Equitable Life

We set out below a letter from Mike Caley, Chairman of Equitable Life Policyholders' Action Group (ELPHAG), that makes some constructive proposals regarding with-profits annuitants. Of course, the Directors share the concern about the position of with-profits annuitants. The Board has considered ELPHAG's proposals for with-profits annuitants and below we set out our response, which is highlighted in bold italics.

Annuitants – The Case for Enhancement

Background

I am writing as a follow up to the discussion with respect to Annuitants, which took place at our meeting on 17th June. At the meeting I made an oral submission to support our agenda item summarised as "Annuitants – ELPHAG remains unconvinced of the fair treatment of this sub-group".

The reaction to my submission summarised by Vanni Treves was that it contained fundamental issues to which the Board must give serious consideration and he requested that a written statement should be submitted to which the Board could provide a written response.

Fairness vs equality

The first assertion to make is that we are NOT claiming that annuitants have not been treated EQUALLY in comparison with other policyholders. Indeed we accept that the Board has been very concerned about their relativity and their particular circumstances. Off record conversations with specific Directors has made this fact self evident to us.

Our case is simply this – we believe that annuitants are DIFFERENT in many respects from other policyholders and deserve a measure of priority above other policyholders. Indeed we hope other policyholders would support our case for a modicum of enhancement for this group albeit at their expense, such being the nature of the With-Profits concept.

Our starting point and core to our submission is that annuitants are in a different position from other policyholders. We would assert that their only common factor is that they both (unfortunately) share membership of the With-Profits Fund.

Annuitants are different

What then differentiates annuitants?

a) Only group with no freedom to leave – this is a major difference

Equitable Life response: ***Of course, you are correct that with-profits annuitants have no option to leave the Society. However, we know that for some of the other policyholders who have stayed the financial adjustment is a major factor in their decision. They may feel that they have no real option to leave, because they feel that the costs are too high.***

b) Only group making a major 'up front' investment that then diminishes – this cash flow has been highly significant for the continuation of Equitable Life

Equitable Life response: ***You are incorrect that with-profits annuitants are the only group making a major 'up front' investment that then diminishes. In particular, income drawdown policies (Managed Pensions) and with-profits bonds where funds are periodically withdrawn will fit this description. You should also note that many other policies do not see any payment until retirement whereas with-profits annuitants receive the returns from their policies relatively quickly. Further, the Society sets up reserves to cover the expected costs of future annuity payments, so the cashflow between different policy types is very limited.***

c) Only group whose benefits have a year on year reduction that is guaranteed to take place

Equitable Life response: ***Although many with-profits annuities have reductions each year in the guaranteed amounts payable, that depends on the choice of the Anticipated Bonus Rate (ABR) made by the policyholder at the outset. Some with-profits annuities do not have reductions each year and indeed a few have guaranteed benefits that increase each year.***

d) Only group exchanging reductions in guaranteed benefits for non guaranteed bonuses

Equitable Life response: ***As mentioned in our comment at (c) above, not all the guaranteed benefits do reduce. The general position that non-guaranteed benefits tend to increase as a proportion of total benefits as time goes by is typical of Equitable with-profits policies.***

e) Only group that has faced reductions in final bonus AFTER they have been paid – There is an overwhelming lack of annuitant awareness that a final bonus added in the calculation of one year's income payments could be removed from later year's payments – we would challenge the Board to show sales literature that makes this right self evident in plain English

Equitable Life response: ***Final bonus is only added to a policy when a payment is made. For a with-profits annuity, the final bonus added in a particular year is only the final bonus associated with the payment for that particular year. The final bonus added to the policy at a policy anniversary is the final bonus which is paid during the following twelve months and no final bonus is added in respect of later years. This is identical between with-profits annuities and other with-profits policies – final bonus which is paid is only formally added to the policy when the payment is made and future final bonus is decided at the time a future payment is made. The Society's literature has always made it clear that future levels of final bonus are not guaranteed.***

f) Annuitants' up front investments have subsidised compensation payments to other policyholders who joined AFTER the annuitants had made their investments

Equitable Life response: ***In terms of meeting the cost of provisions (including compensation payments to other policyholders), annuities are no different from other policies. All policyholders are subject to the impact of compensation payments and the Board is firmly of the view that the cost of compensation payments has been shared fairly among all with-profits policy types.***

Proposals

Having made in our view a strong case for differentiation what actions do we believe are possible? In our opinion three remedial steps should be considered.

