable Life Finance plc (issuer of the subordinated debt) up to an amount not exceeding 50% of the Society's RMM. Because of the reduction in the RMM, the amount to be taken into account for the subordinated debt has been reduced accordingly.

(2) The implicit item is a concession, available to insurance companies, which is granted in certain circumstances by the FSA to permit margins in the reserving basis, from business previously written, to be taken into account. The FSA is in the process of eliminating reliance on implicit items in the regulatory returns of insurance companies. Accordingly, and in contemplation of the changes to be introduced in regulatory reporting, the Society has decided not to take an implicit item into account at December 2003. There remains an excess of regulatory net assets over RMM without recourse to the use of implicit items.

(3) Certain balances are required to be held at values that are measured on bases different from those adopted for the Accounts or otherwise are treated differently between the FSA Returns and Accounts.

correct the position. However, if the Society has a positive FFA, and can meet its liabilities as they fall due, it will remain solvent even if the RMM is not met.

In addition to its requirement that net assets be compared with RMM, the FSA is to introduce new requirements for the measurement of financial strength in the annual regulatory returns. The Society will be required to report its net asset position under "realistic balance sheet" reporting at the end of 2004. Under this reporting basis, unlike the statutory basis, non-guaranteed final bonuses are

included as liabilities. In determining its realistic position, the Society takes credit for an ongoing margin of 1% per annum against future investment income, in order to meet the cost of guarantees and provide some additional risk capital. If future experience allows, it will be possible to release some or all of those margins to with-profits policyholders gradually over time and increase policy values at a faster pace. With this approach to managing policy values, the Society aims to manage the run-off of the fund without building up excessive amounts of capital. However, if there is

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continued

adverse experience in future, for example in investment returns, mortality experience or changes in the level of provisions, it may be necessary to reduce policy values. The FSA's requirements in respect of realistic balance sheets continue to evolve, but initial estimates indicate that the required risk capital margin of the Society can be met in this way. It is unclear at this time what the FSA's requirements will be in respect of individual capital assessments and their applicability to closed mutual insurance companies, such as the Society. Any developments in regulatory requirements may also impact on the Society's approach to managing policy values and payouts.

### **Protection of the fund and policy surrenders**

Where a policyholder surrenders his policy (or switches to a unit-linked fund) before maturity, contractual obligations in respect of payouts under the policy generally do not apply. The Society takes account of the interests of all policyholders in these circumstances by paying the policy value (or equivalent), less a financial adjustment. The financial adjustment can be changed at any time without advance notice to policyholders. In setting the financial adjustment, the aim is for the amounts paid to surrendering policies to be fair, but not disadvantage continuing policyholders. In particular, the amounts paid to surrendering policyholders should not

reduce the payout prospects of the continuing policyholders. There has been no change to the level of the financial adjustment in 2003, being 11.1% for most products.

Any reduction in values of property or assets other than fixed-interest securities is not offset by a reduction in guaranteed liabilities, so that any future adverse change in the Society's financial circumstances resulting from a significant fall in net asset values or increase in provisions or non-matched liabilities would necessitate policy value reductions.

Where the Society is forced to sell fixed-interest securities to its disadvantage before their relevant maturity dates, in order to make payments to surrendering policyholders, the position of assets and liabilities ceases to be matched.

In such circumstances, those policyholders would be expected to bear the related costs incurred, by way of a higher financial adjustment.

### **Investment performance and capacity to pay bonuses**

During 2003, the Society continued to operate the more cautious investment strategy, introduced in the previous year, of retaining a significantly reduced proportion of the with-profits fund in equities, in order that its liabilities be matched more closely.

The weighting in favour of fixed-interest securities and bonds within the investment portfolio results in there being

limited scope for its growth, as any changes to values resulting from movements in yields are mirrored in equivalent and largely offsetting changes in the value of liabilities. The key consideration with such a portfolio is the yield on the fixed-interest securities and bonds on acquisition; any subsequent changes in market values and yields have no impact on the coupons actually received, or on the amount obtained on redemption. Any change in market yields on the assets is matched by a corresponding change in the yield used to discount the guaranteed liabilities.

Any uplift in equity values in the market generally has little direct impact on the value of the Society's assets and on its ability to boost future rates of bonus. The ability to increase policy values depends to a considerable extent on the returns achieved on the Society's property and private equity portfolios - the value and liquidity of these assets could be affected by adverse market conditions. It is also dependent on actual and expected expense levels, the expected cost of guarantees, miscellaneous profits and losses (including those from non-profit business) and changes in the level of provisions.

The Society's limited exposure to the equity market in 2003 meant that the with-profits investment assets produced a positive return of 4.2% during the year, and 2.7% after allowing for the impact of provisions, expenses and mortality reserves and any changes to those

The Board has increased policy values at the rate of 2% per annum (1.5% per annum for life assurance policies) for applicable with-profits policies for 2003.

amounts. In determining bonus policy, the Society needs to consider the longer-term picture and aims to balance the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of its policies as fairly as possible.

As noted above, with the introduction of realistic balance sheet reporting, it is necessary for the Society to retain greater amounts of capital. Accordingly, after consideration of these matters, the Board has increased policy values at the rate of 2% p.a. (1.5% p.a. for life assurance policies) for applicable with-profits policies for 2003. These rates will also be applied as the interim growth rate for policy values in 2004. The Board may change interim rates during the year and at the time when it considers policy values after the end of the year.

Policyholders should note that, in order to meet all its future contractual liabilities for the foreseeable future, any new distributions of surplus will be made in non-guaranteed form, and there is no expectation of any further reversionary bonus being awarded in the near to medium term. Accordingly, there will be no reversionary bonuses for 2003. However, for those policies with GIRs, the value of the guaranteed benefit is increased at the rate set out in the policy conditions, typically being 3.5% p.a.

### Expenses and provisions

Expenses shown in the Profit and Loss Account, incorporating administration, exceptional, claims and investment costs, have reduced to £168m in 2003 from £353m in 2002. Lower administration and claims costs reflect lower levels of activity as the run-off in the business decelerated in 2003. Investment costs have declined in line with the reduction in funds invested. In addition, the prior year figures included a provision of £106m for contractual costs in respect of pension obligations and an expense of £23m incurred in meeting retention, severance and redundancy costs relating to former employees who transferred to HBOS.

Balance sheet provisions, included as part of the technical insurance provisions, have been increased over the year, as reported at the interim stage. The rectification and managed pension provision has grown marginally by £10m, but has reduced from the half-year level as interest rates have changed and claims have begun to be settled. The provision for exceptional expenses has been increased marginally at the year-end and further details are provided later in this Review. Other miscellaneous liabilities have increased during 2003, principally in the first half, and reflect the outcome of a review of possible claims for miscellaneous mis-selling, net of settlements. In addition, appropriate provision has been made for the estimated costs relating to settling the

value to be ascribed to assets transferred as part of the reinsurance of the linked and non-profit book to a subsidiary undertaking of HBOS in 2001, further to recent representations made by HBOS in respect of the complex actuarial and legal matters involved.

The above FFA reconciliation table shows an increase in provisions and expenses, taken together, of £179m. Almost one third of the increase results from technical adjustments to assumptions in respect of future policy expenses, as those policies run off. A variety of other factors have caused the balance of the increase. Reference has been made above to the changes in provisions at the balance sheet date. It continues to be an expensive process, both in terms of legal and advisory and contractors' costs to put processes in place to review and make payments. In addition, the continuing complexity of the Society's affairs has resulted in providing for an organisational infrastructure substantially greater than would be the norm in run-off situations and which is likely to be required for a longer period than anticipated.

The Society, in undertaking its responsibility to be fair to all members, including former members such as former non-GAR policyholders, adopts a robust procedure for dealing with mis-selling claims, which has been discussed with the FSA. However, there remain inherent uncertainties in establishing appropriate values relating to certain

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provisions, both mis-selling and rectification, including the appropriateness of assumptions relating to take-up rates and the applicable split of claimants into categories representing the most appropriate form of redress. There continues to exist the possibility of changes arising from regulatory interpretations or requirements. There remains, moreover, the risk of exposure to other claims or that the provisions prove insufficient. There also remains the possibility of a return in the future to a situation of volatility in the number of policy exits, with related increases in costs.

Because of the contractual arrangements in place, the outsourcing of administration activities to a third party causes inherent uncertainties in estimating future expense levels. Discussions with HBOS continue in relation to the negotiable issues under the outsourcing contract with a view to effecting savings in relation to their recharged costs.

### **Actuarial assumptions and asset values**

The FFA reconciliation table shows a net figure of £159m for changes in net asset values and valuation rates of interest. Gains were recorded in equities and unit trusts of £57m. There were minor changes in other asset values. Technical and valuation adjustments account for the balance. The valuation rates of interest, applied to calculate technical

provisions, have been updated to reflect asset yields.

In providing for mortality, the Society continues to incorporate assumptions, which reflect the latest research by the actuarial profession with regard to assumed improvements in life expectancy. Ongoing research may result in a requirement to re-evaluate mortality reserves.

No provision is made for future discretionary guaranteed bonuses. It is the Society's intention that any future bonuses will be in a non-guaranteed form. Allowance is made for continuing contractual commitments, such as the GIR of 3.5% per annum that is applicable to many policies. In valuing the liabilities in respect of those policies, it is assumed that the relevant duration is to the first contractual date. If the market level of fixed-interest yields falls below this rate, higher reserves would be required.

### **Maturities and surrenders**

During the year, and particularly in the second half of the year, the Society experienced a reduced level of both maturities and surrenders. Surrenders in 2003 were £1,788m (2002: £3,800m). Maturities and other claims totalled £1,910m (2002: £3,052m).

The Board has had to ensure that the amounts applied in settling claims do not impair the position of continuing policyholders. The application of this principle is closely monitored and

relevant potential courses of action to avoid undue strain on the FFA, including changes to policy values, are kept under continuous review.

### **Equitable Life Finance plc (ELF)**

The payment of principal and interest and all other monies payable by ELF, a wholly owned subsidiary of the Society, in respect of the £350m 8% undated subordinated guaranteed bonds, issued in 1997, has been irrevocably and unconditionally guaranteed on a subordinated basis by the Society.

If, when payment of interest in relation to the Bonds becomes due, the Society does not meet RMM as of the date of its latest actuarial valuation, then the payment will be deferred by ELF unless FSA consent to such payment is obtained.

The regulatory returns prepared as at 31 December 2003 show the Society's net assets to be in excess of its estimated RMM. However, there exists the possibility that the Society may not meet RMM at all times in the future. There is, therefore, uncertainty in respect of the payment of the interest on and principal of the Bonds, because Bondholders' interests are subordinated to those of the Society's policyholders and other creditors in the event of a winding up of the Society.

The Society will continue to need very diligent management of its risks and your Board will not hesitate to take appropriate action in any circumstances which jeopardise the fund's ability to meet guaranteed obligations to policyholders.

### **The Board's conclusions on provisions and going concern**

The Board is responsible for making a formal assessment as to whether the "going concern" basis is appropriate for preparing these accounts. The going concern basis presumes that the Society will continue to be able to meet its guaranteed obligations to policyholders and other creditors as they fall due. To do this, the Society must have sufficient assets not only to meet the payments associated with its business but also to withstand the impact of other events that might reasonably be expected to happen.

Considerable time has again been spent by the Board in examining the issues relevant to the going concern basis which, in summary, are mainly the exposure to: increases in provisions, investment losses, impact of discretionary bonus payments, future expense levels (including the costs of the continuing pension obligations to former staff) and mortality risks.

The financial position of the Society has been projected under a very wide range

of economic scenarios. The Board has also considered the level of contingent liabilities (that is, liabilities not recorded in the Accounts but which could conceivably arise) in its analysis of the Society's financial position. The results of this work show that the probability, over the foreseeable future, of the Society being unable to meet its guaranteed obligations to policyholders is not significant. The Board is confident of its ability to manage adverse scenarios that may arise, but there cannot be absolute assurance. In such circumstances, as with any other long-term fund, painful actions could be necessary to adjust maturity values, with-profits annuity payments and surrender values.

