B&W Deloitte

Non-GAR Mis-selling Claims: Independent Actuarial Review

September 2002

Prepared for

The Equitable Life Assurance Society

Contents

Executive Summary

Introduction

B&W Deloitte was asked by the Board of Equitable Life ("The Society") at the request of the Financial Services Authority ("FSA") to review and report on:

(a) How the payouts from the Society's products compared to those of its competitors;
(b) What value, if any, could be placed on any flexibility built in to the Society's products over and above the flexibility in comparable products offered by competitors; and
(c) By how much may Non-GAR policyholder benefits have been reduced to meet the cost associated with paying Guaranteed Annuity Rates ("GAR") on GAR policies.

The terms of reference agreed between The Society, The FSA and B&W Deloitte are attached as Appendix 1 to the report. They relate to individually held policies which did not have guaranteed annuity options and which were excluded from the compromise scheme because they were no longer in force at the effective date of the scheme.

Our report deals only with actuarial issues. It does not comment on whether policies have been mis-sold, or whether the Society has any liability. Nor does it deal with legal questions concerning redress or the quantification of loss. We understand that our report is to be used to assist the Society in determining quantification of any loss.

In preparing our report, we have relied upon published surveys to compare payouts on the Society's policies with those of its peer group. Several sources have been used, and the data covers a variety of premiums, ages and terms appropriate to Non-GAR policies.

Results of our work

This summary gives a high level synopsis of our conclusions. A more detailed understanding can be obtained by reading the report that follows in full.

(a) How do the payouts from the Society's products compare to those of its competitors?

In our work we have compared the Society's payout against the mean of its peer companies. In all cases we have compared actual published payouts which we have taken to be after application of any Market Value Adjustment. We have also assumed that all policies have broadly similar guarantees at maturity or vesting.

For ***regular premium pension policies*** payouts were broadly at or better than average until the policy value cut in July 2001. Since then they have been significantly lower (in the range 5% to 23%) than the peer group average, although the gap has closed markedly as time has moved on and other companies have announced their own cuts in payouts.

The same pattern appears to hold for transfer value payments, although, based on the limited data available for policies transferring away before reaching "full term", the point at which the Society's payouts fell below their peers was earlier in 2001,

For ***single premium pension policies*** payouts were below peers by more than a few percentage points from January 2001 onwards. After the policy value cuts in July 2001, payouts were even further (up to 30%) below the comparison group, though the gap had closed as we entered 2002.

For payouts in 2000, the comparison is less clear. Depending on the source of the survey, the premium size and the term, payouts ranged from being in line with peers to a few percentage points below. The same is true of 1999, although any shortfalls were small, and generally within the bounds of reasonable smoothing.

For transfer values, the pattern is similar to that for regular premium policies noted above.

For ***With-profits bonds*** payouts were in line with the peer group for 1998 and 1999. For 2000 and beyond, payouts were (5% to 15%) below the peer group average.

(b) What value, if any, could be placed on the flexibility built into the Society's products over and above comparable products offered by competitors?

As a result of our work, we have concluded that there was some additional value in the flexibility of the Society's pensions products and with-profits bonds, but not in its endowments. An example of flexibility is that most of the Society's pensions policies allowed benefits to be taken "on contractual terms" (i.e. without penalty) at any time after reaching a given age, typically 50. Where there was such flexibility, we have valued it only to the extent that it exceeded that available from peer companies. We have estimated the value of flexibility to be up to 6.5% of payouts.

The terms of reference asked for our opinion on the value placed on flexibility by policyholders. Whether or not policyholders did ascribe value to the contract flexibility our opinion is that it did hold real value. We also believe that the flexibility had real value whether or not it was "exercised". The flexibility of the Society's products was undoubtedly a potential selling point, and may have been for some policyholders an important attraction in choosing the Society.

Both the perceived and actual value will vary from policyholder to policyholder. Some groups will have placed much more value on it. Our figures give our best estimate of the value at the time the policies were taken out.

(c) By how much may Non-GAR policyholder benefits have been reduced to meet the cost associated with paying Guaranteed Annuity Rates ("GAR") on GAR policies?

Claims paid depend on the bonuses allocated to the policies. In the event of non-contractual claims such as surrenders, they also depend on the financial adjustment which may be applied to the policy value for retirement policies (and with-profits bonds) or on the basis which is used to calculate the surrender value for conventional with-profits policies. Consequently, we have based our assessment on changes to bonus rates and to the financial adjustments which appear to have been attributable directly to the cost of GARs.

In July 2000 the Society removed the bonus which had been accruing on policy values during the first 7 months of 2000 in order to meet the anticipated £1.5 billion impact of the House of Lords decision. This had the effect of reducing most pensions policy values by approximately 5% and most life policy values by approximately 4.5%. Payouts were affected by approximately the same percentage reductions.

In our opinion, at the times set out in the terms of reference, the impact of GARs on payouts was as shown in the table below:

Impact of GARs on Non-GAR Payouts

As percentage of claim

Claims period	Pensions	Life
Early 2000	Nil	Nil
From August 2000 to March 2002	5% (for non-contractual claims it is unclear whether it could have been 7.5% for all or some of August 2001)	4.5% (for non contractual claims its is unclear whether it could have been 7.0% for all or some of August 2001)

This table should be read together with the accompanying notes to the more detailed tables shown in the body of our report.