1. **Make all future bonus added to with-profits annuity policies guaranteed (that is, once declared it cannot be removed)** – the cost to ELAS is zero and provides some assurance that new bonus payments will not be removed as happened to final bonus additions paid in earlier times. We can see no reason why this cannot be implemented.

Equitable Life response: ***Unfortunately, your suggestion that the cost of this would be "zero" is wrong. If the Society guarantees to pay £95, it must demonstrate in a wide range of economic circumstances that it will be able to pay that £95. These circumstances include rising and falling interest rates and rising and falling equity markets. The Financial Services Authority (FSA) also requires the Society to hold a margin above the assets needed to cover the guarantees. This could mean, for example, that the Society would need to hold £100 in assets to cover a guaranteed payment of £95.***

In this example, if we have assets of £100 and all benefits are to be guaranteed, the guaranteed benefit would be £95 and the policyholder would receive £95. However, if benefits do not all have to be guaranteed, we might be able to pay benefits to the policyholder of £100 (of which £95 are guaranteed). The policyholder has the chance of greater benefits by not having all the benefits guaranteed.

Making bonuses guaranteed does cost more, so, in normal circumstances, the choice would be to have a lower level of bonus which is guaranteed or a higher level of bonus which is not guaranteed. The Society's current level of guaranteed benefits is already uncomfortably high so currently no new bonus can be guaranteed. The choice is only whether to add any final bonus or not.

The impact of your proposal would be to reduce payments to with-profits annuitants.

2. Earlier with-profits annuity policies include a minimum investment return of 3.5% per annum in the calculation of their guaranteed benefits. This is sometimes called a guaranteed investment return or GIR. Later with-profits annuity policies do not include this minimum return in their guaranteed benefits. **We feel that the Board should declare a guaranteed bonus of 3.5% per annum for the later, non-GIR with-profits annuity policies** so that GIR and non-GIR annuity policies will have the same level of guaranteed benefits. Our justification is that annuitants are heavy subsidisers of these payments.

Equitable Life response: ***As explained above, any increase in guarantees on any policies would be imprudent in current financial conditions. Your suggestion also assumes that future bonuses of 3.5% can be afforded. That will be true in some years, but not in all. In 2003, for example, the discretionary bonus rate was 2%. This illustrates that we simply cannot afford to make a promise of the kind you suggest.***

It is also worth noting that later with-profits annuities were bought in periods of lower inflation and lower expectations of future returns. With-profits annuitants with later policies tended to have lower anticipated returns so they may be less exposed to rapid reductions of their annuities. As you acknowledge elsewhere in your letter, the average growth anticipated for earlier (GIR) policies is 8%, but for later (non-GIR) policies the average growth anticipated is 6%. That is, for historical reasons (and because of lower rates of inflation) later (non-GIR) policyholders are less exposed to reductions in their guaranteed benefits due to the operation of the ABR and current level of investment returns than earlier (GIR) policyholders.

3. **Withdraw the 2004 cuts already announced and spread them over a longer period** as was your original intention. It is now clear that each year there will be a large gap between the bonus added in future (currently 2%) and the weighted average growth assumed by policyholders when their policies were set up (6% for non-GIR policies and 8% for GIR policies). We understand that with-profits annuity policies account for around 20% of the with-profits fund of £10.7 billion at the year-end. Based upon that part of the with-profits fund relating to with-profits annuity policies, (say, £2 billion) each 1% shortfall will save the company £20 million in reduced annual payments. Some proportion of this saving can surely be shared with other with-profits policyholders.