In addition, the Board has considered the potential additional claims referred to in note 23 to the Accounts, entitled "Contingent liabilities and uncertainties". The Board has assessed the probability of these uncertainties arising and on the basis of current information and having taken legal and actuarial advice, has concluded that it is highly unlikely they will result in any material adverse financial consequences. Certain of those

risks, in extremely adverse scenarios, could prejudice the continuing solvency of the Society.

The Board has given due consideration to all the potential risks and possible actions set out above and has concluded that it remains appropriate to prepare these Accounts on a going concern basis.

As a result of volatility in investment and property markets, the uncertain nature of provisions and the other potential strains on the Society's finances, and even though all these issues are subject to close management scrutiny, the Board recognises the possibility that the Society may not meet RMM at all times in the future. As noted above, any failure to satisfy RMM does not, of itself, cause the Society to become insolvent.

The Society will continue to need very diligent management of its risks and your Board will not hesitate to take appropriate action in any circumstances which jeopardise the fund's ability to meet guaranteed obligations to policyholders.

## 14 Board of Directors



**Vanni Treves** (a) (b) (c) (e)  
Chairman

Vanni Treves was appointed non-executive Chairman in February 2001. He chairs the Nominations Committee. He has been a solicitor for nearly 40 years, specialising in corporate law. He was 30 years a Partner, for 12 of them Senior Partner, at the leading law firm Macfarlanes. He has extensive experience on Boards, having been a Director (in the majority of cases Chairman) of six public companies, a statutory corporation and two common investment funds. Vanni is presently Chairman of London Business School and Korn/Ferry International UK and a Governor of the College of Law. He writes and lectures extensively on corporate governance. Age 63.



**Charles Thomson** (b) (e)  
Chief Executive

Charles Thomson joined the Board in March 2001. Since then, as Chief Executive he has restored the Society to a more stable footing through the compromise scheme. He has spent his entire career in the life assurance and pensions industry, having been Deputy Chief Executive at Scottish Widows and Chairman of the Life Board of the actuarial profession. He has served as Appointed Actuary to eight different companies. Age 55.



**Nigel Brinn** (d)  
Finance and Investment Director

Nigel Brinn joined the Board in February 2003. He is a Chartered Accountant and joined the Society after five years as Chief Executive of Homeowners Friendly Society. Previously, he was Managing Director of RAC Financial Services and held a number of senior Board-level executive and finance positions with TSB Group plc, Fidelity Investments, Lazard Brothers, Fairey Group and Allied Dunbar. Age 58.



**David Adams OBE** (a) (d)

David Adams joined the Board in April 2001. He was Finance Director from 1974 and Chief Executive from 1979 of Harrow Council. In 1987 he became Finance Director of the Railways Pension Scheme and was appointed Chief Executive four years later. From 1997 to 2000 he was Chief Executive of CIPFA. He is a Board member of the pensions regulator OPRA, and a non-executive Director of the Keystone Investment Trust plc and Dunnet Shaw Ltd. Age 64.



**Ron Bullen** (a)

Ron Bullen joined the Board in May 2002. He is a qualified Chartered Engineer who has spent his entire career in the manufacturing industry, primarily within the paper sector. From September 2000 until his co-option to the Board of Equitable Life, Ron was the Chairman of EPHAG, then the largest of the Equitable Life policyholder groups. Age 64.



**Michael Pickard** (a) (d)

Michael Pickard joined the Board in April 2001. He was a Director of the mutual insurance company, Royal London, for 22 years and among the positions he occupied were Appointed Actuary, Chief Executive and Chairman. He has been Deputy Chairman of the Association of British Insurers and a Director of the Personal Investment Authority. Since February 1999, he has been the part-time independent Chairman of Mirror Group Pension Scheme. Age 64.



**Fred Shedden** (b) (d)

Fred Shedden joined the Board in May 2002. He chairs the Legal Audit Committee. He retired in 2000 as Senior Partner of McGrigor Donald, a leading Scottish law firm. Between 1992 and 1999 Fred was a non-executive Director of Standard Life Assurance Company. He is currently Chairman of Halladale Group plc and Martin Currie Japan Investment Trust plc and is also a Director of a number of other listed and unlisted companies. He is also a member of The Scottish Further Education Funding Council. Age 59.



**Peter Smith** (a) (b) (c) (e)

Peter Smith joined the Board in April 2001. He chairs the Audit Committee. He is Chairman of RAC plc and a non-executive Director of N M Rothschild & Sons Limited. He was Senior Partner of PricewaterhouseCoopers until June 2000. Age 57.



**Andrew Threadgold** (d)

Andrew Threadgold joined the Board in April 2001. He chairs the Investment Committee. He started his career as a professional economist, holding positions at a range of organisations including the Bank of England. He subsequently moved into investment management and has been Chief Executive of PosTel (now named Hermes), the Investment Manager for the British Telecom and Post Office pension funds, and Chief Investment Officer for the large Australian life company AMP. Age 60.



**Jean Wood** (c) (d)

Jean Wood joined the Board in April 2001. She chairs the Remuneration Committee. She has worked for 25 years in the life insurance and pensions industry, in the UK, Ireland and Canada. Jean's work ranged from staff and management development to management of sales and marketing functions, leading to a position as Managing Director of a medium-sized life company, from which she retired in 1998. Age 61.

Key to membership of principal Board Committees

- (a) – Audit
- (b) – Legal Audit
- (c) – Remuneration
- (d) – Investment
- (e) – Nominations

## 16 Directors' Report

### Principal activities and business review

The Equitable Life Assurance Society (the Society) is the ultimate holding company of the Equitable group of companies (the Group). The principal activity of the Group during 2003 was the transaction of life assurance, annuity and pension business in the form of guaranteed, participating and unit-linked contracts. The Society closed to new business on 8 December 2000.

The results of the Group are presented in the Profit and Loss Account on page 27. The operations of the Group are described in the Corporate Review and Financial Review on pages 2 to 7 and 8 to 13 respectively.

### Valuation and bonus declaration

In accordance with the Society's Articles of Association and insurance company legislation, the Society's Appointed Actuary carried out a valuation of the assets and liabilities of the Society as at 31 December 2003. There is no guaranteed bonus for 2003 although those policies containing a Guaranteed Investment Return (typically 3.5%) will have this added to the guaranteed value of their policies as usual. The Board has increased policy values, or their equivalent, for UK with-profits pensions

policies at an accrual rate of 2% p.a. for 2003 (1.5% p.a. for UK life policies and 1.6% for the Personal Pension 2000 product). The 2003 bonus decision is dealt with in greater detail in the Corporate Review on pages 4 and 5.

### Directors

The Directors shown on pages 14 and 15 were Directors throughout the year except that Nigel Brinn was appointed on 20 February 2003. In addition, Sir Philip Otton, who retired on 31 December 2003, was a Director throughout the year. The three Directors retiring at the Annual General Meeting (AGM) by rotation are David Adams, Jean Wood and Fred Shedden, who offer themselves for re-election. There are no other candidates seeking election as Directors at the AGM.

### Employees

The majority of staff transferred to HBOS group companies at 1 March 2001.

Employees of the Society have been regularly informed of and consulted with on matters of concern to them.

It is the Society's policy to give equal consideration to disabled people as to others regarding applications for employment, continuation of employment, training, career

development and promotion – having regard to their particular aptitudes and abilities.

In relation to employment opportunities, the Society treats applications from all sectors of the community fairly and consistently. All applications for employment, consideration for continued employment, training opportunities, career development and promotion are fully considered with regard to an individual's particular aptitudes and abilities.

As a mutual company, the Society has no employee share scheme.

### Supplier payment policy

It is the Society's policy to agree the terms of payment on commencement of business with all suppliers and to abide by those terms. The average duration of amounts owing to suppliers at the year-end was 29 days (2002 – 38 days).

### Articles of Association

Proposed amendments to the Society's Articles of Association were circulated to members with the Notice of the Annual General Meeting held on 28 May 2003. These changes were approved by members at that meeting. The Society's Memorandum and Articles of Association are available on the Society's



website or a copy can be provided on request.

**Auditors**

PricewaterhouseCoopers LLP have expressed their willingness to continue in office and a resolution to reappoint them as auditors to the Society will be proposed at the Annual General Meeting.

**Signed on behalf of the Board**  
**V E Treves**  
**Chairman**  
**31 March 2004**

# 18 Corporate Governance

## 1. Introduction

The Society continues to aim to meet the highest standards in corporate governance and voluntarily adopts the relevant provisions of the Principles of Good Corporate Governance and Code of Best Practice (The Combined Code). The Board is responsible to the Society's policyholders for good corporate governance.

In July 2003, the Financial Reporting Council issued a revised Combined Code on Corporate Governance to come into effect for reporting years beginning on or after 1 November 2003. The Board has reviewed this revised code and has confirmed its intention to adopt the relevant provisions of the revised code for the Society's reporting years from 1 January 2004 onwards. Unless otherwise stated, references in the accounts to the Combined Code are to the code applying to reporting years commencing prior to 1 November 2003.

This report summarises the Society's governance arrangements and continued enhancements.

## 2. Governance by Directors

### The Board

The Board meets regularly to lead, control and monitor the overall performance of the Society. Senior management supply the Board with appropriate and timely information and are available to attend meetings and answer questions. The Directors are free to seek any further information they consider necessary and advice from the Company Secretary or independent professional advisers. Authority is delegated to the Chief Executive for implementing strategy and managing the Society. There is a formal schedule of matters reserved for the Board's decision.

The roles of Chairman and Chief

Executive are separated and the Chairman has primary responsibility for the effective functioning of the Board.

### Executive Directors

The Board has two executive Directors, the Chief Executive and the Finance and Investment Director.

### Non-executive Directors

There are eight non-executive Directors on the Board, whose diverse experience, skills and independent perspective provide an effective review and challenge of the Society's activities.

The Chairman, Vanni Treves, and the Deputy Chairman, Peter Smith, are elected by the Board. Peter Smith has been nominated as the senior independent non-executive Director. The Board members are described on pages 14 and 15.

All Directors hold policies with the Society. In the opinion of the Board, in no instance do these interests interfere with the independence of the relevant Director.

The Remuneration Report on pages 21 to 24 explains the basis of remuneration of the executive and non-executive Directors.

### Appointments to the Board

Directors must retire and seek re-election at the first Annual General Meeting following appointment. The Society's Articles require one-third of the Directors who are subject to retirement by rotation to retire at each Annual General Meeting and also that all Directors must submit themselves for re-election by rotation at an Annual General Meeting at least every three years. All appointments are subject to review by the Board, as advised by the Nominations Committee, at intervals not exceeding three years. The Board policy on remuneration is set out in the Remuneration Report.

### Board Committees

The Board formally delegates specific responsibilities to five Board Committees, supported by senior management, which are established by the Board.

#### *The Audit Committee*

Peter Smith chairs the Audit Committee, currently comprising five non-executive Directors. It meets at least four times a year, frequently more often, and assists the Board in fulfilling its responsibilities in respect of the Annual Accounts, Interim Accounts and Annual Regulatory Returns to the FSA. It also reports to the Board on the accounting policies, systems of internal control and conclusions from risk management and internal control reports. The external auditors attend key meetings and have direct access to the Chairman of the Committee. The Committee keeps the relationship between the Society and its auditors under review and considers their independence, including the extent of their fees from non-audit services.

#### *The Investment Committee*

Andrew Threadgold chairs the Investment Committee, currently comprising five non-executive Directors and the Finance and Investment Director. It normally meets bi-monthly. It sets policy for strategic asset allocation for the with-profits, non-profit and index-linked funds, delegating implementation to the Finance and Investment Director. It also oversees the activities of the Society's investment managers.