The Society applies a financial adjustment to policy values on surrender to protect ongoing policyholders. It has used three main reasons to justify the adjustment:

- To compensate for Policy Values being higher than justified by market values of assets
- To recover un-recouped initial expenses
- To protect future solvency and investment freedom.

Some or all of these factors may be applied by other providers.

Prior to July 2001 and for the period since September 2001, we have seen no evidence to suggest that any part of the financial adjustment was referable to the cost of GARs (including possible compensation costs for misselling). During the period July to September 2001 the evidence is unclear, although at a maximum there may have been a 2.5% element of the financial adjustment connected with potential misselling claims. Consequently, with the possible exception of the short period referred to above, the impact for non contractual payouts of the costs associated with paying GARs is derived solely from its effect on policy values.

Use of our report

The matters discussed in this report are by their nature technical. The intended recipient of the report, the Society, is familiar with the issues, facts and other matters addressed and the report was written with that in mind.

This report was prepared for the sole and confidential use of the Society at the request of the FSA and for the purposes set out in the terms of reference. It was not prepared for or in contemplation of any other purpose or for the use of any other person. In preparing this report our only responsibility and duty of care was to the Society. We did not, and do not by consenting to publication of this report, assume or accept or owe any responsibility or duty of care to any other person.

Further details covering the scope and limitations of our report, its use and our legal responsibility are set out on pages 5 and 6 below.

Introduction, Use of the Report and Limitations

Introduction and scope of our review

This report was commissioned by the Board of Equitable Life ("the Society") at the request of the Financial Services Authority ("FSA") and has been prepared in accordance with our contract with the Society dated 26 March 2002. The terms of reference are set out in Appendix 1. The report sets out the results of B&W Deloitte's independent actuarial review on quantification of potential loss to Equitable Life's former Non-GAR policyholders not covered by the S425 Compromise Scheme. Non-GAR policyholders are policyholders of the Society who had one or more policies with the Society which did not have any guaranteed annuity rate options.

The report contains three main parts:

- The first deals with comparisons of the Society's payouts with its peers, and starts on page 7. It addresses Section (1) of the terms of reference.

- The second deals with the value of the flexibility of the Society's products over and above comparable products marketed by its peers and starts on page 11. It addresses Section (2) of the terms of reference.

- The third part assesses the effect of the costs associated with paying Guaranteed Annuity Rates ("GARs") on GAR policies and starts on page 15. It addresses Sections (3), (4) and (5) of the terms of reference.

Use of this report and legal responsibility

The matters discussed in this report are by their nature technical. The intended recipient of the report, the Society, is familiar with the issues, facts and other matters addressed and the report was written with that in mind.

This report was prepared for the sole and confidential use of the Society at the request of the FSA and for the purposes set out in the terms of reference. It was not prepared for or in contemplation of any other purpose or for the use of any other person. In preparing this report our only responsibility and duty of care was to the Society. We did not, and do not by consenting to publication of this report, assume or accept or owe any responsibility or duty of care to any other person.

The Society has asked for our consent to making this report publicly available by posting it on their web-site. We have agreed to provide such consent on the following conditions:

- This report will not be suitable for the use of any person other than the Society. Accordingly, publication of this report to persons other than the Society is for information purposes only and no person other than the Society should place any reliance on this report.

- We do not assume or accept or owe any responsibility or duty of care to any person other than the Society. Accordingly, any person other than the Society who, contrary to the above, chooses to rely on this report, does so at their own risk and we will not be responsible for any losses of any such person caused by their reliance on this report.

Our reliance on information

In preparing this report, we have used information and data extracted from published surveys, which we believe to be reliable, to compare payouts on the Society's policies with those of its peer group. Several sources have been used, and the data covers a variety of premiums, ages and terms appropriate to Non-GAR policies. In addition, we have used information and data which has been provided to us by the Society. In either case, we have relied upon such information and data as being true, correct and complete and have not audited, tested or checked any such information or data.

Limitations of our review

In line with the terms of reference, the scope of our review excludes:

- Non-UK business.
- Unit linked and non-profit business (on the grounds that the benefits paid under these contracts were unaffected by the GAR cost as they had no direct interest in the with-profits fund).
- Group and trustee business – i.e. we deal only with individually held policies.
- With-profits annuities, on the grounds that these could not be surrendered before the Compromise scheme came into effect and were included in the scheme.

Our assessment of the value of flexibility in the benefits provided by the Society has not quantified any consideration of individual policyholders' perception of its value; rather it represents an objective valuation of the economic value of the benefit, as priced by the capital markets.

We emphasise that the work focuses on actuarial and related factual issues only. We do not comment on whether policies have been mis-sold, whether the Society has any liability (including, without limitation, to make redress or other compensation payments to policyholders), or the quantification of the loss of any policyholder. The determination of these issues, which requires a legal analysis, did not fall within the scope of our review and we have no responsibility for such issues.

Payout Comparisons

Part 1 - Introduction

This Part of the report addresses Section (1) of the terms of reference set out in Appendix 1.

Data sources

Data has been taken from a variety of published sources, including Money Management surveys, Money Marketing surveys, With-Profits Guides, Standard & Poor's With-Profits Synopses and recent surveys initiated by the FSA. Comparisons are made against the Society's 15 closest competitors as listed in the terms of reference.

Products covered

The products covered are:

- Individual pensions, regular and single premium. We believe that the same analysis applies regardless of the source of contribution (employer, employee or DSS).
- With-profits bonds.
- Regular premium endowments.

