

PART I: ANNUITY GUARANTEES**CHAPTER 1: ANNUITY GUARANTEES AND THE HYMAN CASE**

1. The first of the key events referred to in the foreword as giving rise to this inquiry was the judgment of the House of Lords in the case of *Hyman v Equitable Life*, which was delivered on 20 July 2000. The Appellate Committee held that the differential terminal bonus policy pursued by the Society was unlawful. Later in this report I will discuss the other two key events, the closure to new business and the with-profits policy value cuts, but the starting point must be the annuity guarantee issue. In the aftermath of the decision, it was the natural focus of concern, and it remains the issue that is widely viewed as lying at the heart of these later events. As I will come on to describe, the position is more complicated than that, but the annuity guarantees provide the obvious starting point for any discussion of the Society's position at 31 August 2001. Whatever else contributed to the situation at Equitable Life, the annuity guarantees had a part in it.

2. In brief, the commonly understood version of events runs as follows. From the 1950s to the 1980s the Society sold retirement annuity policies that included a guarantee of the annuity payable in respect of contributions, with provision for bonus additions. The rates were guaranteed for subsequent contributions as they were for the initial contribution that the policyholder contracted to make. From 1973 the Society allocated, in addition to guaranteed reversionary bonuses, a non-guaranteed terminal (later final) bonus that accrued notionally over the duration of the policy.

3. For most of the relevant period current immediate annuity rates exceeded by a clear margin the guaranteed rates under the policies, of whatever generation. The Society in those circumstances paid the higher benefits. Towards the end of 1993 interest rates fell, and the balance swung briefly in favour of the annuity guarantees. After an upswing in interest rates, the rates fell again and from 1995 onwards the annuity guarantees provided a higher rate of return. The Society sought to recover the cost of meeting the annuity guarantees, where claimed, by reducing what would otherwise have been the policyholder's final bonus. This ensured that the guaranteed annuity payable was equal to the annuity that would have been paid at current annuity rates on full fund value, including terminal bonus. This was subject always to the Society's admitted obligation to pay the guaranteed rate on the accumulated guaranteed benefits accrued to the date of the claim.

4. The Society implemented its policy, convinced that it thereby ensured equity between the two broad policy classes, those with guarantees and those without. The decision of the House of Lords caused a material transfer of economic benefit from policyholders who had the benefit of annuity guarantees to those who did not. It amounted to an additional liability that had not been acknowledged previously and affected the Society's financial position. It forced the Board to seek a buyer for the Society's business.

5. In this chapter I will describe how the annuity guarantee issue emerged and was understood within Equitable, how the *Hyman* litigation was initiated and conducted, and the contingency planning that was done by the Society in the course of that litigation. In the next chapter I will consider the forms that the guarantees took, the reasons for writing them in the first place, and for removing them later on. I will also explore the origin of the differential terminal bonus policy that was at the heart of the *Hyman* case.

Emergence of the Annuity Guarantee Issue

6. The financial position of Equitable, and the conduct of its with-profits business, came under close public scrutiny in and after 1998. Before that there was concern on the part of certain IFAs about the Society's position, in some cases as early as 1993. The Society's annuity guarantees were the focus of the *Hyman* litigation. Alan Hyman was not the first policyholder to challenge the Society's position on annuity guarantees. There were some settlements with policyholders who objected to the practice before 1998. Complaints began to be intimated to the PIA Ombudsman in July 1998. Hyman had been an Equitable policyholder for some time and held a number of policies incorporating annuity guarantees. He began to consider changing his pension arrangements in the Autumn of 1998. By then the Society's treatment of policyholders with such guarantees had become controversial.

7. Annuity guarantees emerged as a general issue for the life assurance industry following the take-over of Crusader Insurance by Sun Life of Canada. Sun Life made a provision of £140m to cover guarantees contained in policies it had inherited as a result of the acquisition. Stuart Bayliss of Annuity Direct, an independent financial adviser, identified a similar issue in the case of Equitable. He made public his view that the Society's approach to maturities on contracts incorporating annuity guarantees was not in line with the provisions of the policy documents or the illustrations the Society had provided to policyholders and prospective policyholders. Media interest followed.

8. The risk of general conflict with the Society's annuity guarantee policyholders was raised internally in a paper prepared for the product investigation team (PIT) meeting on 2 April 1998 by Chris Matthews, the assistant general manager responsible for running the actuarial projects department (APD). This was not the first time that the potential for conflict had been identified, however. Towards the end of 1993, probably prompted by a policyholder complaint, an actuary in Matthews' APD team, Andrew Soundy, discussed falling interest rates with Matthews, and, as a result, Soundy became aware of the Society's approach to dealing with the problem.

9. As will be described in more detail in the next chapter, Soundy approached Roy Ranson, the chief executive and actuary, and was set a project to propose alternatives. On 29 November 1993 he sent Ranson an initial memorandum, suggesting that the Society's approach might be thought underhand, followed up by more ample proposals. He suggested ring-fencing the additional liabilities within the annuity guarantee classes. Chris Headdon, who was at that time the executive assistant actuary responsible for valuation, responded, challenging this approach. A meeting followed between Ranson and Headdon on the one hand and Soundy on the other. Soundy made no progress against the two more senior actuaries. But he had warned of the risk of inequity and reputational damage in the Society's proposed approach.

10. When the issue arose again in April 1998, Matthews referred to the practice that had obtained of incorporating an 'annuity rate guarantee' in most of the Society's recurrent single premium with-profits pension contracts written up to July 1988. He drew attention to the fact that, in current financial circumstances, the annuity rate arising from these provisions was relatively generous and, with improving mortality, and a generally low interest rate climate, could be up to 20% higher than the Society's current annuity rates.

11. Matthews reported that the Society's stance, when challenged on its treatment of annuity guarantee policyholders, had been to state that the proceeds of the policy would comprise at least the product of the sum of the contractual guaranteed benefits and declared reversionary bonuses accrued times the guaranteed annuity rate. Final bonus would be adjusted to take account of the cost of providing the guarantee. He pointed to two problems with that approach:

- policyholders had received annual statements showing the full fund value, subject to an explanatory note about guaranteed annuity rates; and
- past illustrations had shown the full fund value applied equally both to guaranteed and contemporary current annuity rates.

He identified a risk that the Society would come under greater pressure on the subject. He referred to media interest. He invited discussion, and proposed three approaches that the Society might take:

- continue with the existing policy and risk a case ultimately landing up in court;
- concede on a case by case basis if it were felt that the client had a strong enough case based on misinformation in the past;
- recognise that there was a problem for particular (identifiable) policy classes and have reduced bonus rates for such classes.