#### *The Legal Audit Committee*

Until his retirement as a Director on 31 December 2003, Sir Philip Otton chaired the Legal Audit Committee. Since 1 January 2004, the Committee has been chaired by Fred Shedden and comprises three non-executive Directors and the Chief Executive. It considers significant legal matters in particular in relation to claims by the Society against previous professional advisers, Directors and

management of the Society and any other significant legal issues. The Committee meets as required by the demands of the business. The Chairman invites representatives from Herbert Smith, management and other professional advisers to attend as appropriate.

#### **The Remuneration Committee**

Until his retirement as a Director on 31 December 2003, Sir Philip Otton chaired the Remuneration Committee. Since 1 January 2004, the Committee has been chaired by Jean Wood and comprises three non-executive Directors. The Committee is responsible for recommending to the Board the terms of remuneration for executive Directors and non-executive Directors, including incentive arrangements for bonus payments.

#### **The Nominations Committee**

Vanni Treves chairs the Nominations Committee, comprising two non-executive Directors and the Chief Executive. The Committee meets as necessary to consider and make recommendations to the Board regarding the appointment of Directors and the continuing suitability of the Society's Directors.

#### **Taking advice**

The Board and its Committees, subject to defined procedures and parameters, take advice from professional advisers, enabling them to manage the risks and issues arising from the Society's affairs.

Each Director has access to the Company Secretary. They may also obtain independent professional advice, at the Society's expense, about any matter concerning the Society relevant to their duties, subject to defined procedures and parameters.

#### **Subsidiary company governance**

The Society's main subsidiaries throughout the year were University Life Assurance Society (University Life) and Equitable Life Finance plc.

University Life, a life assurance and annuity business, has been closed to new business since 1976. It has a separate Court of five Directors (three of whom are Directors of the Society) and its Chairman is Michael Pickard.

Equitable Life Finance plc issued and manages £350 million 8% Undated Subordinated Guaranteed Bonds, the proceeds of which are lent to the Society. The company has a separate Board comprising two Directors (who are Directors of the Society). Its Chairman is Charles Thomson.

The Court of University Life meets at least quarterly and the Board of Equitable Life Finance plc meets as necessary to consider all matters relevant to the effective operation of the respective companies' continuing business, including governance.

Each of the other subsidiary companies has a Board of Directors that meets as appropriate to consider the matters relevant to those companies.

### **3. Management of Society**

The Executive Team meets regularly, usually weekly, to manage business activities. Papers are prepared and presented to the Board and its Committees, by the Executive Team. The Appointed Actuary, David Murray, who is not an employee of the Society, makes recommendations on bonus and payout levels in relation to the different classes and generations of policyholders. It is the Board's responsibility, based on these recommendations, to seek to achieve fairness between these different classes and generations. The Appointed Actuary also provides advice to the Chief Executive and the Finance and Investment Director on matters relating to obligations to the policyholders. In addition, he reports to the Board on the financial position of the Society and on regulatory returns to the FSA. The Appointed Actuary acts as the Reporting

Actuary for the purposes of these Accounts.

The Society retains responsibility for investment strategy and policy, instructing independent investment managers and advisers to implement desired changes to asset allocations within the portfolio. The Finance and Investment Director, taking advice from the Appointed Actuary, liaises with the investment advisers to oversee day-to-day investment matters.

### **4. Accountability and Audit**

The Directors are ultimately responsible for the Society's system of internal control and for reviewing its effectiveness, including any outsourced activities. This system is designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, not absolute, assurance against material loss or misstatement. The Directors actively seek to minimise the exposure to risks and, in doing so, take into consideration the materiality of the risks to be managed and the cost effectiveness of the relevant aspects of internal control in light of the particular environment in which the Society operates.

The Society has outsourced its administration activities to HBOS and it liaises with HBOS to review the appropriateness of the internal control environment and to consider specific needs or requirements of the Society. The Society and HBOS are actively seeking to establish whether a firm basis for specified, contractual service levels for the future is appropriate.

The effectiveness of the Society's system of internal control, including financial, operational and compliance controls and risk management, is reviewed by the Audit Committee on behalf of the Board and the Audit

## 20 Corporate Governance

continued

Committee has reported on the outcome of its review to the Board.

The principal components of the Society's system of internal control, developments in 2003 and plans for 2004 are detailed below.

### Control environment

The Society is committed to the highest standards of business ethics and conduct, and seeks to maintain these standards across all of its operations.

The Society regularly reviews its governance manual and further revisions were made in 2003, confirming the governance structure for the business and the guiding policies for the organisation.

An appropriate organisational structure for planning, executing, controlling and monitoring business operations is in place in order to achieve the Society's objectives. The structure is reviewed and updated on a regular basis, taking into account the pressures and conflicting priorities on the Society's business, to ensure that it provides clear responsibilities and control for key areas. Separate internal functions have been established for risk management, internal audit and programme management.

### Control procedures

The Society operates a number of control procedures to safeguard the policyholders' assets and investments, including:

- Physical controls, segregation of duties and reviews by management
- Forums for the Executive Team and HBOS to consider control and other matters in relation to (i) finance, (ii) operations, and (iii) risk, audit and compliance
- The Society's Compliance Officer monitors the HBOS compliance function as it relates to the Society on a day-to-day basis in accordance with the Society's compliance strategy

- The contractual arrangement with HBOS dated 1 March 2001 that establishes operational delegations and outline service levels
- Implementation and testing of an appropriate Business Continuity Plan
- Preparation and monitoring of detailed budgets for functional business segments
- A programme management function to structure, co-ordinate, monitor and report on the very significant projects that the Society is undertaking.

Developments in 2003 included the further strengthening of financial management processes, including stricter financial controls over the significant projects within the programme management function.

### Information and communication

Monthly management information in respect of financial performance, customer service, complaints handling and investment performance is prepared and reviewed by senior management, the Executive Team and the Board. Additionally, projects have their own management information processes.

The Society prepares an annual business plan and budget to assist in the monitoring of results, assets, liabilities and investment performance. Actual performance against these plans is actively monitored and, where appropriate, corrective action is agreed and implemented.

Developments in management reporting in 2003 included enhancing and expanding the Service Level Agreement (SLA) with HBOS to better reflect the Society's business requirements and introduce qualitative measures to improve quality assurance reporting. These are ongoing developments and further initiatives are planned for 2004.

### Risk management

The Audit Committee has delegated authority from the Board for the review of the Society's internal control and risk management systems.

The Society has an internal risk management function. The function maintains a register of significant risks that could impact the achievement of the Society's objectives and related internal controls. This register is reviewed and updated by senior management and the Executive Team on a regular basis. Significant internal and external risks are identified and evaluated and accountability for their management is allocated to appropriate individuals.

A clear risk management framework and methodology has been established which includes:

- A risk identification, categorisation and assessment methodology
- The implementation of risk identification and management procedures for major projects
- Regular, organisation-wide reviews of significant risks and their management including the related internal controls
- The detailed review of and reporting on certain material risks, including those that impact the solvency of the Society
- The application of detailed modelling to assess the sensitivity of the Society's position to economic and business scenarios.

In 2003, further progress was made in embedding the risk management philosophy into the Society's business processes. Each function within the Society has a risk management representative and the risk management governance structure with HBOS has been strengthened. Significant additional focus is being given to the operational and regulatory risks arising from the administration work outsourced to HBOS and further actions are planned for 2004 for mitigating risks and

strengthening the liaison and communication between the Society and HBOS.

The key focus in 2004 will be on the successful implementation of all aspects of the Prudential Source Book issued by the Financial Services Authority. The Prudential Source Book is the new regime for prudential management of insurance companies. This includes ensuring the existence of adequate financial resources and that appropriate risk management systems and controls are in place. A number of discrete projects have been identified, project managers have been appointed for each and detailed project plans and implementation timetables have been prepared.

There is a discussion in the Financial Review on pages 8 to 13 of significant risks the Society faces.

### Internal audit

The Society has an internal audit capability to provide assurance over the operation of the system of internal control. The programme of internal audit reviews is based on the Society's risk register and the internal audit programme is designed to provide assurance that the risk-mitigating actions identified by management and the risk register are working effectively. All internal audit reviews are reported to the Audit Committee.

The Society also receives regular reports from HBOS in relation to the findings of internal audit reviews HBOS has conducted that are relevant to the Society.

### Monitoring and corrective action

The Head of Risk Management reports to the Executive Team, Audit Committee

and the Board, the results of the risk assessment and other significant changes in the risk register, including specific reports as required.

Assurance is provided to the Audit Committee and the Board on the effectiveness of the key controls through:

- Reporting by the Society's internal audit function on the key controls reviewed. In performing this work reliance may be placed on the HBOS risk management and internal audit functions that review systems and controls operated by HBOS on behalf of the Society
- Reporting on the compliance environment and the management of significant regulatory risks by the Society's Compliance Officer
- Reports received from the Society's Head of Risk Management on specific elements of risk and their management
- The work of other independent advisers commissioned to report on specific aspects of internal control

The Audit Committee monitors the status of corrective actions for the improvement of effectiveness of the system of internal control.

## 5. Policyholder communications

The Board is committed to a policy of openness in its communications with policyholders.

During the year, the Board has consulted with representatives of policyholders and has sought to keep all relevant stakeholders informed on all major issues.

At its Annual General Meeting, the members of the Board are available to answer questions. Separate resolutions

are proposed on each issue so that they can be given proper consideration. The Society counts all proxy votes and will indicate the level of proxies lodged on each resolution, after it has been dealt with by a show of hands, unless a poll is called.

All policyholders can gain access to the Society's Annual Report and Accounts and further information on the website [www.equitable.co.uk](http://www.equitable.co.uk).

## 6. Going concern

As noted in Note 1 to the Accounts on page 30 the Directors consider the adoption of the going concern basis to be appropriate in the preparation of the Accounts. A detailed assessment of the going concern basis is provided in the Financial Review on page 13.

## 7. Remuneration Report

The composition and responsibilities of the Society's Remuneration Committee are set out on page 19. The Remuneration Committee's recommendations are made on the basis of rewarding individuals for the scope of their responsibilities and their performance. Where possible the Committee seeks to meet the standards set out in the Combined Code applicable to listed companies.

Proper regard is paid to the need to retain good quality, highly motivated staff and the remuneration being paid by competitors of the Society is taken into consideration. In this respect the Committee receives information inter alia from a leading firm of remuneration consultants, Monks Partnership, and also receives benchmarking data where required.

## 22 Corporate Governance

continued

The total emoluments of the Directors, excluding pension benefits, comprise:

<b>Non-executive Directors</b>	Notes	2003 £	2002 £
V E Treves, Chairman	1	<b>125,000</b>	<b>365,792</b>
<b>Other non-executive Directors</b>	2		
D H Adams OBE		25,000	33,750
R Bullen		25,000	15,417
Sir Philip Otton		30,000	36,667
M J Pickard		30,000	36,667
F Shedden		25,000	15,417
P A Smith		30,000	36,667
A R Threadgold		30,000	36,667
J Wood		25,000	33,750
		<b>220,000</b>	<b>245,002</b>
<b>Total for non-executive Directors</b>		<b>345,000</b>	<b>610,794</b>

### Notes

- As previously reported, the Chairman's fees are £125,000 per annum with effect from 1 June 2002. The figure for 2002 includes a discretionary payment of £225,000 plus VAT in respect of the Chairman's first 12 months of service. Of the fees shown for 2002, £287,875 (including VAT) was paid to Macfarlanes. Fees in respect of the period from May 2002 have been paid directly to Mr Treves.
- The figures for 2002 include, as previously reported, a discretionary payment of £15,000 for each of the other non-executive Directors (except Messrs Bullen and Shedden) in respect of their first 12 months of service (ending 22 April 2002). Messrs Bullen and Shedden were not eligible for the discretionary payment as they did not take office until 1 May 2002.

As previously reported, from 1 June 2002, the non-executive Directors (other than the Chairman) have received fees at the rate of £25,000 per annum. The following non-executive Directors have also received additional annual fees from 1 June 2002 in relation to specific services: Sir Philip Otton (formerly Deputy Chairman until his retirement), £5,000 p.a.; M J Pickard (Chairman, University Life), £5,000 p.a.; P A Smith (Deputy Chairman), £5,000 p.a.; and A Threadgold (Chairman, Investment Committee), £5,000 p.a.