Our review concentrated on policies sold in the last 15 years. Retirement annuities were not sold beyond 1988, and have not been included in our investigation. Similarly, we have not considered comparisons for other policies which were sold before 1988. Group pensions are also specifically excluded.

Comparative figures for peers

In all cases, we have compared the Society's payout against the mean of its peer companies. The list of peer companies was set out in the Terms of Reference and was agreed by the FSA. We cannot comment on whether the mean is the appropriate legal reference point for determining redress, but we do note that there would be little difference if the median were used instead.

In all cases, we compare actual published payouts. We have taken these to be after application of any Market Value Adjustment ("MVA") that applied. We have also assumed that all policies have similar guarantees at maturity or vesting.

Market data on payout vs asset shares

Many offices have often been paying out more than asset share to maturing policies during the past five years (i.e. more than the amount to which the premiums after deductions had actually accumulated). Such a practice has had a significant effect on the payout comparisons shown in the report. To illustrate this, we reproduce in Table 1 some data comparing asset shares and payouts. This is taken from an article in July 2001 Money Management, based on Tillinghast's Asset Share Survey 2000. It shows that payouts at that time averaged 3% - 10% more than the value that had accumulated under the policies. This is an important influencing factor in considering to what extent the payout comparisons should be relied on as providing a reasonable basis for determining whether the Society's Non-GAR policyholders suffered loss.

TABLE 1: Maturity Payouts as % of Asset Shares

	10 year Pension	20 year pension	10 year life	20 year life
Average % of Asset Share	103%	110%	105%	108%

Source:Money Management, July 2001 (from Tillinghast Asset Share Survey 2000)

Market data on surrender payments vs asset share

The figures shown in Table 1 are for maturing policies. The same source also gives information on payments on surrendering policies. It shows that competitors' payouts on surrender averaged from 89% to 93% of asset share.

Value of flexibility

All of the payout comparisons ignore the value of any additional flexibility within the Society's products compared to those of the peer companies. For a more complete assessment of relative value, the adjustments set out in the Flexibility section ought to be added in. (We believe that this should be possible by simple addition of the factors we calculate).

Qualifying comments

The commentary below considers raw payout comparisons shown in Appendix 2, without making any allowance for the value of flexibility in the Society's products. If that value is factored in, the point at which the Society's payouts fell below average will change, as will the level of any shortfall that does apply.

Regular premium pensions

The Society's payouts on regular premium pensions were broadly at or better than average (or within a very small margin, well within the bounds of normal smoothing) until the policy value cut in July 2001. Since then they have been significantly lower (in the range 5% to 23%) than the peer group average, although the gap has closed markedly as time has moved on and other companies have announced their own cuts in payouts.

The same pattern holds for transfer value payments (made when pension arrangements are transferred to other pension providers), although the point at which the Society's payouts fell below their peers was earlier in 2001, based on the limited data available for policies transferring away before reaching "full term".

Single premium pensions

Payouts on single premium pensions were below peers by more than a few percentage points from January 2001 onwards. After the policy value cuts in July 2001, payouts were even further (up to 30%) below the comparison group, though the gap has again closed as we enter 2002.

For 2000, the comparison is less clear. Depending on the source of the survey, the premium size and the term, payouts were in line with peers, or a few percentage points below. The same is true of 1999, although any shortfalls were small, and generally within the bounds of reasonable smoothing.

For transfer values, the pattern is similar to that noted above.

Recurrent single premiums

Many of the Society's products operated on a recurrent single premium basis, meaning that premiums were expected to recur, but with explicit acknowledgement that the amount paid would vary from year to year. Therefore, we believe that the most appropriate reference point for comparisons on these products is to use the regular premium surveys.

With-profits regular premium endowments

The pattern on regular premium endowments is similar to that for regular premium pensions. Up until July 2001, maturity payouts were generally in line with or above competitors. For the few data points where this was not the case, the shortfall was modest (of the order of 3%) and within the bounds of smoothing.

For policies maturing after July 2001, the Society's payouts were 10% or more below the mean.

For early surrenders, the position is a bit more complicated. Up to and including 2000, the Society outperformed the average. In early 2001, some policies that had been in force for 5 years or more had slipped below the average. We have no data for surrenders after July 2001, but it can be surmised that payouts would have been below the peer group.

Single premium endowments

This is an unusual, and small product line. The only data we have is from the FSA survey of payouts in August 2001 and March 2002. It is apparent that payouts were well below the peer group at that time.

With-profits bonds

For 1998 and 1999, payouts on with-profits bonds were in line with the peer group. For the December 1999 survey, some of the comparisons beyond five years may have fallen slightly short. We note that it is beyond this point that the Society's bond design gave considerable additional flexibility which has not been factored in – see later section.

For 2000 and beyond, payouts were below the peer group average; the longer the term in force, the more the shortfall.

Policies held for less than 5 years

The large majority of payout comparisons are for policies that have been in-force for 5 years or more. This creates a problem when considering policies for people who took out policies late in the review period, and so held them for less than 5 years. Where there is no actual data for the term a policy was held, we suggest that an appropriate comparison might be produced by using the figures for a 5 year policy, and adjusting these to allow for the Society's initial charges which are generally perceived to be low for individually held policies. Indirect evidence that the perception is correct is provided by the high ranking of the Society in certain published tables of early transfer or surrender values of with-profits pension and bond products. These low charges mean that the Society's relative position is generally better the shorter the policy term; the effect then dissipates as more years pass.