12. It is clear from Soundy's statement to the inquiry and the contemporary correspondence that by April 1998 the issue was not novel. By that date there was a developed stance to adopt in the face of challenge, and a range of possible responses had been identified. The notes of the PIT meeting recorded that it was agreed that the Society would continue to defend its approach but, as a last resort and only if approved by APD, would apply guaranteed annuity rates to the full fund value as a gesture of goodwill. So far as the PIT was concerned, the general policy line could be held, and settlements reached on an ad hoc basis. It was agreed that the wording of policyholders' annual benefits statements would be reviewed. The memoranda recording PIT meetings were circulated among senior management of the Society.

13. The PIT discussed the revision of the annual statement of benefits thereafter, but on 26 August 1998 the team returned to the annuity guarantee issue more generally. The Society's confidence in its approach was affirmed. A field force circular was to be distributed. On 28 August 1998, Headdon, by then the appointed actuary, distributed an internal memorandum on the emerging issue to staff. He stated that annuity guarantees had last been written in 1988, and that the Society could identify the affected policies. The Society's practice of treating all pensions business as primarily providing a cash fund at retirement, which was by then widely known, was rehearsed. He set out the approach to the relevant business as follows:

"Where a policy contains guaranteed annuity rates, those provide an alternative form of the guaranteed benefits, i.e. in annuity rather than cash fund form. If, over the years, the basic guarantees had been expressed in annuity rather than cash fund form, different final bonus rates would have applied reflecting the different nature of the guaranteed benefits. In recent years, the Board has determined that, where an annuity is taken on guaranteed terms and the guaranteed annuity rate is higher than the equivalent current annuity rate, the final bonus is lower than would apply if the benefits were taken in cash fund form. For the last few years, as interest rates have fallen and it has become more likely that a guaranteed annuity rate would be higher than the equivalent current annuity rate, a note has been added to relevant annual statements describing that position.

To confirm, the practical operation of a guaranteed annuity rate in the Society's case is that the annuity payable is the greater of

- (a) the total cash fund applied to the current annuity rate
- (b) the guaranteed benefits in annuity form, which are equivalent to the cash fund excluding final bonus applied to the guaranteed annuity rate.

Since policies containing a guaranteed annuity rate are necessarily at least 10 years old, the guaranteed annuity will produce a higher level of income in only

a small minority of cases. Even in that minority the difference between (a) and (b) above is likely to be quite small.”

14. Headdon’s approach, the differential terminal bonus policy, was predicated on the assertion of the Society’s right to treat all of its pensions business as providing primarily a cash fund for conversion at retirement into an annuity.

15. The Society had written business in precisely that form prior to 1988. In particular that was the form of certain pre-July 1988 additional voluntary contribution (AVC) contracts¹. It had been the form of many Federated Superannuation Scheme for Universities (FSSU) contracts written prior to 1970². Fundamentally, the statement asserted the right of the Society to approach all pension business in that way irrespective of the terms of the contracts. Also implicit in the statement was the assumption of a wide discretion to alter final bonus according to the benefits taken.

16. On 1 September, Headdon sent a confidential memo to the non-executive directors. He referred to press publicity of the previous weekend, enclosed a copy of the memorandum to staff, and set out the arithmetical consequences of the policy:

“Assume a policyholder has a cash fund at retirement of £100,000 made up as follows:

Guaranteed cash fund and declared bonus	£80,000
Final bonus	<u>£20,000</u>
	£100,000

If the policy contains a guaranteed annuity rate of 10% then the minimum income guaranteed by the policy is 10% of £80,000 i.e. £8,000 p.a.

If the current annuity rate is 10% or more then it is clearly in the policyholder’s interests simply to use the cash fund on current annuity rates. If the current annuity rate is, say, 7.5% then the cash fund of £100,000 will only buy an income of £7,500 p.a. on current annuity rates, so the policyholder is better off taking the annuity guaranteed by the policy.

At intermediate positions, such as a current annuity rate of 9%, the cash fund will still secure a higher income on current annuity rates (i.e. £9,000 p.a.) than the guaranteed income. If, however, the policyholder realised that the guaranteed annuity rate of 10% was higher than the current annuity rate and insisted on making use of the guaranteed annuity rate, then the final bonus would be adjusted to £10,000 so that the benefits would be calculated as follows:

Guaranteed cash fund and declared bonus	£80,000
Adjusted final bonus	<u>£10,000</u>
	£90,000

Income produced on guaranteed annuity rate = £90,000 x 10% = £9,000 p.a.”

17. The ‘guaranteed annuity rate’ referred to in the calculation was a rate reflecting both the mortality factor at retirement and the interest rate which, on the Society’s approach to all of its pre 1 July 1988 annuity guarantee business, were implicit in the contract as applicable on conversion of the accumulated cash fund. The implicit interest rate was never higher than 7%. The Society’s current annuity rates reflected current mortality assumptions and the current interest rates making up the conversion factor for immediate purchased annuity contracts.

18. The Society’s practice, as reflected in this memorandum, involved substitution of rates reflecting current mortality and current interest assumptions for the contractual terms. It therefore compensated for any inadequacy in the contractual mortality assumptions in addition to the differences in the interest assumptions

¹ See Appendix B for glossary.

² See Appendix C for background notes on the FSSU.

driven by external market conditions. Headdon observed that the position he described had applied for a few years. He commented that the formal statement of bonus determined by the Board each year had allowed for final bonus to be adjusted as described, and that annual statements issued to policyholders had also mentioned the point.

19. The memorandum stated that it was important for directors to remember that the cash fund available under these policies represented the full value of accumulated contributions. Where the guaranteed level of income was higher than could be achieved on current annuity rates, policyholders were claiming an additional benefit, which would be unfair to the rest of the Society's with-profits policyholders on whom the cost would fall. One had in this statement to the non-executive directors a clear indication of the policy stance adopted by management as the issue became more controversial.

20. Media pressure on the Society at this time was becoming more intense. On 7 September executives of the Society met to discuss the situation. Headdon summarised the options and risks:

“At one end there is the option of changing the approach to that which Bayliss is arguing for. The implications and risks associated with that may be summarised as

(i) A 'worst case' cost based upon current annuity rates and policy fund values of £1.5bn (ii) The reserving/solvency implications associated with meeting the cost

(iii) The adverse affect on future bonus policy for either the whole of the with profit business or a sub-set of meeting the cost

(iv) The PR implications of (ii) and (iii) which would be damaging and lasting.