<b>Executive Directors</b>	Notes	Salaries	Benefits	Discretionary Bonuses	Total 2003	Total 2002
		£	£	£	£	£
C G Thomson	1	380,538	86,325	41,250	508,113	679,288
N J Brinn (appointed 20 February 2003)	2	195,994	53,219	18,565	267,778	–
C A J Bellringer (resigned 25 November 2002)	3	–	–	–	–	362,752
<b>Total for Executive Directors</b>		<b>576,532</b>	<b>139,544</b>	<b>59,815</b>	<b>775,891</b>	<b>1,042,040</b>

#### Notes

1. The Chief Executive's annual rate of salary for the period 1 January to 30 June 2003 was £371,250 plus benefits of £84,600. His annual rate of salary was increased to £389,825 and his benefits increased to £88,050 with effect from 1 July 2003 and, with effect from the same date, the maximum potential annual discretionary bonus award he may receive was increased from a maximum of 30% to a maximum of 50% of his salary. In advance of any decision by the Board to award him a discretionary bonus for 2002/03, the Chief Executive informed the Remuneration Committee that he had decided to waive half of any bonus which he may otherwise be awarded. A discretionary bonus of £41,250 was paid accordingly. For 2003/2004 the Remuneration Committee has recommended to the Board that the amount of C G Thomson's discretionary bonus award should be £155,930 and paid in June 2004. The Chief Executive also participates in an annual retention bonus scheme. Under this scheme, a retention bonus of £68,750 vests on 31 March in each of 2003, 2004 and 2005, but is only payable in full at 1 April 2005, provided that service has been continuous to that date. If C G Thomson's employment ceases prior to that date, subject to satisfying certain conditions, he will receive a bonus of between 25% and 100% of the vested amount to that date.
2. The Finance and Investment Director's annual rate of salary for the period 20 February to 30 June 2003 was £210,000 plus benefits of £31,000. In addition, an amount of £12,000 in respect of travel and accommodation for the first year of employment is included in benefits for the year. His annual rate of salary was increased to £240,000 and his benefits increased to £60,000 with effect from 1 July 2003. The Finance and Investment Director's maximum potential annual discretionary bonus award is a maximum of 50% of his salary. The Remuneration Committee has recommended to the Board that the amount of N J Brinn's discretionary bonus award should be £72,000 and paid in June 2004.
3. C A J Bellringer's remuneration in 2002 includes severance compensation of £195,000.

## 24 Corporate Governance

continued

### Benefits

Executive Directors' benefits include a car allowance and payments in lieu of pension contributions. The executive Directors have no accrued pension entitlements (2002: no accrued entitlements).

No benefits are paid to non-executive Directors.

### Service contracts

C G Thomson and N J Brinn have service contracts with a six-month notice period.

No non-executive Director has a service contract.

### Long-term benefits

No share options are available. Other than a retention bonus scheme, the Society does not operate any other long-term benefits scheme.

### Directors' remuneration

Non-executive Directors' remuneration comprises a specified fee, which includes extra amounts for specific additional responsibilities, as set out on page 22.

### Executive bonus entitlements

The Society operates an annual discretionary bonus scheme for executive Directors. The Society's policy is to ensure that executive Directors are appropriately incentivised to meet the objectives of the business. In particular, significant objectives against which targets are set and approved by the Remuneration Committee include the maintenance of solvency, the achievement of business stability, the management of significant regulatory reviews and litigation issues and the maintenance of effective service delivery.

### Directors' pension entitlement

The Society does not provide an occupational pension scheme for Directors. Executive Directors are provided with a specific allowance in lieu of direct contributions.

## 8. Statement of compliance with the Code of Best Practice

The Society confirms it complied with all the relevant provisions of the Combined Code throughout the year except for the matters explained in this report, summarised below:

The Board continues to seek to adopt the relevant provisions of the Combined Code including formalisation of service level arrangements with outsourced providers.

Non-executive Directors are not appointed for a specific term. However, each Director's continued appointment is subject to periodic review by the Nominations Committee at intervals not exceeding three years. The Society's Articles of Association require that all Directors must seek re-election at the AGM at least every three years.



## Directors' Responsibilities in respect of the Accounts 25

Company law requires the Directors to prepare Accounts for each financial year which give a true and fair view of the state of affairs of the Society and of the Group and of the results of the Group for that period. In preparing those Accounts, the Directors are required to:

- Select suitable accounting policies and then apply them consistently;
- Make judgements and estimates that are reasonable and prudent;
- State whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the Accounts;
- Prepare the Accounts on the going concern basis unless it is inappropriate to presume that the Group will continue in business (see page 13 of the Financial Review above).

The Directors have complied with the above requirements. The Directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the Society and the Group, and enable them to ensure that the Accounts comply with the Companies Act 1985 as described above. They also have a general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

The Accounts are published on [www.equitable.co.uk](http://www.equitable.co.uk) website. The maintenance and integrity of this website is the responsibility of the Directors. Legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

## 26 Independent Auditors' Report to the members of The Equitable Life Assurance Society

We have audited the financial statements which comprise the Profit and Loss Account, the Balance Sheet and the related notes which have been prepared in accordance with the accounting policies set out in the statement of accounting policies.

### Respective responsibilities of Directors and auditors

The Directors' responsibilities for preparing the annual report and the Accounts in accordance with applicable United Kingdom law and accounting standards are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the Accounts in accordance with relevant legal and regulatory requirements and United Kingdom Auditing Standards issued by the Auditing Practices Board. This report, including the opinion, has been prepared for and only for the Society's members as a body in accordance with Section 235 of the Companies Act 1985 and for no other purpose. We do not, in giving this opinion, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

We report to you our opinion as to whether the Accounts give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' Report is not consistent with the Accounts, if the Society has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and transactions is not disclosed.

We read the other information contained in the annual report and consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the Accounts. The other information comprises only the Corporate Review, the Financial Review, the Corporate

Governance report, the Directors' report and the Statement of Directors' Responsibilities in respect of the Accounts.

### Basis of audit opinion

We conducted our audit in accordance with auditing standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Accounts. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the Accounts, and of whether the accounting policies are appropriate to the Society's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Accounts are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the Accounts.

### Fundamental uncertainty

In forming our opinion we have considered the adequacy of the disclosures in Note 17b (iv) and Note 23, which in turn refers to the Financial Review, in respect of the uncertainties regarding the:

- Estimates of compensation payments or adjustments to future benefits which may be payable under the Rectification Scheme to policyholders who had policies with guaranteed annuity options which matured prior to the House of Lords' decision, and compensation and other costs which may be payable under the review of managed pensions sales;
- Estimates of anticipated additional expenses; and
- Estimates of other miscellaneous liabilities including potential mis-selling costs, including those in respect of

non-GAR policyholders who left the Society prior to the GAR compromise scheme, GAR policy endorsements, provisions relating to the reinsurance of the linked and non-profit book to HBOS in 2001 and other miscellaneous costs.

In the context of the current level of the Fund for Future Appropriations, there is fundamental uncertainty as to whether the provisions will prove to be overstated or understated when compared with the actual cost of additional expenses, GAR rectification, managed pension and other mis-selling liabilities.

### Other uncertainties

In arriving at our opinion we have also considered the adequacy of the disclosures made in relation to other uncertainties in Note 23 and under the heading "The Board's conclusions on provisions and going concern" in the Financial Review, in respect of the potential additional claims against the Society that could arise as a result of different legal and regulatory views on its historical conduct. If these different views prevail, further obligations would arise in respect of mis-selling and other claims, which may also have consequences for the going concern preparation of the Accounts.

Our opinion is not qualified either in respect of the fundamental uncertainty or the other uncertainties.

### Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Society and the Group at 31 December 2003 and of the result of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

**PricewaterhouseCoopers LLP**  
**Chartered Accountants and**  
**Registered Auditors**  
**London**  
**31 March 2004**

# Profit and Loss Account

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For the year ended 31 December 2003

## Technical account – long-term business

	Notes	Group	
		2003 £m	2002 £m
<b>Earned premiums, net of reinsurance</b>			
Gross premiums written	2a	362.7	646.9
Outward reinsurance premiums	3	(188.7)	(418.2)
		174.0	228.7
<b>Investment income</b>	4a	1,170.9	2,135.1
<b>Other technical income</b>	5a	14.5	12.2
		1,359.4	2,376.0
<b>Claims incurred, net of reinsurance</b>			
Claims paid – gross amount	6	3,747.7	6,883.7
Reinsurers' share	3	(545.8)	(906.1)
		3,201.9	5,977.6
Change in provision for claims – gross amount	6, 17a	(42.9)	(19.2)
		3,159.0	5,958.4
<b>Changes in other technical provisions, net of reinsurance</b>			
Long-term business provision – gross amount	17a	(2,472.5)	(4,350.2)
Reinsurers' share	3	41.6	(17.9)
		(2,430.9)	(4,368.1)
Technical provisions for linked liabilities – gross amount	17a	(17.3)	(927.2)
Reinsurers' share	3	27.1	959.5
		(2,421.1)	(4,335.8)
Net operating expenses – non-exceptional	7a	69.6	123.8
Net operating expenses – exceptional	7b	43.7	164.2
<b>Net operating expenses</b>		113.3	288.0
<b>Investment expenses including interest</b>	4b	47.7	51.6
<b>Unrealised losses on investments</b>	4c	476.6	945.3
<b>Other technical charges</b>	5b	3.0	7.9
<b>Taxation attributable to the long-term business</b>	10a	(16.7)	21.2
<b>Minority interests</b>		–	1.2
<b>Transfers from the Fund for Future Appropriations</b>	16	(2.4)	(561.8)
		621.5	753.4
		1,359.4	2,376.0
<b>Balance on the Technical Account</b>		–	–

All significant recognised gains and losses are dealt with in the Profit and Loss Account. Exchange gains and losses arising on retranslation of overseas operations are taken directly to the Fund for Future Appropriations. All the amounts above are in respect of continuing operations. The notes on pages 30 to 48 form an integral part of these financial statements.

## 28 Balance Sheets

As at 31 December 2003

### Assets

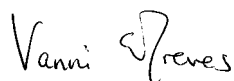
	Notes	Group		Society	
		2003 £m	2002 £m	2003 £m	2002 £m
<b>Investments</b>					
Land and buildings	11a	1,336.8	1,794.2	1,234.5	1,676.2
Investments in group undertakings	11b	–	–	118.0	132.8
Other financial investments	11c	13,921.7	16,130.8	13,869.5	16,089.1
		15,258.5	17,925.0	15,222.0	17,898.1
<b>Assets held to cover linked liabilities</b>	12	680.3	670.5	680.1	670.3
<b>Reinsurers' share of technical provisions</b>					
Long-term business provision		369.4	411.0	369.4	411.0
Technical provisions for unit-linked liabilities		2,348.1	2,375.2	2,348.1	2,375.2
		2,717.5	2,786.2	2,717.5	2,786.2
<b>Debtors</b>					
	13				
Debtors arising out of direct insurance operations		29.5	53.0	29.5	53.0
Debtors arising out of reinsurance operations		4.9	21.7	4.9	21.7
Other debtors		44.2	52.5	58.6	54.3
		78.6	127.2	93.0	129.0
<b>Other assets</b>					
Cash at bank and in hand		23.7	13.6	12.2	9.1
		23.7	13.6	12.2	9.1
<b>Prepayments and accrued income</b>					
Accrued interest and rent		208.5	226.8	207.8	226.3
Deferred acquisition costs	8	–	18.0	–	18.0
Other prepayments and accrued income	14	1.9	4.9	1.8	4.8
		210.4	249.7	209.6	249.1
<b>Total assets</b>		<b>18,969.0</b>	<b>21,772.2</b>	<b>18,934.4</b>	<b>21,741.8</b>

The notes on pages 30 to 48 form an integral part of these financial statements.