This effect is clearly borne out for the data which we do have. A comparison of 5 year and 10 year policies shows that the 5 year policies are generally about 5%-8% better on both regular and single premium pensions. With-profits bonds have a similar level of disparity, while for regular premium endowments the impact of moving shorter than 5 years is higher still. For simplicity, adjustments of the amounts shown in Table 2 appear reasonable. These would be applied to the appropriate 5 year industry comparison statistic, taken from Appendix 2.

TABLE 2: Suggested Adjustments for Policies held for less than 5 years by Time in-force

Product type	1 year	2 years	3 years	4 years
Regular premium	+ 8%	+ 6%	+ 4%	+ 2%
Single Premium	+4%	+3%	+2%	+1%

Value of Flexibility

Part 2 - Introduction

This part of the report addresses Section (2) of the terms of reference set out in Appendix 1.

Flexibility of the Society's products

Following our review, we have concluded that there was some additional value in the flexibility of the Society's pensions products and with-profits bonds, but not in its endowments. Where there was such flexibility, we have valued it only to the extent that it exceeded that available from peer companies.

Premium flexibility

The Society's products were based on the principle that the policyholder could pay what they liked, when they liked. Although this would generally be true of peer company products, they tended to be less flexible in practice. For example, where a regular premium was missed, or the amount paid was varied, other providers often imposed a penalty, or took additional charges. For the Society, there were no such one-off penalties. Any benefit that might have arisen from this is not reflected in the comparisons shown. There is no empirical evidence to measure this, and the circumstances would vary from case to case (for example depending on how individual policyholders vary their premiums). While the value cannot be quantified, in certain individual circumstances it could be significant to conclusions drawn from the other comparisons.

Pensions policies

Most of the Society's pensions policies allowed benefits to be taken "on contractual terms" at any time after reaching a given age, typically 50. This meant that the full policy value would be payable, without any application of a Market Value Adjustment ("MVA"). Although other companies also allowed policyholders to take benefits at varying times, they typically retained greater discretion in determining what the level of benefits should be. We believe that the Society's products contained additional flexibility in this regard compared to most of its peers. The value of this flexibility is greater for those policies that also had a minimum guaranteed interest rate ("GIR"). The value of the benefit has been modelled and the results are set out in Appendix 3.

A small number of pensions products had a threshold age other than 50, and the value of their flexibility will differ from that shown in Appendix 3.

Bonds

For some single premium bonds there was another form of flexibility. The Society did not have the right to apply the MVA at any anniversary from the 5th anniversary onwards, or in a few earlier policies, the 10th anniversary onwards. Most other offices offered this only on the 10th anniversary itself. This is another area where we have concluded that the Society's products contained additional value relative to the market. Results for the value of this benefit are set out in Appendix 3.

Overview of the approach

The flexibility in the Society's products gives policyholders options which in many ways are similar to futures and options available in the capital market. The approach and calculation method outlined below are intended to produce a value for the flexibility which is consistent with the prices in the capital markets.

The value of flexibility that existed on the Society's pension policies has been estimated by:

1) Projecting policy benefits with and without the "No MVA" flexibility.
2) Taking the present value of the difference between these benefits. To calculate the present value, we have used deflators. These allow for the time value of money and the investment risk inherent in different economic simulations, in a manner that is consistent with prices in the capital markets at the end of 2001.
3) The value of the flexibility is then the mean of the values produced in 2) across all simulations.

Calculation method

To obtain our results, we have used a prospective calculation of cashflows over the lifetime of each model policy from the point of sale. The calculation is carried out for each simulation of future economic conditions that is generated from our economic model.

Our simulated investment returns are based on an end 2001 calibration. For policies taken out several years ago, expected returns were higher. Adjustments were made allowing for the effect of varying economic conditions at point of sale in earlier years.

Other assumptions for investment mix, expenses, transfers away, age at retirement and bonus rates were chosen to reflect as closely as possible the Society's actual experience and practice.

Sample Policies

We calculated the value of flexibility for five sample model points which had the following characteristics:

- Ages at outset of 30, 35, 40, 45 and 50.
- Single premium of £10,000.
- Retirement age of 65.

Results for regular premium policies have been derived using a similar process.

Adjusting for the value of flexibility

The following example illustrates the way in which the values of flexibility set out in the following tables could be used. If the Society's payout from the earlier tables was say 97% of the average, and the value of flexibility from the following tables was 2%, the overall effect is for the Society's product to "be worth" 97% plus 2% i.e. 99% of the average.

Value placed upon flexibility by policyholders

The terms of reference asked for our opinion on the perceived value placed on flexibility by policyholders. We can only talk in general terms, but the following points are probably relevant:

- The flexibility of the Society's products was undoubtedly a potential selling point, and may have been for some policyholders an important attraction in choosing the Society.
- The perceived and actual value will vary from policyholder to policyholder. Some groups will have placed much more value on it, for example those with variable disposable income, those unsure of when they wished to retire, or those attracted by the 3.5% p.a. minimum guaranteed interest rate.

Our figures give our best estimate of the value of flexibility when the policies were taken out.

Actual vs perceived value

Whether or not policyholders did ascribe value to the contract flexibility, our opinion is that it did hold real value. It would certainly have been given a value had a similar kind of guarantee been sold or purchased directly in the capital markets.