At the other end there is the option of continuing with the current approach. The implications and risks associated with that may be summarised as

(i) Loss of reputation for 'fairness' with as a consequence an adverse effect on our dealings with clients, new and existing

(ii) An ongoing opportunity for IFAs etc. to attack us

(iii) Open to comment that the approach is forced upon us because we are in a weak position (at the extreme we cannot afford to meet our guarantees).

The possibility of positions between the extremes was discussed. Whilst it was felt that there may be merit in relaxing in some areas where a strict interpretation was available to us, and a virtue could possibly be made of that, a more general compromise position, if indeed one could be found, would not remove the implications and risks of the extremes.”

21. Headdon emphasised that the current policy of the Society reflected the internal view held consistently over the previous fifteen years. The conclusions of the executives' meeting were:

“It was agreed that even if at the end of the day we might not rely on the strict legal position it was imperative that immediate action was taken to confirm that our interpretation of the legal position was correct and also to get opinion on a small number of areas of uncertainty.

Overall the view of the meeting after a wide ranging discussion was that we should

(a) continue with the current approach

- (b) continue with the current line of argument in support of that approach with the press and policyholders. This should be in a low key way
- (c) seek urgent confirmation of the legal position
- (d) take suitable urgent action to ringfence the problem, subject to confirmation of the legal position.”

The practical implications, taking legal advice, setting out the arguments for internal use, and further briefing of directors were put in hand. It was made plain by Headdon that actuarial staff were expected to subscribe to the policy thereafter without question.

22. On 9 September there was an informal briefing meeting for directors. A note of the meeting was circulated on 11 September 1998. Headdon summarised the background. He told directors that there were approximately 100,000 retirement annuity policies and 20,000 individual pension plans containing annuity guarantees still in existence. In addition, there was an unknown but substantial number of group pension scheme members entitled to annuity guarantees. He made these comments:

“Current annuity rates first fell below GARs in late 1993 and a special calculation of final bonus for cases where a GAR is exercised was introduced in the declaration at the end of 1993 (and was included in the formal Statement of Bonuses resulting from the Valuation and approved by the Board). This special calculation provides that where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus is reduced such that the annuity secured by applying the cash fund (so reduced) to the guaranteed annuity rate would be the same as applying the cash fund otherwise available to current annuity rates.

CPH emphasised that the manner in which the Society is operating in respect of GARs is that which it always intended and that a change of approach would give rise to inequity between classes of policyholder.

Our current approach can be summarised as follows:

The income available to the policyholders is the higher of:

- (i) Fund (including final bonus) x current annuity rates
- (ii) Fund (excluding final bonus) x GAR.”

23. Headdon reported that the guaranteed annuity rates included in policies issued from 1956 to 1975 were very close to the Society’s then current annuity rates. Those contained in policies issued from 1975 to 1988 were approximately 25% higher than current annuity rates. That was where the main current problem lay. To apply the full fund (including full final bonus) to guaranteed annuity rates contained in policies would represent a potential cost of up to approximately £1 billion in respect of retirement annuity policies, subject to the inherent uncertainties arising from the long-term nature of the business, rising to approximately £1.5 billion with the inclusion of individual pension plans and group pension schemes. He said that the Society’s current approach would also have some cost, if interest rates remained at current levels or became lower. He stated that he would make a reserve in respect of this liability at the end of year valuation, but it was not likely to be significant, and was likely to be in the order of £100m. Headdon also commented that a factor contributing to the cost to the Society was the flexibility of the Society’s contract in providing annuity guarantees for retirement from ages 60 to 75.

24. Headdon informed the directors that executive management had concluded that meeting the annuity guarantees on full fund value was not tenable because of the very adverse effect such a change of approach would have on the Society’s solvency position, the resulting restrictions on investment freedom and the effects

on bonuses which the Society could declare together with the major inequity which would inevitably be introduced between different groups of policyholder.

25. Headdon then went on to describe the calculation of policy benefits as they had been set out in the relevant policy documents. The approach adopted came to characterise the Society's approach to contractual interpretation throughout. The latest form of retirement annuity contract was selected as the basis for generalisations, ignoring the historical development of the policy forms. The interpretation most favourable to the Society's position was selected. And warnings by Dentons³, the Society's solicitors, albeit tentative, were simply recorded. The calculation was described as follows:

"Each premium secures an "Accumulation Value" which receives a 3½% per annum guaranteed roll up to the date the benefits are taken.

The "Annuity" guaranteed by the policy = Accumulation Value x GAR

The "Policy Annuity Value" = $\frac{\text{Annuity} - \text{'Related Bonuses'}}{\text{GAR}}$

The policy provides that:

"Related Bonuses" means ... such amounts (if any) as shall under the rules and regulations of the Society have been allotted by way of addition to or bonus thereon"

26. The Society's solicitor⁴ confirmed that the directors had discretion regarding bonuses allotted to policies and referred to the wide powers given to the directors by regulation 65 of the Society's articles. He confirmed that, in his opinion, this enabled directors to take a differential approach between classes of policies and between benefits within a policy. He referred to the requirement that the directors must do justice between different classes of policyholder and expressed the view that this was what had been done by the Society. He added a caveat, however, that there was nothing in the policy conditions that would lead a policyholder to believe that a differential approach would be applied. The policy did not distinguish between 'related bonuses' applied to guaranteed rates and those applied to current rates. He thought that this could be the basis of an argument by a policyholder that he was led to believe that the same 'related bonuses' would apply both to guaranteed and current annuity rates. There is no record of the directors' response to the warning.

27. Headdon then rehearsed some of the material distributed to policyholders over time, and commented on the representations it contained. He commented that it was a potential weakness in the Society's position that until 1988 illustrations showed the fund including terminal bonus being applied to both the current annuity rate and the GAR. He thought that this position could be defended on the basis that that was what would have happened at the time. However, a policyholder could argue that this had led to an expectation that this approach would continue to apply. Also, it was likely that the existence of the guarantee had been drawn to clients' attention as part of the sales process at the time. There were detailed discussions of the form of annuity benefit available, the impact on transfers, and the enforcement of policy conditions. Directors were given a wide briefing on the issues. Among other decisions recorded, it was agreed that the solicitors should seek counsel's opinion on the strength of the Society's legal position.

28. The Society's management put in hand a range of practical exercises over the following period, providing information to staff, checking the Society's procedures on maturities, examining other policy types to identify guarantees, standardising letters of reply to enquiries, amending illustrations, and dealing with media. Vulnerability to a hostile take-over became an issue.

³ The law firm, Denton Hall, later Denton Wilde Sapte, later simply Dentons, which is referred to in the report generally as Dentons.

⁴ Brian McGeough of Dentons.