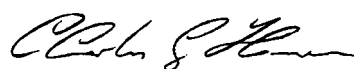
**Liabilities**

	Notes	Group		Society	
		2003 £m	2002 £m	2003 £m	2002 £m
<b>Minority interests</b>		–	0.1	–	–
<b>Subordinated liabilities</b>	15	348.3	347.9	346.2	346.2
<b>Fund for Future Appropriations</b>	16	552.0	554.3	542.2	556.2
<b>Technical provisions</b>	17a				
Long-term business provision – gross amount		14,833.8	17,287.8	14,808.5	17,260.8
Claims outstanding		1.0	43.9	1.0	43.9
Technical provisions for linked liabilities		3,028.4	3,045.7	3,028.2	3,045.5
		17,863.2	20,377.4	17,837.7	20,350.2
<b>Provisions for other risks and charges</b>	18	63.1	87.3	63.1	87.3
<b>Creditors</b>					
Creditors arising out of direct insurance operations		53.9	94.2	53.3	93.4
Amounts owed to credit institutions	19a	26.8	167.7	26.8	167.7
Other creditors including taxation and social security	19b	25.8	81.2	41.6	90.2
		106.5	343.1	121.7	351.3
<b>Accruals and deferred income</b>		35.9	62.1	23.5	50.6
<b>Total liabilities</b>		<b>18,969.0</b>	<b>21,772.2</b>	<b>18,934.4</b>	<b>21,741.8</b>

These Accounts were approved by the Board on 31 March 2004 and were signed on its behalf by:



Vanni Treves  
**Chairman**



Charles Thomson  
**Chief Executive**

The notes on pages 30 to 48 form an integral part of these financial statements.

## 30 Notes on the Accounts

### 1. Accounting policies

#### Basis of presentation

The Accounts have been prepared in accordance with sections 255 and 255A of, and Schedule 9A to, the Companies Act 1985 and in accordance with applicable accounting standards and the Association of British Insurers' Statement of Recommended Practice (SORP) on Accounting for Insurance Business dated November 2003. Application of the SORP has resulted in additional disclosure in these Accounts and there are no material changes to accounting policies. The true and fair override provisions of the Companies Act have been invoked; see Valuation of investments below.

The Directors have considered the appropriateness of the going concern basis used in the preparation of these Accounts, having regard to the ability of the Society to be able to meet its liabilities as and when they fall due, and the adequacy of available assets to meet liabilities. In the opinion of the Directors, the going concern basis adopted in the preparation of these Accounts continues to be appropriate. A more detailed explanation is provided in the Financial Review on pages 8 to 13.

The Directors have reviewed the accounting policies and satisfied themselves as to their appropriateness. There are no material changes from the prior year.

Certain administrative expenses were incurred in respect of customer support services provided by HBOS. For the purposes of these accounts, references to HBOS relate to various HBOS plc group companies including HECM Customer Services Ltd, Halifax Life Ltd and Clerical Medical Investment Group (Holdings) Ltd.

#### Basis of consolidation

The Accounts for the Group consolidate the accounts of the Society and all its subsidiary undertakings drawn up to 31 December each year.

The Society, as permitted under Section

230 of the Companies Act 1985, has not presented its own Profit and Loss Account.

#### Earned premiums

Premiums earned are accounted for on a cash basis in respect of single premium business and recurrent single premium pension business and on an accruals basis in respect of all other business.

All pension policies contain an open market option under which, in lieu of the benefits that must be taken on retirement, the equivalent lump sum can be transferred to another provider. All such lump sums, arising from policies within the Group, are included in claims paid. Where such lump sums are used to purchase annuities from the Group, these are included in premium income.

#### Reinsurance contracts

Outward reinsurance premiums are recognised when payable. Reinsurance recoveries are credited to match the relevant gross claims.

#### Investment income

Interest income is included on an accruals basis.

Dividends are included by reference to ex-dividend dates.

Income on fixed-interest investments is adjusted for purchased accrued interest.

Property rental income arising under operating leases is recognised in equal instalments over the period of the lease.

#### Realised gains and losses on investments

Realised gains and losses on investments are calculated as the difference between net sales proceeds and the original cost.

#### Unrealised gains and losses on investments

Unrealised gains and losses on investments represent the difference between the valuation of investments at the Balance Sheet date and their purchase price or, if they have been previously valued, their valuation at the last Balance Sheet date. The movement

in unrealised gains and losses recognised in the year also includes the reversal of unrealised gains and losses recognised in earlier accounting periods in respect of investment disposals in the current period.

#### Claims incurred

Death claims are recorded on the basis of notifications received. Surrenders are recorded when notified, maturities and annuity payments are recorded when due. Claims on participating business include bonuses payable and interest. Claims payable include direct costs of settlement.

#### Bonuses

The Society declares bonuses annually and University Life declares bonuses triennially. Guaranteed bonuses are included in the long-term business provision. Non-guaranteed final bonuses payable when a claim is made are included in claims paid. No provision is made for non-guaranteed final bonus.

#### Deferral of acquisition costs

For contracts of the recurrent single premium type where a series of future premiums is expected to be received, only a proportion of the acquisition costs that are incurred in the year of sale are covered by the premium loadings received in that year. The remaining costs to be covered by loadings in future years are shown as deferred acquisition costs.

For single premium contracts other than managed pensions, acquisition expenses are covered by loadings in the year of sale. There is, therefore, no deferral of acquisition costs.

For managed pensions, the acquisition costs are recovered by loadings in the first four years of the contract. The balance unrecovered at any time is shown as deferred acquisition costs. For conventional level annual premium contracts, the method of calculating the long-term business provision makes implicit allowance for the full acquisition costs at the end of the year of sale. There is, therefore, no explicit deferral of acquisition costs.

Where a deferred acquisition costs asset is created, the rate of amortisation of that asset is consistent with an appropriate assessment of the expected pattern of receipt of the relevant future loadings over the period in which the contracts concerned are expected to remain in force. To the extent that deferred acquisition costs are not recoverable from these loadings, the costs are expensed in the Profit and Loss Account.

### Pension costs

Pension costs are recognised on a systematic basis so that the costs of providing retirement benefits to those remaining employees of the Society for whom contributions are made under the contractual commitment with HBOS, are matched evenly, so far as possible, to the service lives of the employees concerned.

### Taxation

The charge for taxation in the Profit and Loss Account is based on the method of assessing taxation for long-term funds.

Provision has been made for deferred tax assets and liabilities using the liability method, on all material timing differences, including revaluation gains and losses on investments recognised in the Profit and Loss Account. Deferred tax is calculated at the rates at which it is expected that the tax will arise and has not been discounted.

### Valuation of investments

Investments, including assets held to cover linked liabilities are stated at current value at the Balance Sheet date, calculated as follows:

- Freehold and leasehold properties are valued individually by qualified surveyors on the basis of open market

value, account being taken of the estimated cost of disposal.

- Investments in limited partnerships are held at net asset value.
- No depreciation is provided in respect of investment properties. The Directors consider that this accounting policy is appropriate for the Accounts to give a true and fair view as required by SSAP 19 (Accounting for Investment Properties). Depreciation is only one of the factors reflected in the annual valuations and the amount which might otherwise have been shown cannot be separately identified or quantified.
- Listed securities are stated at the middle market value.
- Unit trust units are stated at bid value.
- Short-term deposits are included at cost.
- Unlisted investments are stated at Directors' valuation and are generally valued using local industry valuation guidelines.
- Investments in subsidiaries are held at net asset value.
- Securities lent, where substantially all the risks and rewards of ownership remain with the Society, are retained on the Balance Sheet. Collateral received in respect of securities lent is not recorded on the Balance Sheet.

### Technical provisions – Long-term business provision and provision for linked liabilities

The long-term business provision for the Group is agreed by the Directors, on the recommendation of the Reporting Actuary of each entity following, in each case, his annual investigation of the long-term business. For the Society and University Life, the long-term business provision is calculated using the gross

premium method of valuing the liabilities. Provisions for overseas business are calculated on a UK basis.

Technical provisions represent the amounts needed to meet the guaranteed benefits under contracts, including declared reversionary bonuses added up to and including the date of the Accounts, and make allowance, in accordance with the assumptions used, for specific levels of future contractually guaranteed bonuses and are discounted where appropriate.

The technical provision in respect of property-linked business is equal to the value of the assets to which the contracts are linked. The technical provision in respect of index-linked annuities in payment is equal to the discounted value of the annuity benefits which allows for indexation.

### Fund for Future Appropriations

The Fund for Future Appropriations represents the amount, which is available for future bonuses of various kinds in excess of the levels allowed for in the technical provisions.

### Foreign currency translation

Assets and liabilities in foreign currencies are expressed in sterling at the exchange rates ruling at 31 December. Revenue transactions and those relating to the acquisition and realisation of investments have been translated at rates of exchange ruling at the time of the respective transactions. Exchange gains and losses arising on retranslation of overseas operations are taken directly to the Fund for Future Appropriations.

### Segmental reporting

In the opinion of the Directors, the Group operates in one business segment, being that of long-term insurance business.

## 32 Notes on the Accounts

continued

### 2. Earned premiums

	Group	
	2003	2002
	£m	£m
<b>a. Analyses of gross premiums written</b>		
Individual premiums	295.1	520.1
Premiums under group contracts	67.6	126.8
	<b>362.7</b>	<b>646.9</b>
Regular premiums	182.5	318.6
Single premiums	180.2	328.3
	<b>362.7</b>	<b>646.9</b>
Premiums from non-profit contracts	72.1	240.0
Premiums from with-profits contracts	171.5	213.9
Premiums from linked contracts	119.1	193.0
	<b>362.7</b>	<b>646.9</b>
Premiums from life business	70.0	90.6
Premiums from annuity business	6.6	13.6
Premiums from pension business	285.0	541.6
Premiums from permanent health business	1.1	1.1
	<b>362.7</b>	<b>646.9</b>
Premiums from UK business	357.4	634.6
Premiums from overseas business	5.3	12.3
	<b>362.7</b>	<b>646.9</b>
<b>b. Gross new business premiums</b>		
Individual premiums	169.3	324.6
Premiums under group contracts	22.7	32.2
	<b>192.0</b>	<b>356.8</b>
Regular premiums	11.8	28.5
Single premiums	180.2	328.3
	<b>192.0</b>	<b>356.8</b>
Premiums from non-profit contracts	32.3	179.4
Premiums from with-profits contracts	111.0	112.3
Premiums from linked contracts	48.7	65.1
	<b>192.0</b>	<b>356.8</b>
Premiums from life business	0.1	0.5
Premiums from annuity business	0.7	1.7
Premiums from pension business	191.2	354.6
	<b>192.0</b>	<b>356.8</b>
Premiums from UK business	192.0	353.5
Premiums from overseas business	–	3.3
	<b>192.0</b>	<b>356.8</b>

Annual equivalent premiums in respect of new business received during the year were £29.8m (2002: £61.3m). New premiums in respect of reassured business during the year were £48.7m (2002: £65.1m).



### Classification of new business

The Society closed to new business on 8 December 2000. However, the Society continues to recognise new business premiums in the following instances:

- Recurrent single premium contracts are classified as regular where they are deemed likely to renew at or above the amount of initial premium. Incremental increases on existing policies are classified as new business premiums.
- Department for Work and Pensions rebates are classified as new single premiums.
- Funds at retirement under individual pension contracts reinvested with the Society and transfers from group to individual contracts are classified as new business single premiums, and for accounting purposes are included in both claims incurred and as single premiums within gross premiums written. Such amounts constitute the majority of premiums from non-profit contracts. Where an amount of fund under a managed pension is applied to secure an immediate annuity, that amount is included in both claims incurred and as a single premium within gross premiums written.
- Increments under existing group pension schemes are classified as new business premiums.

Where regular premiums are received other than annually, the regular new business premiums are stated on an annualised basis.