We also believe that the flexibility had real value whether or not it was "exercised". By analogy, having the option to sell a particular share at say 200p on 1 January 2003 has a value. Somebody wishing to have that option could buy it in the financial markets – it is called a Put option. If on 1 January 2003 the share price was 220p, the option would not be exercised, but that does not mean that it had no value when originally purchased.

In a similar way, the flexibility we have described was definitely of value, even though in some circumstances there will not have been an actual "payoff". We believe this applies whether policies reached maturity or were surrendered early. Consequently the values of flexibility have been assessed at the time of purchase of the modelled policies.

Pensions policies results

In current interest rate conditions the value of flexibility for single premium pensions ranged from 2% to 6.5% of payouts and from 2.5% to 5.5% of payouts for regular premium payouts. For with-profits bonds the value ranged from 0.5% to 6%. Values were lower for the higher interest rate conditions applying in the mid 1990s and earlier.

The full results are shown in Appendix 3.

With-Profits Bond results

The With-Profits Bond has been modelled in a very similar way to the With-Profits Pension Product. It has a "guaranteed" term of 5 or 10 years. Under the Society's terms, policies had the flexibility to surrender at any anniversary after the 5th or 10th, without an MVA being applied. Depending on when the Society's contracts were effected they had either a 5 or 10 year guarantee. Competitor products in general only offered a 10 year guarantee. Consequently 5 and 10 year guarantee products of the Society have been compared with competitors 10 year guarantee products.

The age of the policyholder does not affect the results significantly, except possibly at older ages. Therefore the policies valued have been varied by premium size and the guaranteed period. All results have been rounded to the nearest 0.5%, as further accuracy would be spurious. The value of flexibility ranged from 0.5% of payout for a guaranteed period of 10 years to 5.5% for a guaranteed period of 5 years. For more details see Appendix 3.

Endowments

We do not believe that the Society's endowment product was any more flexible than those offered by its peer group. Most conventional endowment contracts have similar guarantees.

GAR Related Costs – Effect on Non-GAR Policies

Part 3 - Introduction

This Part of the report addresses Sections 3, 4 and 5 of the terms of reference set out in Appendix 1. It deals with the effect of the costs associated with paying GARs on GAR policies on claims values for a range of policies. It should be noted that the effect is already taken into account in the comparisons made in Appendix 2.

Contracts covered

This section concentrates on unitised with-profits products, i.e. pensions and with-profits bonds.

How claims are affected

Claims paid depend on the bonuses allocated to the policies. In the event of non-contractual claims, such as surrenders, they also depend on the financial adjustment which may be applied to the policy value for retirement policies and with-profits bonds, or on the basis which is used to calculate the surrender value for more conventional with-profits policies. Consequently, we have based our assessment on changes to bonus rates and to the financial adjustment which appear to have been directly attributable to the cost of GARs.

Individual policies

An individual's policy that has left the with-profits fund will have been directly impacted only to the extent that GAR costs have been recognised in bonus and financial adjustment decisions.

Estimated Cost of GARs

Section 3(1) of the Terms of Reference refers to the Society's estimate of the realistic cost of GARs prior to the House of Lords (HoL) Judgement in the Hyman litigation. We understand that the Society's provisions in this respect are now the subject of proceedings issued by the Society against its former directors and auditors. In the circumstances, we do not seek to comment on this issue in this report.

After the judgement the estimate was £1,500m made up of £1,300m for the in force business with GARs and £200m for rectification of GAR cases which had already vested without the benefits to which the House of Lords judgement entitled them. Much work was done on the estimate prior to the Compromise Scheme and it was considered by the Independent Actuary. We have no reason to believe the estimate was unreasonable.

Summary of findings

The £1,500m estimate represented approximately 5% of with-profits funds and policy values around the time of the House of Lords decision. The removal in July 2000 of bonuses which had been accruing during the first 7 months of 2000 had the effect of reducing most pensions policy values by approximately 5% and most life policy values by 4.5%.

Subsequent changes to bonus rates, policy values and financial adjustments were, with one possible temporary exception, attributed to reasons other than the cost of paying GARs. The major reason was the poor investment performance of the with-profits assets.

Consequently, in our opinion, at the times set out in the terms of reference, the impact of GARs on payouts was as shown in the tables below:

TABLE 3: Impact of GARs on Non-GAR Payouts (Pensions)

As percentage of claim

Claims period	Contractual Claims	Non-Contractual Claims
Early 2000	Nil	Nil
August 2000	5%	5%
Early 2001	5%	5%
August 2001	5%	5% (unclear whether it could have been 7.5% for all or some of August)
Early 2002	5%	5%

Notes

- The figures are approximate percentages of policy values that might have applied in the absence of the HoL judgment.
- The figures apply to policy values derived from premiums paid prior to 2000. Modifications are required in respect of any premiums paid during 2000, 2001 and 2002 (because that part of a claim value derived from premiums paid after July 2000 would have suffered no reduction in July 2000 and that part of a claim value derived from premiums paid in the early part of 2000 would have suffered only a partial reduction).

TABLE 4: Impact of GARs on Non-GAR Payouts

(Life With-Profits Bonds) As percentage of claim

Claims period	Contractual Claims	Non-Contractual Claims
Early 2000	Nil	Nil
August 2000	4.5%	4.5%
Early 2001	4.5%	4.5%
August 2001	4.5%	4.5% (unclear whether it could have been 7.0% for all or some of August)
Early 2002	4.5%	4.5%

Notes

- The figures are approximate percentages of policy values that might have applied in the absence of the HoL judgment.