29. There was a regular board meeting on 23 September 1998. The minutes set out a lengthy discussion of the guaranteed annuity rates issue. The chief executive, Alan Nash, had submitted a written report. The minutes set out his brief oral comments and Headdon's extended discussion. There was considerable repetition of earlier material. But the minutes can be taken to record the directors' understanding of the situation at a crucial stage, shortly before publication of the Society's position.

30. Headdon referred to ring-fencing of the annuity guarantee liabilities as an alternative to treating policyholders claiming the contractual benefits individually, and commented on the unfairness that would imply in the case of those within the annuity guarantee classes who elected to take benefits on current annuity terms. He repeated the description of the approach adopted, and the cost of implementing the guarantees. By now the Society had obtained counsel's opinion supporting the management's approach. The Board was advised of current steps to deal with the public relations issues that were emerging.

31. On 9 October 1998, Nash wrote to all non-executive directors. A further opinion from counsel had confirmed the regularity of the Society's actions, and was said to have given helpful advice on the amendment of the annual statements to reinforce the Society's position. He reported on a meeting with regulators which had taken place on 2 October:

"A meeting has been held with the Treasury and Government Actuary's Department at their request, as I indicated at last month's Board. The Treasury/GAD are gathering information on how offices are dealing with the guarantee. I ran through our approach and responded to questions from those present. I, plus Chris Headdon and David Thomas who attended with me, gained the impression that the Treasury/GAD were reasonably comfortable with our approach and they expressed no real concern that we were failing to meet policyholders' reasonable expectations. That was on the basis of the consistent messages we have given to clients over the years about the aims of our bonus system in seeking equity between clients and on the basis of some warning notes regarding guarantees which we have included on annual statements over the last few years. In addition they recognised that the guarantee (of guaranteed annuity rate times guaranteed cash fund) was actually being operated by us.

There was also some discussion on the most appropriate form of reserving for contracts with guaranteed annuity rates and on the possible impact on the statutory solvency position. Since the discussion involved detailed technical issues, Chris Headdon agreed to pursue that separately with the GAD and to produce some data on the Society's position as a basis for that further discussion."

The regulators' view of the meeting is recorded in a later chapter⁵. So far as those receiving the note were concerned, the import was that management had the support of counsel, and following discussions, reasonable comfort from regulators. Nash reported that a leaflet had been drafted, had been circulated to staff and was being used as the basis of responses to clients. A copy of the current text was attached to his letter. The draft leaflet was a bold and assertive expression of the Society's position along the lines discussed with the Society's lawyers.

32. On 14 October 1998 there was a meeting between management and some non-executive directors. Additional information was provided about the contacts with regulators:

"Alan Nash, David Thomas and Chris Headdon had attended a meeting with the Treasury and the Government Actuary's Department. A detailed letter had been sent before that meeting, setting out the Society's approach. Alan Nash

⁵ See chapter 17, paragraphs 25 to 27.

reported that the Treasury/Government Actuary's Department appeared to be reasonably comfortable with the Society's approach and that there was no indication that they would require a change in approach. The matter of reserving for the guarantees and the effect on solvency had been discussed and Chris Headdon was doing some further work on the reserving basis prior to discussing the matter further with the Government Actuary's Department. There were indications at the meeting that the Government Actuary's Department considered the current market volatility sufficiently unusual to be able to consider relaxing the normal resilience testing requirements. Alan Nash confirmed that the tone of the meeting was that the Treasury and Government Actuary's Department were reasonably supportive and appeared to be prepared to exercise some flexibility.

The point was made, however, that should policyholders complain to these or other Government departments they could take a different approach."

33. At the same meeting there was further discussion of steps taken to preserve mutuality. Salomon Schroder Smith Barney⁶ had been consulted. Nash expressed the view that the current subjects of guaranteed annuity rates and solvency should not affect the position, and that the Society's strong stance in favour of mutuality should be maintained. The guaranteed annuity issue remained a major topic at board and committee level in October and November. A manuscript note from Julian Hirst, the Society's chief accountant, and apparently addressed to the risk management group, briefly recorded a meeting between Hirst, Nash, Roger Bowley, an executive director of the Society, and Alan Tritton, the chairman of the audit committee, on 28 October. The note records Tritton as pointing out that the guaranteed annuity issue had taken the Board and directors by surprise, and saying that he thought the Society needed a wider solvency margin and "perhaps need to reconsider our full distribution policy".

34. On 10 November 1998, there was a meeting with the Society's solicitors to discuss recent press articles. Media comment on the Society's position had been mixed. Those attending agreed that there should be a letter to all policyholders (c.650,000), which they should ideally receive on the same day, dealing with proceedings before the Ombudsman, inter alia. There was discussion of the Society's response should a writ be served.

35. At a further meeting on 11 November 1998 to review the guaranteed annuity position and associated public relations issues, involving some of the non-executive directors, there was discussion regarding the reasons for the Society first offering guaranteed annuity rates. There was also a question regarding when terminal bonuses were first introduced and whether the implications of these and guaranteed annuities were identified and consideration given to them at the time. Peter Martin, vice president and an experienced lawyer, advised that a confidentiality agreement be entered into when the Society paid out beyond the terms of the policy, and emphasised the need to pay 'without prejudice'. David Thomas, the investment director, noted that the unit-linked guarantees would have to be met by the "shareholders", "a point which had not yet been made in the press." The contributions suggested growing concern about the Society's public image.

36. At the Board meeting on 25 November, the requirement by regulators and GAD for full reserving for guarantee liabilities was discussed. Various options, including judicial review, were mentioned. It was reported that information had been sought by regulators on policyholders' reasonable expectations. The possibility of litigation on the annuity guarantee issue was raised, but deferred on Martin's advice until the reaction of policyholders and the press was clear.

37. On 9 December there was a further meeting between management and selected non-executive directors. The main issues were the outcome of the meeting

⁶ For ease and consistency with the documents quoted, Salomon Schroder Smith Barney are referred to simply as 'Schroders' or by the acronym 'SSSB' throughout this report.

with HM Treasury and GAD and public relations. But the possibility of raising declaratory proceedings on the annuity guarantee issue was raised. It had been decided to prepare a writ, but not to serve it at that stage. Headdon reported that regulators had not dropped the question of policyholders' reasonable expectations and had asked for further information.