## 3. Outward reinsurance premiums

On 1 March 2001, the Society entered into reinsurance contracts with HBOS in respect of certain of its unit-linked and non-profit business. The establishment of the reinsurance contracts has effectively transferred the risks and rewards in respect of the reinsured business to HBOS.

Premiums received from policyholders in respect of reinsured business are immediately forwarded to HBOS. Similarly, HBOS reimburse the Society for any claims the Society has paid to policyholders in respect of reinsured business. As a result of these processes, after allowing for special features of the reinsurance contracts, the impact to the Society of these contracts is minimal.

The Society has several other outward reinsurance contracts under which relatively small volumes of business are reinsured.

Under the terms of the HBOS reinsurance contracts, if the Society were to become insolvent, or reasonably likely to become insolvent in the opinion of the reinsurers' Appointed Actuary, then the reinsurers can make payments directly to policyholders whose policies have been reinsured.

Ongoing outward reinsurance premiums paid under the contracts during 2003 were £188.7m (2002: £418.2m).

The reinsurance balance, as required to be disclosed by the Companies Act 1985, and as defined by the SORP, which represents the aggregate total of all those items included in the technical account which relate to reinsurance transactions, net of related gains of £287.2m (2002: £433.7m losses), is a net credit of £1.2m (2002: £20.0m charge).

## 4. Total investment return

	2003 £m	Group 2002 £m
<b>a. Investment income</b>		
Land and buildings	78.5	102.4
Other investments	862.7	1,062.0
	941.2	1,164.4
Gains on realisation of investments	229.7	970.7
	<b>1,170.9</b>	<b>2,135.1</b>
<b>b. Investment expenses including interest</b>		
Investment management expenses	19.3	22.7
Interest charges		
Bank loans and overdrafts	0.4	0.9
Other loans	28.0	28.0
	<b>47.7</b>	<b>51.6</b>

## 34 Notes on the Accounts

continued

### 4. Total investment return (continued)

	Group	
	2003	2002
	£m	£m
<b>c. Investment activity account</b>		
Investment income	941.2	1,164.4
Realised investment gains	229.7	970.7
Unrealised investment losses	(476.6)	(945.3)
	694.3	1,189.8
Investment management expenses and charges	(47.7)	(51.6)
<b>Investment return for the year</b>	<b>646.6</b>	<b>1,138.2</b>

### 5. Other technical income and charges

	Group	
	2003	2002
	£m	£m
<b>a. Other technical income</b>		
Income from non-insurance business	12.4	9.9
Other income	2.1	2.3
	<b>14.5</b>	<b>12.2</b>

#### **b. Other technical charges**

Other technical charges of £3.0m (2002: £7.9m) comprise expenses for non-insurance business of subsidiary companies.

## 6. Claims incurred – gross

	Group	
	2003 £m	2002 £m
Claims paid – gross amount	3,747.7	6,883.7
Change in provision for claims	(42.9)	(19.2)
<b>Gross claims</b>	<b>3,704.8</b>	<b>6,864.5</b>

Gross claims incurred comprise gross claims paid and the change in provision for claims outstanding.

	Group	
	2003 £m	2002 £m
<b>Gross claims</b>		
On death	58.2	81.0
On maturity	1,155.9	2,192.3
On surrender	1,787.9	3,800.1
By way of periodic payments	695.8	778.4
Claims handling expenses	7.0	12.7
	<b>3,704.8</b>	<b>6,864.5</b>
Life and annuity business	494.0	869.0
Pension business	3,203.8	5,982.8
Claims handling expenses	7.0	12.7
	<b>3,704.8</b>	<b>6,864.5</b>
Linked business	546.1	904.6
Non-profit business	375.8	387.1
With-profits business	2,775.9	5,560.1
Claims handling expenses	7.0	12.7
	<b>3,704.8</b>	<b>6,864.5</b>
UK business	3,613.3	6,700.5
Overseas business	84.5	151.3
Claims handling expenses	7.0	12.7
	<b>3,704.8</b>	<b>6,864.5</b>

Attributable final and interim bonuses for the Society and University Life were £171.5m (2002: £484.8m).

## 36 Notes on the Accounts

continued

### 7. Net operating expenses

	Group	
	2003	2002
	£m	£m
<b>a. Non-exceptional</b>		
Acquisition costs	0.7	1.1
Change in deferred acquisition costs (see Note 8)	6.0	13.4
Administrative expenses	62.9	109.3
	<b>69.6</b>	<b>123.8</b>

Acquisition costs reflect the expenses incurred in processing new business and drawing up insurance documents. The Society has been closed to new business since 8 December 2000 and continues to administer existing policies.

Administrative expenses include costs of £13m in 2002 in respect of contracted customer support services provided by HBOS through the former Society branch network. These contracted services terminated at 31 December 2002.

#### b. Exceptional

The Group incurred the following exceptional expenses during the year:

	Group	
	2003	2002
	£m	£m
Rectification and other GAR-related expenses	12.7	15.1
Additional write-down of deferred acquisition costs (see Note 8)	12.0	13.6
Costs of pursuing litigation against third parties	7.9	5.1
Administration and legal costs of non-GAR leavers review	6.4	–
Other projects	5.2	–
Former staff pension scheme costs	(0.5)	105.7
Recharge from HBOS of staff retention costs, severance costs and other redundancy costs	–	23.4
Costs associated with the compromise scheme	–	1.3
	<b>43.7</b>	<b>164.2</b>

Recharges of staff costs and retention costs, comprising retention bonuses payable to former staff now employed by HBOS, result from contractual obligations with HBOS entered into in March 2001 when the Society sold its administrative and sales operations to HBOS.

The litigation costs of £7.9m (2002: £5.1m) include an amount of £2.7m (2002: £1.5m) for litigation support services shown in Note 7c below, within the table of non-audit fees payable to PricewaterhouseCoopers LLP (PwC).

#### c. Expenses

The Group audit fees and expenses, inclusive of VAT, of £915,000 (2002: £931,000) comprised £857,000 (2002: £872,000) in respect of statutory audit and £58,000 (2002: £59,000) in respect of regulatory requirements. The element of the total fees and expenses relating to the Society was £857,000 (2002: £835,000).

The fees payable to PwC in respect of non-audit fees, inclusive of VAT and expenses, were £3.8m (2002: £5.1m) all of which related to the Society. On 1 October 2002, PwC Consulting, a division of PwC, was sold to IBM Consulting. Advisory work previously undertaken by PwC Consulting therefore ceased to be payable to PwC from that date.

PwC is one of a number of professional firms that undertake advisory work for the Society. Where PwC has been engaged to perform such non-audit work, in circumstances where it is to the Society's advantage to do so, the Society's regular commitments procedures are followed and the Audit Committee ensures that auditor independence is preserved.

The non-audit fees, including VAT and expenses, related to services in the following areas:

	Group	
	2003	2002
	£m	£m
<b>Further assurance services:</b>		
Review of interim accounts and other accounting advice	0.2	0.3
Tax advisory services	0.5	0.3
<b>Other non-audit services:</b>		
Governance and compliance work	0.2	0.3
Services to support litigation against third parties	2.7	1.5
<b>Other services:</b>		
Project and management support in respect of the compromise scheme	–	1.3
Rectification Scheme support services	–	0.1
Secondment of staff to administration and special projects	0.1	0.4
Former non-GAR policyholder review	–	0.6
Other services	0.1	0.3
	3.8	5.1

Other services of £0.1m (2002: £0.3m) include employment agency services in 2003 and, in 2002, remuneration survey data, assistance with Annual General Meeting planning and an independent assessment of the Society's compliance with the requirements of the Financial Services and Markets Act 2000.

## 8. Deferred acquisition costs

	Group and Society	
	2003	2002
	£m	£m
At 1 January	18.0	45.0
Change in deferred acquisition costs		
Non-exceptional (see Note 7a)	(6.0)	(13.4)
Exceptional (see Note 7b)	(12.0)	(13.6)
<b>At 31 December</b>	<b>–</b>	<b>18.0</b>

The Group has considered its ability to recover acquisition costs in future periods from margins arising on existing business and as a result has fully written off all costs. The exceptional element of change in deferred acquisition costs arises from a review of the likely pattern of receipt of premiums on business in force in future compared to that at previous period ends, after giving consideration to the recent pattern of renewals and surrenders.

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### 9. Directors and employees

	Group	
	2003 £m	2002 £m
<b>a. Staff costs</b>		
Wages and salaries	3.1	1.8
Social security costs	0.3	0.2
	<b>3.4</b>	<b>2.0</b>

The monthly average number of employees employed by the Group during the year, including executive Directors, required to be disclosed in accordance with the Companies Act 1985, was 18 (2002: 12).

In addition, the Society employs a number of contractors and, under its agreement with HBOS, uses the services of HBOS staff.

#### b. Emoluments of Directors

Full details of Directors' emoluments, pensions and interests, as required by the Companies Act 1985, are included in the Remuneration Report on pages 21 to 24.

#### c. Pension arrangements

Following the sale of operations to HBOS on 1 March 2001, the Group has retained a small number of staff. Of those staff retained, two remain members of the pension schemes now operated by HBOS as the principal employer.

The Society is contractually committed to meeting the major part of the funding in respect of the pension schemes for those staff transferred to the employment of HBOS. An amount of £63m (2002: £105.7m) has been provided in respect of the contractual commitment to HBOS in relation to the defined benefit scheme, following the triennial actuarial valuation performed as at 31 December 2001, as modified for relevant changes to the Balance Sheet date. An additional provision of £32.9m (2002: £27.2m), representing an estimate of the current value of the contractual commitment to HBOS in respect of future service costs over the next 13 years (2002: 14 years), is included within technical provisions for long-term business. These contractual commitments to HBOS arise as part of the sale agreement entered into with HBOS in March 2001 when the Society sold to HBOS its administrative and sales operations.

## 10. Taxation

	Group	
	2003 £m	2002 £m
<b>a. Taxation charged to the technical account</b>		
UK corporation tax		
Current tax on income for the period	0.9	36.9
Adjustments in respect of previous years	(20.7)	(9.1)
	(19.8)	27.8
Double taxation relief	–	(0.1)
	(19.8)	27.7
Foreign tax		
Current tax on income for the period	1.4	1.5
Adjustment in respect of prior year	–	4.9
	1.4	6.4
Deferred tax		
Unrealised gains/(losses) on investments	0.3	(15.6)
Accelerated capital allowances	(0.2)	0.3
Deferred expenses carried forward	1.6	2.4
	1.7	(12.9)
<b>Total (credit)/charge</b>	<b>(16.7)</b>	<b>21.2</b>

The UK corporation tax charge is provided at rates between 20% and 22% (2002: 20% and 22%), computed in accordance with the rules applicable to life assurance companies whereby no tax is charged on pension business profits.

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>b. Deferred taxation</b>				
Provided in the accounts:				
Deferred tax of the long-term fund				
Accelerated capital allowances	(0.6)	(0.8)	(0.6)	(0.8)
Unrealised appreciation in investments	(0.3)	–	(0.1)	–
Deferred expenses carried forward	3.8	5.4	3.8	5.4
	2.9	4.6	3.1	4.6
	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>c. Deferred taxation</b>				
Not provided in the accounts:				
Deferred tax of the long-term fund				
Unrealised appreciation in investments	0.6	0.9	0.6	0.9

Deferred taxation not provided for in the accounts represents the proportion of unrealised losses in excess of anticipated future gains.

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### 11. Non-linked investments

	Current value		Cost	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>a. Land and buildings</b>				
Group				
Leasehold	391.1	503.0	367.9	475.5
Freehold	945.7	1,291.2	896.1	1,223.1
	<b>1,336.8</b>	<b>1,794.2</b>	<b>1,264.0</b>	<b>1,698.6</b>
Society				
Leasehold	313.4	425.3	292.3	399.9
Freehold	921.1	1,250.9	875.8	1,187.8
	<b>1,234.5</b>	<b>1,676.2</b>	<b>1,168.1</b>	<b>1,587.7</b>

Independent professional valuers have valued the Group's and the Society's properties individually. The properties are included in these Accounts at those valuations. The valuations of commercial properties were carried out by Jones Lang Lasalle. Properties held under limited partnerships, amounting to £600.4m (2002: £638.9m) for the Group and £498.0m (2002: £520.9m) for the Society, were valued by independent valuers appointed by the respective general partner. The limited partnerships are held at net asset value.