- The figures apply to policy values derived from premiums paid prior to 2000. Modifications are required in respect of any premiums paid during 2000, 2001 and 2002 (as explained in the notes to the preceding table).
- For with-profits endowments, the equivalent figures should in principle be similar but are likely to be less accurate because policy values are translated into a terminal bonus scale which is then used to calculate the amounts paid for claims.

Make up of financial adjustment

(Section 4 of the terms of reference)

The Society justifies applying a financial adjustment to policy values on surrender by reference to protecting ongoing policyholders. It has used three main reasons:

- To compensate for policy values being higher than justified by market values of assets
- To recover unrecouped initial expenses
- To protect future solvency and investment freedom

Some or all of these factors may be applied by other providers.

Prior to July 2001 and for the period from September 2001, we have seen no evidence to suggest that any part of the financial adjustment was referable to the cost of GARs (including possible compensation costs for misselling). During the short period between these dates, the evidence is unclear, although at a maximum there may have been a 2.5% element of the financial adjustment connected with potential misselling claims.

Make up of policy value cuts

(Section 5 of the terms of reference

The reductions in policy value with effect from 16 July 2001 were made because policy values had become significantly in excess of the with-profits assets. At the time there was a possibility of potential mis-selling claims in respect of Non GAR policies. Some evidence suggested that 2% of the policy value cut was due to possible misselling claims **and** future stock market fluctuations. The suggestion that Non-GAR misselling claims were the cause of this 2% appeared to be contradicted by subsequent evidence.

It is clear that by September 2001 the GAR impact was as described for previous periods and we think that this position also applied during August 2001.

Appendix 1: Terms of Reference

Title	Terms of Reference for Actuarial Report on Quantification of Potential Redress to non-GAR Policyholders not covered by S425 Compromise Scheme.

Section (1)

The scope of this report should cover the following items, all in respect of individually held non-GAR policies

(1) A comparison for a range of typical ELAS policies (retirement annuities, with-profits bonds, endowment assurances and any other significant class) of the payouts on (a) contractual claims and (b) non-contractual claims (i.e. surrender or transfer), between the Society and an industry average comparator based on a range of other insurers, at the start of the years 1999, 2000, 2001 and 2002 (or any other times during that period when suitable data is available. It is envisaged that a series of data at between say 4 and 8 dates can be constructed).

For this purpose, the comparison should take account of

(i) An average premium size that is typical of the ELAS policies.

(ii) Regular premium policies, and single premium policies separately. Suitable allowance should be made for recurrent single premium policies.

(iii) The closest available similar policies in the market, allowing suitably for the different options inherent in the product design.

(iv) A range of typical ages and terms of policies at inception

Section (2)

(2) An assessment of the economic value of any flexibility (e.g. on retirement ages) that may exist on the Society's policies but not the above market comparators, taking due account of:

(a) The amount of the charge (if any) made by ELAS for this flexibility.

(b) The average charge for this flexibility on new policies in the market at present (if any) with similar flexibility.

(c) The adjustment (if any) made to the ELAS claim values to reflect the value of this flexibility.

(d) The cost of the flexibility assessed approximately by stochastic modelling or an equivalent alternative method.

(e) The effect on ELAS claim values had they reflected this cost fully.

(f) An assessment of the perceived value of the flexibility to the customer.

Section (3)	(3) An assessment of the effect of the costs associated with paying GARs on GAR policies, on claim values for a range of policies as in (1) above, paid on (a) contractual events and (b) non-contractual events occurring (i) in early 2000 (in particular, what is the reviewer's opinion on the estimate then made of £50m as the realistic cost of GAR options), (ii) in August 2000 (following the HoL judgement), (iii) in early 2001, (iv) in August 2001, (v) in early 2002 (prior to the effective date of the S425 scheme) This assessment should estimate the cost of GARs as determined by the HoL judgement and quantify approximately the proportion of surrender, transfer or maturity value that cost might represent, the extent to which that cost was represented in the amount paid out and the extent to which the amount paid, with or without that cost, might be said to be outwith normal bounds for smoothing of with-profits payouts.
Section (4)	(4) The reviewer should understand the components of the 'financial adjustment' and provide an analysis of any component of the 'financial adjustment' applied on non-contractual claims since it was introduced in December 2000 which reflects the costs of GARs as determined by the HoL judgement.
Section (5)	(5) The reviewer should consider the components of the cut in policy values on 16 July 2001 and provide an analysis of any component which reflects the costs of GARs as determined by the HoL judgement.
Footnote	The phrase "the costs of GARs" in (4) and (5) above is to be interpreted to include any potential misselling costs associated with GARs.
Peer companies	The range of other insurers for comparison are Clerical Medical, Commercial Union, Friends Provident, Legal & General, Norwich Union, NPI, Prudential, Royal & Sun Alliance, Scottish Amicable, Scottish Equitable, Scottish Life, Scottish Provident, Scottish Widows, Standard Life and Sun Life Assurance.