38. On reserving he reported that the official view was that it was necessary to have regard to the contract terms and to reserve for the whole of the primary benefit under each contract. The official view was that the primary benefit in individual pension and group pension contracts was a cash benefit, to which the guaranteed annuity was applied as a secondary benefit. In those cases the primary benefit had to be reserved in full, and a prudent provision made for the option, but not necessarily on the basis of full take-up. However, the retirement annuity contracts were, in GAD's view, written with the annuity as the primary benefit, and full reserving was required. The Society had argued strongly that the distinction was illogical. Counsel's opinion was being taken. Preparations for the declaratory proceedings were taken forward. The minutes make clear that the Society's actuaries had now had a firm statement of the official position on the application of the regulations to the Society's retirement annuity business. There was increasing pressure on the Society.

39. At a meeting on 16 December 1998, there was further discussion of the guaranteed annuity issue. Nash presented a wide-ranging report on the Society's financial position and options. The proposal to initiate declaratory litigation was discussed. Counsel were said to be firmly of the view that the directors did have the discretion on terminal bonus that they claimed. There was reference to further legal advice on the reserving issue in respect of which separate litigation was a possibility.

40. It appears to be clear that the Board were given substantial comfort by the opinions of Anthony Grabiner QC and Brian Green QC. Having been assured in firm terms that they were correct in the course adopted, there was no incentive for the directors and in particular the executives to revise their views. However, in order to meet some of the regulatory pressure on reserving, the possibility of financial reassurance was investigated, to take the liability off balance sheet if GAD did not change its mind. And the investment committee was considering means of easing the solvency position. There were also discussions with the Society's auditors on the presentation of figures.

41. The minute of the December meeting⁷ indicated that the directors were informed in discussion that the actuaries' approach to the valuation of the annuity guarantees was dependent on the validity of the terminal bonus policy. The actuary again reported that the 'special calculation' for annuity guarantee cases had first been introduced at the 1993 declaration. The inquiry has not recovered anything in the nature of a detailed paper for the information and decision of the Board in December 1993.

42. In the actuary's report for the Board meeting of 27 January 1999 reserving was discussed in relation to particular factors rather than generally. The report dealt with reserving for annuity guarantees on three bases: (i) a 'best cautious estimate', appropriate for the statutory accounts; (ii) a prudent basis, appropriate for general regulatory requirements; and (iii) the basis for meeting the FSA and GAD guidance. At the meeting Nash reported on public relations matters relating to the guaranteed annuity issue. The declaratory proceedings had commenced. Nash told the Board that the declaratory action had been started earlier than expected to avoid solicitors acting for the action group from being able to issue a writ. Alan Hyman had been selected as representative defendant. Litigation was in hand. The narrative to this point reflects the position as presented to the Board. There had been contact with Hyman and others in the meantime.

⁷ See also chapter 17, paragraphs 83 to 87.

Conduct of the Hyman Case

43. In September 1998 Hyman had requested a statement of the benefits currently payable under his policies. The information provided initially, dated 1 and 2 October 1998, illustrated a wide range of alternative benefits all computed by reference to the policy values of his contracts at current annuity rates. He requested an illustration of the benefits at the relevant guaranteed annuity rates in the hope that the outcome would be more favourable. An internal memorandum dated 5 October 1998 expressed the Society's view that taking benefits in guaranteed annuity form produced a lower annuity than that available from current annuity rates. It was stated that no special illustrations were required, in the view of the writer. The writer noted:

“We compare guaranteed fund x guaranteed annuity rate with current fund x current rate and in each case the latter gives higher benefits.”

The arithmetical exercise described by Headdon to executives and to the Board in September had been carried out.

44. Hyman persisted. On 9 October 1998 an illustration of the benefits payable should he require the implementation of the annuity guarantee demonstrated that on the Society's approach the outcome would be less favourable than on the application of current annuity rates. The Society's current annuity rates had been reduced in the interim, but Hyman was not informed of that change since he had not specifically asked for the information. Hyman had ready access to advice. He became aware of the approach adopted by the Society to calculating terminal bonus when the annuity guarantee was applied. He transferred his funds to Canada Life Assurance Company and intimated a complaint to the PIA Ombudsman. He had joined a growing band of disaffected policyholders and former policyholders of the Society.

45. After intimation of the first complaints by policyholders to the PIA Ombudsman in July 1998, the Society's executive management had in contemplation the alternative fora, in which challenge of the differential final bonus policy might be dealt with. Piecemeal disposal of individual complaints by the Ombudsman was possible, but not attractive. On 7 September 1998, the Society sought legal advice on a series of questions, as decided at the meeting of executives that day⁸. The solicitors responded on the following day, covering a range of questions, some of which were collateral to the central issues, but, in particular, they affirmed that the directors had discretion to reduce final bonus on the basis of the policy wording and the articles of association, but warned of the risk of contrary expectations generated by publications and communications with policyholders and possible exposure to claims on that basis.

46. The solicitors' letter, written at an early stage in the process that resulted in litigation, presented a reasonably balanced view of the issues that might confront the Society. Assessment of the collateral risks soon became subordinated to discussion of the strength of the Society's contractual position. Detailed instructions were prepared for counsel's advice on the most material questions. The instructions included the following statements and questions:

“Overview

Instructing Solicitors act for the Society. The Society is a mutual life assurance company whose members are its with-profits policyholders. Profits are allocated to members of the Society in the form of bonuses. Bonuses are of two types - "declared", i.e., bonuses which attach to policy benefits annually and thereafter become guaranteed policy benefits and "final" or "terminal" bonuses which are non-guaranteed and only finally determined when a policy claim becomes due for payment.

⁸ See paragraph 21 above.

Between 1956 and 1 July 1988 the Society issued With-Profits retirement policies providing for benefits expressed in the form of an annuity at guaranteed rates depending on the age (between 60 and 75) at which the policyholder takes the annuity, and increased by "Related Bonuses" which provide the with-profits element of the benefit under the policy. No additional premium was charged in respect of the guarantee.

Policies other than the very earliest provide for a cash sum benefit corresponding to the annuity benefit to be calculated. When legislation was introduced in 1979 allowing the proceeds of a policy to be transferred to another provider at retirement as an "open market option", the Society allowed such transfers to be made without penalty. As a result of the availability of that option, communications with policyholders over the last decade have increasingly focused on the cash sum rather than annuity benefits.

In July 1988 the Society stopped writing retirement policies of this type and started writing personal pension plan policies which contain no annuity guarantee and which accumulate benefits solely in the form of a cash sum to be used to secure appropriate benefits at retirement. Those benefits include "Related Bonuses" which are defined in a similar manner to bonuses under the pre-July 1988 retirement annuity policies.

The pre-July 1988 retirement policies permitted policyholders to take the guaranteed annuity at the guaranteed rate or an annuity at the Society's current rate at the relevant time or an annuity with another company (the latter option being introduced by legislation in 1979).