	Society		Society	
	Current value		Cost	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>b. Investments in group undertakings</b>				
Shares	13.3	27.4	30.2	37.1
Loans	104.7	105.4	102.0	110.0
	<b>118.0</b>	<b>132.8</b>	<b>132.2</b>	<b>147.1</b>

On 20 September 2002, the Society transferred one leasehold property interest to a limited partnership within the Group, increasing loans by £81.2m. The Society sold its interest in this limited partnership on 13 February 2004 for an amount not materially different from its carrying value in these Accounts.

	Current value		Cost	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>c. Other financial investments</b>				
Group				
Shares and other variable yield securities and units in unit trusts <sup>1</sup>	569.7	749.9	697.8	849.8
Debt and other fixed-income securities <sup>2</sup>	12,488.1	14,171.2	12,130.7	13,390.1
Loans secured by mortgages	3.2	4.3	3.2	4.3
Loans secured by policies	2.0	2.7	2.0	2.7
Deposits with credit institutions	858.3	1,202.3	871.1	1,214.6
Other investments	0.4	0.4	0.4	0.4
	<b>13,921.7</b>	<b>16,130.8</b>	<b>13,705.2</b>	<b>15,461.9</b>



	Current value		Cost	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>c. Other financial investments (continued)</b>				
<b>Society</b>				
Shares and other variable yield securities and units in unit trusts <sup>1</sup>	552.0	731.7	682.9	833.4
Debt and other fixed-income securities <sup>2</sup>	12,465.0	14,148.6	12,107.5	13,368.8
Loans secured by mortgages	3.2	4.3	3.2	4.3
Loans secured by policies	1.9	2.6	1.9	2.6
Deposits with credit institutions	847.0	1,201.5	859.8	1,213.8
Other investments	0.4	0.4	0.4	0.4
	<b>13,869.5</b>	<b>16,089.1</b>	<b>13,655.7</b>	<b>15,423.3</b>

Investments of £2,485.1m (2002: £3,019.2m), which have been lent in the normal course of business to authorised money brokers on a secured basis, are included in other financial investments. Similar investments of £2,571.9m (2002: £3,108.8m) were received as collateral from the broker. Income earned on stock lending during the year, net of fees paid, was £1.7m (2002: £1.9m).

<sup>1</sup> Includes listed investments of £202.4m (2002: £205.7m) for the Group and £190.2m (2002: £192.2m) for the Society at current value.

<sup>2</sup> Includes listed investments of £12,433.0m (2002: £14,091.1m) for the Group and £12,409.9m (2002: £14,068.9m) for the Society at current value.

## 12. Assets held to cover linked liabilities

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>Current value of linked assets</b>	<b>680.3</b>	<b>670.5</b>	<b>680.1</b>	<b>670.3</b>

The cost of assets held to cover linked liabilities is £543.6m (2002: £557.9m) for the Group and £543.6m (2002: £557.9m) for the Society. In respect of the Society, assets relate to index-linked business only for both 2003 and 2002.

## 13. Debtors

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>Debtors arising out of direct insurance operations</b>				
Amounts owed by policyholders	29.5	53.0	29.5	53.0
<b>Debtors arising out of reinsurance operations</b>				
	4.9	21.7	4.9	21.7
<b>Other debtors</b>				
Debtors other than Group and related companies	38.3	29.7	37.2	27.7
Deferred tax	3.0	4.9	3.2	4.9
Outstanding sales of investments	2.9	17.9	2.0	17.9
Balances with group companies	–	–	16.2	3.8
	44.2	52.5	58.6	54.3
	<b>78.6</b>	<b>127.2</b>	<b>93.0</b>	<b>129.0</b>

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### 14. Other prepayments and accrued income

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>Accrued income</b>	<b>1.9</b>	<b>4.9</b>	<b>1.8</b>	<b>4.8</b>

### 15. Subordinated liabilities

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>Amounts falling due after more than five years</b>	<b>348.3</b>	<b>347.9</b>	<b>346.2</b>	<b>346.2</b>

On 6 August 1997, Equitable Life Finance plc (ELF), a wholly-owned subsidiary of the Society, issued £350m 8.0% undated subordinated guaranteed bonds (the Bonds), which are guaranteed by the Society. The proceeds, after deduction of costs associated with the issue, were loaned to the Society on similar terms as to interest, repayment and subordination as to those applicable to the Bonds. All (but not some only) of the Bonds are repayable at the option of ELF on 6 August 2007 and each fifth anniversary thereafter, so long as the Bonds are outstanding.

The payment of principal and interest in respect of the Bonds has been irrevocably and unconditionally guaranteed by the Society. The obligations of the Society under the guarantee constitute direct and unsecured obligations of the Society. In the event of a winding up of the Society, the claims of the bondholders under the guarantee will be subordinated in right of payment to the claims of all creditors of the Society.

In accordance with the Trust Deed, where the payment of any amount in relation to the Bonds is due and the Society cannot meet the Required Minimum Margin (RMM) of assets over liabilities required under the Trust Deed, by reference to the Insurance Companies Act 1982, on the due date (or would not be able to meet RMM immediately after such payment), then the payment (or an appropriate part thereof) will be deferred unless the FSA's consent is obtained.

### 16. Fund for Future Appropriations

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
At 1 January	554.3	1,113.6	556.2	1,104.9
Transfer to the Profit and Loss Account	(2.4)	(561.8)	(14.1)	(551.4)
Exchange gain on retranslation of overseas operations	0.1	2.5	0.1	2.7
<b>At 31 December</b>	<b>552.0</b>	<b>554.3</b>	<b>542.2</b>	<b>556.2</b>

## 17. Technical provisions

### a. Gross technical provisions movement

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
At 1 January				
Long-term business provision	17,287.8	21,622.7	17,260.8	21,592.0
Claims outstanding	43.9	63.1	43.9	63.1
Provisions for linked liabilities	3,045.7	3,972.9	3,045.5	3,972.6
	<b>20,377.4</b>	<b>25,658.7</b>	<b>20,350.2</b>	<b>25,627.7</b>
Retranslation of opening foreign branch technical provisions	18.5	15.3	18.5	15.3
Change in long-term business provision	(2,472.5)	(4,350.2)	(2,470.8)	(4,346.5)
Change in provision for claims	(42.9)	(19.2)	(42.9)	(19.2)
Change in technical provisions for linked liabilities	(17.3)	(927.2)	(17.3)	(927.1)
<b>At 31 December</b>	<b>17,863.2</b>	<b>20,377.4</b>	<b>17,837.7</b>	<b>20,350.2</b>
At 31 December				
Long-term business provision	14,833.8	17,287.8	14,808.5	17,260.8
Claims outstanding	1.0	43.9	1.0	43.9
Provisions for linked liabilities	3,028.4	3,045.7	3,028.2	3,045.5
	<b>17,863.2</b>	<b>20,377.4</b>	<b>17,837.7</b>	<b>20,350.2</b>

### b. The long-term business provision

The long-term business provisions for the Society and University Life have been calculated using the gross premium method of valuing the long-term, non-linked liabilities. The provisions are based on guaranteed benefits only and do not include non-guaranteed final bonuses. The technical provisions have been calculated on the actuarial bases considered most appropriate by the Reporting Actuary. The principal assumptions and the comparatives at 31 December 2002 are shown in the table overleaf.

Actuarial bases have been modified in respect of valuation interest rates and the future expense allowance for annuities in payment. Explanations of the effect of those changes are set out in Notes 17(b) i and ii.

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### 17. Technical provisions (continued)

#### b. The long-term business provision (continued)

The principal assumptions used in valuing the main classes of business of the Society were as follows:

Class of business	Interest rate %		Future expense allowance	
	2003	2002	2003	2002
<b>Endowment assurances (with-profits)</b>				
Basic Life and General Annuity business	2.000	2.000	3.00% of premium	3.00% of premium
Pension business	2.500	2.500	4.00% of premium	4.00% of premium
<b>Recurrent single premium (with-profits)</b>				
Life business	3.875	3.625	See Note ii	See Note ii
Pension annuities in payment – old series	4.875	4.625	£70 p.a.	£40 p.a.
Pension annuities in payment – new series	4.875	4.625	£70 p.a.	£40 p.a.
Pension business – old series	4.875	4.625	See Note ii	See Note ii
Pension business – new series	4.875	4.625	See Note ii	See Note ii
<b>Non-profit annuities in payment</b>				
Basic Life and General Annuity business – pre 1992	4.875	4.750	£50 p.a.	£40 p.a.
Basic Life and General Annuity business – post 1991	4.375	4.250	£50 p.a.	£40 p.a.
Pension business	4.875	4.750	£50 p.a.	£40 p.a.

- i. Valuation interest rates are based on the yields on the assets held reduced for risk. Reductions from the yield for risk for corporate fixed-interest securities are based on credit ratings. In general, fixed-interest yields rose during 2003, and the valuation interest rates have also increased. The changes to the valuation interest rates have reduced the technical provisions by approximately £175m. Similarly, the market value of the backing assets has fallen as yields have risen and because of the close matching of assets and liabilities there is little net effect on the Fund for Future Appropriations. There is no allowance for future discretionary increases to guaranteed benefits.
- ii. The aggregate amount for ongoing expenses, grossed up for taxation where appropriate, allowed for in the calculation of the long-term business provisions for the next twelve months, is £58m (2002: £68m). The amount included for each successive year allows for the effect of inflation and policy exits at a rate consistent with the valuation assumptions.

Future expenses are allowed for in different ways depending on the nature of the product:

- For with-profits recurrent single premium business, expenses are allowed for by an explicit per policy expense differing by policy type, increasing by 3.75% p.a. (2002: 3.5% p.a.) and an expense allowance for fund management, expressed as a percentage of the value of the fund.
  - For annuities in payment, an expense amount per policy per annum is applied. Following a review of expenses, the future expense allowances for annuities in payment have been revised. Due to the additional administration and fund management costs related to with-profits annuities in payment, the future expense amount is higher for these products than that for non-profit annuities. The changes to the expense amounts have increased technical provisions by approximately £26m.
  - For other business, expense allowances are a percentage of future premiums. For certain assurance contracts, the discounted value of a policy fee of £3.00 p.a. is included in the provision.
- iii. The mortality assumptions are detailed in the table below and are consistent with those used at 31 December 2002. A sensitivity analysis has been carried out in connection with the effect of a change in mortality basis on the technical provisions and that has demonstrated that a 10% change in the mortality basis would result in a £160m change in the long-term business provisions. That is equivalent to the life expectancy of a 65-year-old male increasing by an additional 10 months.