Appendix 2 – Payout Comparisons Results

Regular Premium Pensions

Source	Policy details
FSA Survey of With-Profits Payouts	Male, aged 65 taking normal retirement on payout date, £200pm
Money Management	Male aged 60yrs, and aged 55 yrs. Benefits taken at age 65. £200pm
Money Marketing	Male aged 60 or 55 next birthday at inception. 60y prem £50pm;55y - prem £35pm
Standard & Poor's With-Profits Synopsis 1999, 2000, 2001	Payouts calculated from Net Return to Policyholders (no details given about policyholder)
Source: With-Profits Guides	Payouts calculated from Net Return to Policyholders (no details given about policyholder)

ALL FIGURES SHOW THE SOCIETY'S PAYOUT AS % OF INDUSTRY AVERAGE

Term (yrs)	Source	Maturity Payout Date	Maturity payout	Transfer Value
5	FSA Survey	Mar 02	95%	
	Money Management	Jan 02	88%	
	FSA Survey	Aug 01	88%	
	Money Marketing	Apr 01	107%	91%
	Money Management	Jan 01	100%	
	Money Management	Jul 00	105%	
	Money Marketing	Apr 00	112%	111%
	Money Management	Jan 00	103%	
	Money Management	Jul 99	103%	
	Money Marketing	Apr 99	110%	113%
	Money Management	Jan 99	103%	
	Money Marketing	Apr 98	106%	108%
10	FSA Survey	Mar 02	85%	
	Money Management	Jan 02	80%	
	FSA Survey	Aug 01	80%	
	With-Profits Guides	May 01	99%	
	Money Marketing	Apr 01	103%	96%
	Money Management	Jan 01	95%	
	Standard & Poor's With Profits	2001	99%	
	Money Management	Jul 00	99%	
	Money Marketing	Apr 00	105%	119%
	Money Management	Jan 00	99%	
	Standard & Poor's With Profits	2000	103%	
	Money Management	Jul 99	99%	119%
	Money Marketing	Apr 99	106%	
	Money Management	Jan 99	99%	
	Standard & Poor's With Profits	1999	100%	
		Apr 98	107%	124%

15	FSA Survey	Mar 02	93%	
	FSA Survey	Aug 01	77%	

Appendix 2 – Payout Comparisons Results (continued)

Single Premium Pensions

Source	Policy details
FSA Survey of With-Profits Payouts	Male, aged 65 taking normal retirement on payout date, £10000 SP
Money Management	Male aged 60yrs, and aged 55 yrs. Benefits taken at age 65. £10000
Money Marketing	Male aged 60 or 55 next birthday at inception. 60y - prem £5000; 55y - prem £3500

ALL FIGURES SHOW THE SOCIETY'S PAYOUT AS % OF INDUSTRY AVERAGE

Term (yrs)	Source	Maturity Payout Date	Maturity payout	Transfer Value
5	FSA Survey	Mar 02	84%	
	Money Management	Jan 02	79%	
	FSA Survey	Aug 01	77%	
	Money Marketing	Apr 01	91%	79%
	Money Management	Jan 01	93%	
	Money Management	Jul 00	96%	
	Money Marketing	Apr 00	99%	98%
	Money Management	Jan 00	96%	
	Money Management	Jul 99	98%	
	Money Marketing	Apr 99	98%	100%
	Money Management	Jan 99	99%	
	Money Marketing	Apr 98	98%	101%
10	FSA Survey	Mar 02	76%	
	Money Management	Jan 02	70%	
	FSA Survey	Aug 01	70%	
	Money Marketing	Apr 01	87%	75%
	Money Management	Jan 01	87%	
	Money Management	Jul 00	93%	
	Money Marketing	Apr 00	100%	91%
	Money Management	Jan 00	92%	
	Money Management	Jul 99	96%	
	Money Marketing	Apr 99	100%	102%
	Money Management	Jan 99	102%	
	Money Marketing	Apr 98	101%	103%

15	FSA Survey	Mar 02	85%	
	FSA Survey	Aug 01	77%	
20	FSA Survey	Mar 02	81%	
	FSA Survey	Aug 01	71%	

Regular Premium Endowments

Source	Policy details
FSA Survey of With-Profits Payouts	Male, aged 65 taking normal retirement on payout date, £10000 SP
Money Management	Male aged 30yrs at outset; £50 pm
Money Marketing Summer 2001	Male non-smoker aged 29.5 for premium £35 (10y);£30 (15y);£25 (20y);£20 (25y)
Standard & Poor's With-Profits Synopsis 1999, 2000, 2001	Calculated from Net Return to Policyholders (no details given about Policyholder)
Source: With-Profits Guides	Payouts calculated from Net Return to Policyholders (no details given about policyholder)

ALL FIGURES SHOW THE SOCIETY'S PAYOUT AS % OF INDUSTRY AVERAGE

Term (yrs)	Source	Maturity Payout Date	Maturity payout	SV(3)	SV(5)	SV(7)	(SV10)
10	FSA Survey	Mar 02	93%				
	Money Management	Sep 01	87%				
	With-Profits Guides	Aug 01	89%				
	With-Profits Guides	May 01	97%				
	Money Management	Feb 01	97%	107%	96%	94%	
	Money Management	Sep 00	98%				
	With-Profits Guides	Mar 00	102%				
	Money Management	Feb 00	99%	105%	102%	101%	
	Standard & Poor's With Profits	2000	97%				
	Money Management	Sep 99	100%				
	With-Profits Guides	Feb 99	105%				
	Standard & Poor's With Profits	1999	102%				
15	FSA Survey	Mar 02	92%				
	Money Management	Sep 01	86%				
	FSA Survey	Aug 01	87%				
	Money Management	Feb 01	95%	119%	95%	93%	90%
	Money Management	Sep 00	96%				
	Money Management	Feb 00	99%	116%	101%	103%	100%
	Money Management	Sep 99	100%				

Note: SV(3) means surrender value after 3 years of a policy whose original term was longer.