Until 1993 the Society's current rates always produced a higher annuity than the guaranteed rates. The effect of recent interest rate reductions and longer life expectancies has meant that the guaranteed annuity rates are now usually above the corresponding current rates for the relevant age of policyholder.

As a mutual office the Society has sought to treat its members (i.e., its with-profits policyholders) equitably and in allocating bonuses the Directors try to ensure that justice is done between the various classes of with-profits policies and that the policyholders receive a fair return on their respective investments. The allocation of bonuses each year is and has been throughout the Society's history a carefully thought through decision based on actuarial advice and designed to promote fairness and equality between current policyholders and between different generations of policyholders.

In pursuit of this aim the approach followed by the Directors in recent years has been to treat retirement annuity policies in the same way as the corresponding post-June 1988 personal pension contracts, when the benefits are taken in the form of a cash sum to be applied on current annuity rates, but to reduce final bonus where the guaranteed annuity form of benefit is taken, in order to achieve benefits of the same actuarial value. This was judged to be a fairer treatment than the alternatives available, such as meeting the cost of the annuity guarantees by means of lower bonuses to the whole class which would have led to those policyholders who died or took the benefits in cash fund form receiving benefits of significantly lower value than those choosing the guaranteed annuity benefit.

The reduction in final bonuses has been expressed as the amount needed so that the resulting reduced fund applied to the guaranteed annuity rate will produce the same income as that which could have been achieved by applying the Society's current annuity rates to the total (unreduced) fund. The Society recognises that if annuity rates were to fall to such an extent that even a complete removal of the final bonus would not equalise guaranteed policy benefits with those under non-guaranteed Policies, the Society will be obliged to pay the guaranteed rates on the accumulated premiums and guaranteed (i.e., declared) bonuses. Policyholders taking benefits in guaranteed annuity

form, therefore, never receive benefits of lower value than those taking cash sums and, in some cases, will receive more valuable benefits.

To date, the cost of the additional benefits payable on those cases where the guaranteed annuity produced the higher level of income has been relatively modest and, except in extreme financial conditions, that situation is expected to continue. The effect on the general level of bonuses is, therefore, expected to be minimal. By comparison, the application of the guaranteed annuity rates to the full cash fund benefit including final bonus would lead to significantly higher benefits under policies where a guaranteed annuity is taken. The cost of that would need to be reflected in material reductions in bonus rates more generally with the consequence of significant inequity to other groups of with-profits policyholders.

The above practice has applied since 1 January 1994 and retiring policyholders who have enquired as to the calculation of their benefits have been told that this treatment has been applied. The approach was explained more generally by means of a note on annual statements introduced in 1995....

More recently, the matter of guaranteed annuity rates generally, and the Society's approach in particular, have been reported in the Press Adverse press comment has caused the Society to seek to confirm the legality (and conformity to its policy and other published documentation) of its treatment of retirement policies with a guaranteed annuity element."

The instructions then rehearsed various provisions of the policy forms, and set questions for counsel⁹ in the following terms:

"Counsel is now asked to advise in consultation and thereafter, if required by the Society, by written opinion on the following matters:

1. Does Counsel agree with Instructing Solicitors that under Article 65 of the Society's Articles of Association the Board of the Society has a complete discretion as to the allocation of bonuses among policyholders? Specifically,

(a) does their discretion permit them to award different bonuses to different classes of policyholder and, within any class, to different policyholders depending on those policyholder's choice of benefits?

(b) the Board has always taken the view that, in exercising its discretion, it must act reasonably and fairly in the interests of the members of the Society (i.e. as a mutual, its with-profits policyholders) and of the various generations of members as described on page 4 of these Instructions. Does Counsel agree with this? If so, does this put any constraints on the exercise of the discretion in this case?

(c) is the Board's power constrained by any statements made in the illustrations and communications to the policyholders sent herewith as documents 5 and 6 or the Society's leaflets sent herewith?

(d) generally, is the method of dealing with the issue of guaranteed annuity policies set out in the note sent herewith as document 9 legally correct and in accordance with policy terms?

(2) As mentioned above, the Society has dealt with the issue of paying for the guaranteed annuity rates by "charging" the holders of guaranteed annuity policies by means of a reduction in their final bonuses. Effectively, therefore, the expression "Related bonuses" has a different meaning in the expression "Annuity increased by Related Bonuses", where it is a lower amount, from that in the expression "Policy Annuity Value", where it is a higher amount. It is thought that the definition of "Related Bonuses" is

⁹ Brian Green QC.

sufficiently flexible to produce these meanings. Does Counsel agree that this is the case or is the freedom of the Board to allot bonuses in its discretion in any way limited by the wording of the Policy?

(3) If a policyholder were to challenge the differential treatment of "Related Bonuses" under his policy, is he likely to succeed? If so, what would be the remedy afforded by the Court? Would it be feasible or desirable in Counsel's view to obtain a test case ruling on the matter. If so, what would be the procedure to achieve this?

(4) Given the statements already made in illustrations, literature and statements sent to policyholders over the years, are there any steps which the Society could take to improve its chances of succeeding in any argument with policyholders as mentioned at 3 above. One method which has occurred to Instructing Solicitors is to restate the bonus entitlements of all policyholders of this type (whether they wish to take the guaranteed annuity or not) by reducing the final bonuses but at the same time make a statement that, on an ex gratia basis, the Society would be prepared to make a larger amount of final bonus available to policyholders taking benefits other than the guaranteed annuity. Could this be done without the "Ex gratia" route coming within the options already granted to policyholders under the Fourth Schedule of the policy.

(5) Do the statements made in the leaflets and other documents enclosed as documents ... with these instructions given policyholders additional rights which are being contravened by the Society's present course of action in relation to guaranteed annuities. ..."

47. Instructions may, without any positive intent to influence counsel, so present issues for advice that the strengths in the client's position are exaggerated and possible weaknesses understated. The narrative excluded a number of the solicitors' own earlier reservations about the Society's position. A consultation was held on 17 September 1998. Counsel's answers to the relevant questions were:

"1. Counsel agreed with Instructing Solicitors. In this respect the Board of Directors could be regarded as trustees. The Courts will not interfere with the exercise of discretion by trustees unless there is mala fides. Even if the decision of the Board was irrational or based on irrelevant data but the Board would have reached the same conclusion if rational criteria had been used, the Court will not interfere If a different result would have been reached applying rational criteria, the Court would order the Board to reconsider its decision ... Applying this to the specific circumstances, Counsel said that if the Board had used its power to apply larger bonuses to policies with less advantageous terms than to those with the guaranteed terms, that would be defensible. If, however, the rationale for the use of the discretion was to reduce bonuses on the more expensive policies as they were too costly, this would be difficult to defend. The representatives of the Society present stated firmly that this was not how the discretion had been exercised: bonuses had been devised to give a fair return on all policies of the same business class, eg. life, pensions, etc.