Equitable Life response: ***Essentially, what the Society has been able to do is:***

- ***The original cost of the House of Lords' judgment was a 5% reduction in policy values for all other with-profits polices. The cost was spread for with-profits annuitants and indeed has still not been fully applied.***
- ***The more general policy value reductions (16% in 2001 and 10% in 2002) were applied to all other with-profits policies. Again, the only exception was with-profits annuitants, where the reductions were delayed until 2003 and then were spread over two years.***

The 2004 reductions are the result of spreading forward the reductions which applied to other policies in 2001 and 2002. We are not able to delay any longer, now that we are effectively locked into having a low equity content – a risk we highlighted to policyholders in April 2002. The Board must always act with the over-riding aim of treating all policyholders fairly. Indeed, if we did not do so, the FSA could be expected to intervene.

Having considered the possible gap between future bonus and the levels anticipated by policyholders (the ABR), you suggest that the cost of a 1% shortfall in making the reductions will be £20 million. There are two different issues here. The 2004 reductions combine a single large change to 'catch up' for previous reductions already applied to other with-profits policies together with the normal action of the ABR which applies every year. It is important to recognise that the effect of the difference between the returns allocated and the ABR applies each year and has a compounding effect. The cost of a 1% shortfall in the application of the ABR is of the order of £100 million. That is, even a small reduction in the application of the ABR would have a significant adverse impact on the solvency position of the Society as a whole.

This highlights that because with-profits annuities pay benefits every year, the cost of a modest change in the yearly payment is very high (and we cannot ignore the total cost). On the other side of the equation, the Society's free assets are very limited and hard won. It would really not be fair to other policyholders for us to make the sort of bias you suggest.

We would hope that your continued assurances of financial stability are based upon firmer grounds than relying on the year on year reductions in annuity payments that will otherwise take place.

Equitable Life response: ***The Society's liabilities are calculated based on the guaranteed benefits under its policies. This naturally reflects the reducing level of the with-profits annuity payments guaranteed under those policies where the payments reduce.***

We also seek your written assurance on one final point. Annuity policies were originally largely protected from the reductions made to other with-profits policies in 2000, 2001 and 2002. To the extent of that 'protection', part of the income paid to annuitants during those years could be described as 'over-payments'. We seek an assurance that those over-payments in the past were 'written off' against the fund as a whole and that in making the annuity reductions in 2003 and 2004 the Society did not attempt to recover those over-payments from annuitants.

Equitable Life response: ***The Board is happy to give the written assurance you ask for. This is no different from the position with other policies from time to time where it might be thought – with hindsight – that a maturity payment was a little above or below the theoretical level.***

Conclusion

In conclusion we are aware that as a Board you have high freedom of actions. We believe that should you wish to do so you could implement these changes without challenge.

Equitable Life response: ***Whilst, in theory, the Board does have 'high freedom of actions' as you suggest, in practice, it must also balance the books and it also has a duty to be as fair as possible to all members. This is a very complex balancing act that has led us to the actions we have taken.***

We look forward to your considered response to the plight of this group of policyholders.

Equitable Life response: ***Thank you for your constructive and interesting proposals. The third was exactly what the Board had in mind when it decided to spread the annuity reductions three years ago. We explained in 2002 why we could not continue with that approach. We are sorry that we do not think the other proposals are workable.***

We can understand why with-profits annuitants feel that they are different from other policyholders, but the examination of the features highlighted shows this is not a 'black and white' situation. Each of the features identified is shared by other groups in different ways or to different degrees.

The Board has to consider the interests of all groups of policyholders and is duty bound to share the fund (which is smaller than we would all like) as fairly as possible. We hope we have demonstrated that we have taken all of the arguments into account before reaching our decisions.

Yours sincerely,

M J Caley

Mike Caley

Chairman of Equitable Policyholders' Action Group (ELPHAG)