Single Premium Endowments

Source: FSA Survey of With-Profits Payouts 2001/2002

ALL FIGURES SHOW THE SOCIETY'S PAYOUT AS % OF INDUSTRY AVERAGE

Term (years)	Payout August 2001	Payout March 2002
1	82%	N/A
2	80%	83%
3	78%	84%
5	79%	85%
7	77%	82%
10	73%	77%

With-Profits Bonds

ALL FIGURES SHOW THE SOCIETY'S PAYOUT AS % OF INDUSTRY AVERAGE

	Surrender Values	
	Five years	**10 years**
01-Apr-01	90%	85%
07-Apr-00	95%	85%
09-Apr-99	98%	100%
09-Apr-98	100%	Not given

Source : Money Management June 2000, 1999, 1998

Single Life non-smoker male 29.5, Ssingle premium of £1,000

Equitable as % of mean	**Cash-in Values**						
	1 yr	**2 yr**	**3 yr**	**4 yr**	**5 yr**	**6 yr**	**7 yr**
1 Oct 2001	85%	83%	80%	80%	79%	76%	77%
1 Dec 2000	99%	99%	96%	94%	90%	91%	89%
1 Dec 1999	103%	100%	101%	100%	96%	96%	92%

Source : Money Management Jan 2000, Dec 2000 and Dec 2001

Male aged 50 at maturity, on date shown, lump sum £10,000 invested

Comment

Some companies' entries at five and ten years are believed to be for maturing policies (where these had a specific term) rather than for surrendering policies. There is therefore a question of comparability, but it is not possible to comment further without questioning each of the companies concerned.

Appendix 3 – Results of Value of Flexibility

Pensions

Results

Tables 5a and 5b below shows the results on the central assumptions. The results are expressed as a percentage of the claim value, and are shown separately for policies with and without a 3.5% p.a. guaranteed investment return ("GIR"). It should be noted that even the policies without the 3.5% guarantee effectively have a guarantee of 0% (ie non negative investment return) and their results are shown under the heading of 0% GIR. All results have been rounded to the nearest 0.5% as further levels of accuracy would be spurious.

TABLE 5a: Value of Flexibility in Single Premium Pensions

(as % of payout value)

	Economic conditions at 31.12.2001	
Age at Outset	**0% GIR**	**3.5% GIR**
30	2.0	4.5
35	2.5	5.5
40	3.0	6.0
45	4.0	6.0
50	5.0	6.5

TABLE 5b: Value of Flexibility in Regular Premium Pensions

(as % of payout value)

	Economic conditions at 31.12.2001	
Age at Outset	**0% GIR**	**3.5% GIR**
30	2.5	5.5
35	3.0	5.5
40	3.5	5.5
45	3.5	5.5
50	4.0	5.0

Limitation of the above results

The results above are a reflection of the value of flexibility for policies sold at times where the prevailing economic conditions were similar to those at the end of 2001. However, we recognise that many of the policies under consideration were sold at times where interest rates were higher. The following tables 6a and 6b give results that are more appropriate to the economic circumstances of the mid 1990s. and tables 7a and 7b for the late 1980s to early 1990s.

TABLE 6a: Value of Flexibility in Single Premium Pensions in Higher Interest Rate Environment (sold in mid 1990s)

(Value as % of Payout Value)

Age at Outset	0% GIR	3.5% GIR
30	0.5	1.0
35	1.0	1.5
40	1.0	2.0
45	2.0	3.0
50	3.0	4.0

TABLE 6b: Value of Flexibility in Regular Premium Pensions in Higher Interest Rate Environment (sold in mid 1990s)

(Value as % of Payout Value)

Age at Outset	0% GIR	3.5% GIR
30	1.0	2.0
35	1.5	2.5
40	1.5	3.0
45	2.0	3.0
50	2.5	3.5

TABLE 7a: Value of Flexibility in Single Premium Pensions in Higher Interest Rate Environment (sold in late 1980s & early 1990s)

(Value as % of Payout Value)

Age at Outset	0% GIR	3.5% GIR
30	0.0	0.5
35	0.5	1.0
40	0.5	1.0
45	1.0	2.0
50	2.0	2.5

TABLE 7b: Value of Flexibility in Regular Premium Pensions in Higher Interest Rate Environment (sold in late 1980s & early 1990s)

(Value as % of Payout Value)

Age at Outset	0% GIR	3.5% GIR
30	0.5	1.0
35	1.0	1.5
40	1.0	2.0
45	1.5	2.5
50	2.0	3.0

TABLE 8a: Value of Flexibility in WP Bond

(as % of Payout Value)

Single Premium	Guaranteed Period	Value of Flexibility
£10,000	5	5.5%
£10,000	10	0.5%
£5,000	5	6.0%
£5,000	10	0.5%

TABLE 8b: Value of Flexibility in WP Bond in Higher Interest Rate Environment (mid 1990s)

(as % of Payout Value)

Single Premium	Guaranteed Period	Value of Flexibility
£10,000	5	5.0%
£10,000	10	0.5%
£5,000	5	5.5%
£5,000	10	0.5%

TABLE 8c: Value of Flexibility in WP Bond in Higher Interest Rate Environment (late 1980s & early 1990s) (as % of Payout Value)		
Single Premium	**Guaranteed Period**	**Value of Flexibility**
£10,000	5	4.5%
£10,000	10	0.5%
£5,000	5	5.0%
£5,000	10	0.5%

.