2. [Specific issues]:

(a) Yes, subject to the general points mentioned at 1 above. The Society cited at the consultation the example of one of their Personal Pension Policies which had a guaranteed premium roll up of x per cent per annum. Bonuses declared on these policies were also declared at a lower rate than other policies of the same class without this guarantee.

(b) Counsel agreed.

(c) In Counsel's view, the only problematical document was document 4 which states on page 3 (first paragraph in column 2) that "a final share of

profits is also allotted at the point the policy benefits become contractually payable". This seemed to indicate that some form, however small, of final bonus would be payable in all cases. However, against this was the fact that no guarantee of the amount of final bonuses had ever been given. Chris Matthews of the Society noted that, in the more modern form of this leaflet, the word "may" is used instead of "is". Counsel also noted the need to redraft the annual statements assuming that the course suggested at Question 3 below is adopted.

(d) Counsel was unhappy with the opening sentence of the fifth paragraph of this note and with one of the comments in the press clipping which appeared to be derived from it. Mr Matthews of the Society noted that this Memorandum was being redrafted in fuller form.

3. Counsel stated that, in his view, the difficulty was that under the policy wording there was a requirement to establish the Policy Annuity Value first before the policyholder decided which benefit to take. Counsel considered that in effect the Society had allocated a rate of final bonus for guaranteed annuity policies which was a bonus at the lower rate but had provided for an additional final bonus if alternative non-guaranteed annuity benefits were chosen. In future, this should be made clear in bonus statements.

4. As a matter of law, in Counsel's view, such a policyholder would not succeed but defence of the action would, because of the presentation of bonuses to policyholders at the outset and subsequently during the life of the policies, be tougher than it might have been had the presentation been different. On the basis of the Hastings-Bass case, if the action was successful, the last four years' bonus allocations by the Society would be void and the Society would have to recalculate bonuses for that period.

5. [Continuing question 4] It would be feasible but not desirable in Counsel's view to obtain a test case ruling on the matter.

6. [Question 5] It was noted at the Conference that the annual statements would have to be re-cast if lower final bonus rates were to apply. This would give rise at the least to cosmetic difficulties where policyholders compare their previous annual statements with their new current statement.

7. [Question 5] In general, Counsel stated that these documents did not give rise to additional rights (save as mentioned at paragraph 2(c) above in relation to document 4). However, they gave rise to difficulties in explaining what is now being done.

Specifically - in relation to the annuity illustrations, the reference to "corresponding fund value" was not ideal wording since it did not sufficiently alert policyholders to the lower fund value which would apply if guaranteed rates applied. If the method of dealing with the issue referred to at Question 3 above is used then, again, these illustrations will need to be redrafted. There is also the issue of whether the guaranteed annuity illustration should be given to all policyholders enquiring about retirement benefits where any reduction in final bonus applied because of guaranteed rates. It is understood that the Society's current policy on this issue is to give two illustrations only where guaranteed rates give rise to a higher annuity amount after total exhaustion of the final bonus.

[Another issue for the Society is how the cash fund value is calculated based on the method of declaring bonuses which refer to an annuity amount rather than a cash fund value amount. Is the cash fund based on guaranteed rates or current rates?] ..."

48. Further instructions and advice followed on particular issues, but these initial exchanges set the tone of the legal advice tendered over the following days. The re-interpretation in answer 3 of the actual practice of the Society was ingenious, but

difficult to reconcile with Matthews' statement to the PIT on 2 April 1998 or Headdon's analysis of the position on 28 August.

49. Counsel provided a written opinion on 11 October, confirming earlier advice, and expanding on his proposals for revising the annual statements of benefits:

"This opinion is supplemental to the settled note of consultation held on 17 September 1998, and is written in response to my further instructions dated 2 October 1998.

1. At a further consultation on 25 September 1998, the Society further explained its practices in relation to the allocation of bonuses, and the representation of the ongoing value of with-profits policies to individual policyholders in the various generations of annual statement which have been issued. Having had the benefit of the Society's further explanation, I confirmed the advice given on 17 September 1998 and set out in the settled note of that consultation.

2. In particular, I confirmed that the Society was justified in law in adopting the approach of declaring different final bonuses in order to ensure (so far as was possible having regard to the operation of guaranteed annuities on previously guaranteed values) that the ultimate "cash value" of any given policy would be a single sum, irrespective of whether the policyholder took the guaranteed benefits under his policy, or elected to take an alternative annuity based on an application of current annuity rates.

3. Having regard to the wording of the policy documentation, in current economic conditions, this approach required a two-stage process of bonus allocation to any particular member of the Society who had a guaranteed annuity policy. First, the allocation of a lower final bonus to guaranteed annuity policies (FBG) than that which would be declared in the case of a policy which did not contain guarantees (FBNG). Second, in the case of any guaranteed annuity policyholder who wished to take an alternative annuity based on current annuity rates, the allocation of a top-up element of bonus representing the difference between FBNG and FBG.

4. In the language of the relevant retirement annuity policy documentation, only FBG would constitute "Related Bonuses" in the strict sense. The top-up element would be allocated by the Board of the Society as a separate exercise of its discretion under Article 65, which is a wide enough discretion to enable bonuses to be allocated amongst members in 'top-up' form, as well as in annual and final (or 'terminal') form as conventionally understood.

5. The Board's decision to seek to achieve a result under which all persons holding similar policies achieve the same investment return, irrespective of whether some policyholders had the benefit of guaranteed annuity rates applicable to guaranteed benefits, is perfectly legitimate. Guaranteed annuity rates, just like guaranteed values, confer valuable rights nevertheless; as is clear whenever a case arises where the cash value (that is the present value) of an application of such guaranteed rates to guaranteed values is greater than that which would be available if current annuity rates were applied to such guaranteed values plus FBNG.

6. The statement of "cash values" in the annual statements is the most useful manner of presenting the 'value' of a member's policy benefits. However, the abbreviated manner in which such cash values have been presented in the past has not served the Society well in now attempting an explanation of the above practices.

7. Statement of guaranteed values is clearly necessary, for it is to these values that any applicable annuity rates will be applied as of right. Further, it

is clearly desirable that a policyholder should have some sense of the final value of his policy.