<b>Mortality assumptions by class of business</b>	2003	2002
<b>Endowment assurances (with-profits)</b>		
Basic Life and General Annuity business	AM80 ultimate for males AF80 ultimate for females	AM80 ultimate for males AF80 ultimate for females
Pension business	AM80 ultimate for males AF80 ultimate for females	AM80 ultimate for males AF80 ultimate for females
<b>Recurrent single premium (with-profits)</b>		
Pension annuities in payment – old series	PMA92MC (U=2012) for males PFA92MC (U=2010) for females	PMA92MC (U=2011) for males PFA92MC (U=2009) for females
Pension annuities in payment – new series	PMA92MC (U=2012) for males PFA92MC (U=2010) for females	PMA92MC (U=2011) for males PFA92MC (U=2009) for females
<b>Non-profit annuities in payment</b>		
Basic Life and General Annuity business	85% IMA92 (U=2003) for males IFA92 (U=2003) for females	85% IMA92 (U=2002) for males IFA92 (U=2002) for females
Pension business	PMA92MC (U=2012) for males PFA92MC (U=2010) for females	PMA92MC (U=2011) for males PFA92MC (U=2009) for females

iv. Technical provisions include amounts in respect of specific provisions:

- An amount of £430m (2002: £420m), which is the current estimate of the compensation or adjustments to future benefits which may be payable under the Rectification Scheme to policyholders who had policies with guaranteed annuity options which matured prior to the House of Lords' decision, and compensation and other costs which may be payable under the review of managed pensions sales. This provision is based on an assessment of the likely level of claims, the level of current interest rates and the possible form of compensation which may be payable on individual cases, if a claim is found to be appropriate.
- Anticipated additional exceptional expenses of £134m (2002: £130m) over future years, including Rectification Scheme and managed pensions review administration costs, contractual commitments to HBOS in respect of pension scheme future service costs, litigation being pursued against third parties and anticipated additional costs associated with servicing policies in 2004 and 2005.
- An amount of £8m (2002: £15m) in respect of the Society's potential liability for compensation relating to the pensions transfers and opt outs review and the review of free-standing AVCs.
- An amount of £184m (2002: £147m) for other miscellaneous liabilities, including potential mis-selling liabilities. The principal components are provisions for mis-selling claims from non-GAR policyholders who left the Society prior to the GAR compromise scheme, liabilities in respect of GAR policy endorsements, provisions relating to the reinsurance of the linked and non-profit book to HBOS in 2001 and miscellaneous costs.

### **c. Technical provision for linked liabilities**

The technical provision in respect of property-linked business is equal to the value of the assets to which the contracts are linked. This business is wholly reinsured to HBOS (see Note 3).

For index-linked annuities in payment, the technical provision is equal to the discounted value of the annuity benefits which allow for indexation, calculated using the same mortality assumptions as shown above for non-profit annuities in payment and using an interest rate of 1.875% p.a. (2002: 2.00% p.a.) for pension business, 1.875% p.a. (2002: 2.00% p.a.) for pre-1992 general annuity business and 1.625% p.a. (2002: 1.75% p.a.) for post-1991 general annuity business.

A provision in respect of future expenses on all linked business and mortality risks on property-linked business is included in the long-term business provision – gross amount. The future expenses on property linked business are wholly reinsured.

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### 18. Provisions for other risks and charges

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
Provisions for deferred taxation	0.1	0.3	0.1	0.3
Former staff pension commitments	63.0	87.0	63.0	87.0
	<b>63.1</b>	<b>87.3</b>	<b>63.1</b>	<b>87.3</b>

The movement in the provisions for deferred taxation assets and liabilities is included in Note 10a.

Of the £24m reduction in the former staff pension commitment, £18.7m has been in respect of scheduled repayments in line with the contractual agreement with HBOS as described in Note 9c. A further £5.3m has been released, primarily reflecting the improved performance of the scheme's underlying assets during the year.

### 19. Creditors

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>a. Amounts owed to credit institutions</b>				
Bank overdrafts	<b>26.8</b>	<b>167.7</b>	<b>26.8</b>	<b>167.7</b>

The bank overdraft was partly matched by an amount of £19m placed in an assigned account owned by HSBC. The amount is recorded as a debtor in Note 13.

	Group		Society	
	2003 £m	2002 £m	2003 £m	2002 £m
<b>b. Other creditors including taxation and social security</b>				
Outstanding purchases of investments	0.2	13.6	0.2	13.6
Balances with group companies	–	–	22.1	18.6
Corporation tax	9.0	40.1	9.0	40.1
Other creditors	16.6	27.5	10.3	17.9
	<b>25.8</b>	<b>81.2</b>	<b>41.6</b>	<b>90.2</b>

### 20. Subsidiary and associated undertakings

#### a. Principal subsidiary undertakings

The principal subsidiary undertakings, all of which are wholly and directly owned, are as follows:

Nature of business	
Equitable Life Finance plc	Arranging and managing loan finance
University Life Assurance Society	Life assurance and annuity business. Closed to new business.

The above holdings are of ordinary shares. During the year the Society had an interest in the loan capital of Covent Garden Retail LP, a property investment vehicle. The Society sold its interest in this limited partnership on 13 February 2004. Other holdings in subsidiary undertakings do not materially affect the results or assets of the Group.

### **b. Significant holdings**

At 31 December 2003, the Group and the Society held more than 20% of the nominal value of a class of equity shares in 20 (2002: 23) companies.

At 31 December 2003, the Group and the Society held more than 20% of the partnership interests in 5 (2002: 7) limited partnerships investing in properties and included in Land and Buildings.

At 31 December 2003, the Group and Society held more than 20% of the partnership interests in 12 (2002: 11) portfolios investing in private equity investment companies included in shares and other variable yield securities.

None of the above companies and limited partnership interests are regarded by the Directors as associated undertakings as the Society does not exert significant influence. None of the holdings materially affect the results or net assets of the Group or of the Society. These investments are included in the Balance Sheet at current value which is based upon the Group and Society's share of the partnership net assets.

Full information on subsidiary undertakings and companies and limited partnerships in which the Group and the Society hold more than 20% of the nominal value of a class of equity share or ownership interests will be annexed to the Society's next statutory annual return submitted to the Registrar of Companies.

## **21. Related party transactions**

There were no material related party transactions during 2003 (2002: nil).

## **22. Commitments**

The Society has no material operating lease commitments.

Property investment commitments not provided for in the Accounts amounted to £87.1m (2002: £131.5m) for the Group and for the Society. The commitment is to finance the estimated costs of developments to completion and final costs may be more than currently expected.

Commitments in respect of uncalled capital on certain investments not provided for in the Accounts amounted to £93.5m (2002: £142.1m) for the Group and for the Society.

## **23. Contingent liabilities and uncertainties**

The Society has made appropriate provisions for mis-selling and other risks based on currently available information. Over time, as more information becomes available, the range of possible outcomes in relation to these issues can be expected to continue to narrow and the degree of confidence around the levels of the individual provisions can be expected to increase. However, as discussed in the Financial Review on pages 8 to 13, in the context of the amount of the balance of the Fund for Future Appropriations, which is expected to continue to reduce as the with-profits liabilities decline, the potential impact of the range of uncertainties relating to the provisions is significant.

In March 2001, the Society entered into a reinsurance arrangement with a subsidiary undertaking of HBOS in respect of all of the Society's insurance policies except with-profits policies and immediate annuities. Assets were transferred by the Society following a provisional calculation of the initial premium payable under the agreement. After discussions, the parties have still to agree the final amount of assets transferable in respect of this initial premium. The Society has provided in its Accounts an amount considered appropriate to satisfy its estimated liability for any balance of assets to be transferred. The Society has reason to believe that HBOS may be seeking a larger sum, but no agreement has been reached to date. HBOS has notified its intention to refer the matter to an umpire for resolution, as contemplated by the reinsurance arrangement in the event of a dispute in respect of the calculation of the initial premium.

Although there exists a fundamental uncertainty in relation to the amounts of provisions, the Directors do not consider that this extends to the going concern basis of preparation of the Accounts.

In addition, as noted in the Financial Review on page 13 and in the following sections of this Note, there exist other uncertainties that, in the event they arose, could adversely impact on the appropriateness of the going concern basis of preparation. Certain of those risks, in extremely adverse scenarios, could prejudice the continuing solvency of the Society.

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continued

### 23. Contingent liabilities and uncertainties (continued)

#### Potential additional claims

- The Report of the Equitable Life inquiry, led by Lord Penrose, was published on 8 March 2004. His terms of reference precluded his opining on the subjects of individual fault for past problems of the Society and to whom any redress may be due. However, Lord Penrose has commented upon several aspects of the Society's affairs in a way that may impact on the likelihood of further claims being made against the Society for breach of statutory duty, or in tort or contract. In particular, Lord Penrose has commented that there was a shift in the policy adopted by the Society during the 1980s and 1990s towards terminal bonus as an increasing proportion of total allocations which, "in the absence of any coherent or consistently applied smoothing policy, resulted in the Society beginning to over-allocate from the late 1980s onwards with the effect that the realistic financial position . . . was progressively weakened, and policy claims progressively withdrew funds in excess of prudently calculated policy values. By the end of 2000, the position reached could only be dealt with by a radical re-alignment of policy values, as happened in July 2001".

The current Directors believe that, subsequent to December 1999, when policy values were broadly in line with assets, the growing gap between policy values and asset values was principally accounted for by deteriorating investment conditions, having regard to the high level of surrenders and maturities. The reduction in policy values, announced in July 2001, was made to align payouts with underlying values to ensure fairness to remaining policyholders at that time.

The Board has been advised that any claims regarding alleged "over-allocation" would face very significant difficulties and that a claim effectively seeking to recover losses relating to investment conditions would be highly unlikely to succeed.

Lord Penrose has made other observations, comments and criticisms relating to, inter alia, the structure of the rectification scheme, the payment of further premiums under extant policies, the treatment of former non-GAR policyholders, reinsurance arrangements, additional premiums accepted under GAR policies based on the Society's representations, policyholders' reasonable expectations, risks in relation to with-profits annuities, levels of payment to surrendering policyholders and financial adjustments thereto, and the impact on risk of continuing to write new business. His Report comments on the existence of "weak" valuation bases in relation to liabilities, practices considered to be of dubious actuarial merit, bonus policy, smoothing policy and policy in respect of payouts to surrendering and maturing policies. Lord Penrose is also critical of the conduct of the regulators and former directors.

However, Lord Penrose himself noted that the information he had gathered exposed potential problems of entitlement to compensation and quantification of loss (where loss was recoverable) of considerable complexity and he acknowledged the Society's current attempts to resolve claims on individual bases rather than collectively.

There is a possibility that policyholders could try to assert claims, although policyholders would be, in effect, suing themselves. Certain former policyholders, particularly those who left after July 2001, may seek to assert claims whether via the Courts or the Financial Ombudsman Service. The Society is currently advised that it has very substantial defences to claims that might be asserted and indeed that the claims are, as Lord Penrose indicated, complex and will be enormously difficult to litigate.

- In addition, potential claims could arise as a result of any criticism of the conduct of the Society or its former management and advisers following any FSA and/or Serious Fraud Office (SFO) investigations, or reviews by the actuarial and accounting professions (for example, in relation to non-disclosure of the differential terminal bonus policy relating to GAR policyholders or in relation to the Society's former reinsurance arrangements with the Irish Reinsurance Company).
- Moreover, there remains the possibility of adverse regulatory interpretation of the definition of claims and quantum of any possible redress, including claims by certain former non-GAR policyholders and other miscellaneous claims. The position with regard to former non-GAR policyholder complaints to FOS is set out in the Corporate Review.
- Although no proceedings have been initiated, allegations of fraud have been made by former non-GAR policyholders in respect of the non-disclosure of GAR risks after 1998. Having taken legal advice, the Board believes that there is no sustainable case of fraud and, in the event that any proceedings were issued, they would be defended vigorously. There exists the possibility that further claims could be made against the Society, alleging fraud or mis-selling not addressed hitherto or otherwise seeking compensation. Both Lord Penrose and the Treasury have asked the SFO to consider certain issues in Lord Penrose's Report. The Society will co-operate fully with the SFO.

The Board has assessed the probability of these other uncertainties arising and, on the basis of current information and having taken legal and actuarial advice, has concluded that it is highly unlikely they will result in any material adverse financial consequences. The Board is resolved to resist vigorously any unsubstantiated claims and will resort to court action where appropriate. The Board has therefore concluded that it remains appropriate to prepare these Accounts on a going concern basis.

The uncertain nature of the provisions, the incidence of other uncertainties and risks, the potential volatility of asset values and potential strains on the FFA arising from surrenders and maturities could, in adverse outcomes, result in the possibility that RMM (which is a measure of the capital that the FSA requires life assurance companies to hold in excess of that required to meet guaranteed obligations to policyholders) may not be satisfied at all times in the future. Attention is also drawn to the implications of these uncertainties on the ability of the Society to meet payments of interest and principal in relation to the subordinated debt as explained in Note 15 to the Accounts.