8. What is not made sufficiently clear in the annual statements is that, in the economic conditions prevailing at the date of the annual statements in question, the total value will depend on two factors. First, whether guaranteed annuity rates apply to the policy. Second, on the level of non-guaranteed final bonus added to the policy by the Society in exercise of its discretion reserved under the policy. In the economic conditions prevailing at the date of any given annual statement the total value of the benefits provided under the policy will be the stated figure. But the amount of non-guaranteed final bonus which will need to be added to the policy in order to reach that total value will vary according to whether the annuity rates under the policy are guaranteed or not.

9. The non-guaranteed final bonus figures quoted in the annual statement represent FBNG. What needs to be got across to policyholders is that the actual final bonus paid in relation to them may be a lesser sum if they have the benefit of guaranteed annuity rates applicable to guaranteed values, but that - since if they take a guaranteed annuity the Society will be applying the guaranteed annuity rates to any final bonus allocated - the total value of policy will not be reduced by one penny as a result.

10. It follows that in the case of a guaranteed annuity policy, the guaranteed value stated may in current economic conditions - actually purchase a larger annuity than were current annuity rates to be applied. In other words, whereas the total value figure attempts to state an aggregate cash equivalent value for benefits payable under the policy irrespective of the annuity rates to be applied, the guaranteed value figure is not a cash equivalent of the benefits which would be available irrespective of the annuity rates to be applied. This follows from the past practice of the Society in adding the same annual bonuses to all retirement annuity policies irrespective of whether or not annuity rates were guaranteed under such policies.

11. The abbreviated nature of the annual statement tends to obscure the fact that a number of different things are being stated in a single table which tends to create an impression that one is comparing like with like at all stages, when one is not (or may not be) doing so.

12. The guaranteed value is the guaranteed cash sum which will be made available by the Society for the purpose of securing the benefits to which the member is entitled under the terms of his policy, irrespective of the level of annuity rates applicable thereto at the date that the policy benefits are taken.

13. The total value is the cash equivalent value of the aggregate benefits which the member could expect under his policy on an application of whichever annuity rates are applicable to the benefit taken by him. What is being stated is that, taking due account of such presently non-guaranteed final bonuses as could be expected to be added to the member's policy were he to take his benefits as of 1 April following the date of the annual statement the cash equivalent value of his policy will be its total value; and this will be so irrespective of whether he takes his annuity in a form which attracts more generous guaranteed annuity rates or current annuity rates.

14. The non-guaranteed final bonus as stated is such sum as the Society would be adding to the guaranteed value in current economic conditions in order to produce the total value, on the assumption that more generous guaranteed annuity rates do not apply. It is the sum which the Society will need to allocate to the policy by way of addition to the guaranteed value in order to produce the stated total value, if current annuity rates apply to the benefits actually taken.

15. What is missing is an explanation that, where guaranteed annuity rates exceed current annuity rates, the sum which the Society will need to add by

way of non-guaranteed final bonus will be less in order to produce the stated total value. In other words, that the non-guaranteed final bonus figure is a maximum figure stated in current economic conditions.

16. For my own part, I would prefer to see the annual statements recast so as to make the foregoing absolutely clear. That is, so as to explain clearly that guaranteed value is a sum which will - in the economic conditions prevailing at the date of the annual statement - buy greater benefits for a person enjoying the benefit of guaranteed annuity rates. And so as to explain clearly that the total value of the policy is the greater non-guaranteed cash equivalent value of the policy benefits (inclusive of guaranteed annuity rates where applicable). The annual statement would then state that the Society would be securing the difference between the guaranteed value and the greater non-guaranteed cash equivalent value by the allocation of discretionary final bonuses when the benefits are taken under the policy. The non-guaranteed final bonus figure - if it has to be included - would then be stated as an indicator of the sum which the Society would need to add by way of final bonus were current annuity rates to be applied to the guaranteed value, in order to produce the total value.

17. Any explanatory leaflet could then explain that for many years current annuity rates had exceeded guaranteed annuity rates, and the Society had in practice stated non-guaranteed final bonuses on that basis accordingly. In recent times guaranteed annuity rates had exceeded current annuity rates, but the Society had continued with the previous practice in the interests of consistency. The cash equivalent value of the annuity which the guaranteed value of the policy could secure if the benefits were taken in the current environment was presently greater than the value of the benefits available to those without the benefit of guaranteed rates (although economic conditions could always change), and the dependence of such policyholders on an additional non-guaranteed final bonus which would be necessary in order to bring the total value of the benefits up to the stated total value would therefore be smaller so long as (and to the extent that) the differential in favour of guaranteed annuity rates continued to exist.

18. I believe that a presentation and explanation along the above lines would best serve the Society's interests in the present circumstances.

19. I have settled the notes and insert to the annual statement sent to me under cover of my instructing solicitors' letter of 7 October 1998 in accordance with the above advice. In the interests of further clarity, I would prefer to see the expression guaranteed sum substituted for the expression guaranteed value (since the value of the benefits secured by the so-called 'guaranteed value', will depend in fact on applicable annuity rates); but if continuity or other commercial considerations dictate otherwise, so be it. I assume that the Society will have its own comments on the enclosed.

20. I understand that the Society is working on a re-draft of a proposed explanatory leaflet intended to provide a definitive explanation of past and present practice, which I will be glad to look over in due course. I will then give consideration to the possibility and/or desirability of including further material along the lines suggested at points 3(b)(i)-(v) of my instructions in that leaflet. I do not believe that it is necessary to canvas such matters further in relation to the proposed revised annual statement."

50. Counsel had provided strong support to the Society. His interpretation of the Society's past practice was encouraging and imaginative. The steps suggested to strengthen the Society's position appear to have reflected his view of what had happened in fact, though I have not found any evidence that matters had been so presented by the Society itself in literature or correspondence with third parties, or in internal communications. The advice was taken up in the statements of benefits issued for 1998.

51. The Society and its legal advisers continued discussions. On 21 October the risks associated with the Society's discovery obligations if there should be litigation were discussed. Solicitors advised on the scope of documentary material likely to be discoverable. As the autumn proceeded, the directors began planning for the possibility that a writ would be served on the Society. In those circumstances it was agreed that the Society would wish to take the initiative by raising declaratory proceedings, initially with two 'tame' defendants, one policyholder with a guaranteed annuity and one with a non-guaranteed annuity. Counsel remained of the view that court action was not indicated. The possibility of policyholders obtaining by discovery papers relating to a number of specific cases was considered again.

52. A meeting with counsel was held on 23 November 1998. Counsel's emphatic view then was that it was not in the Society's best interests to bring the matter into court. He advised that the question should be reviewed if proceedings became inevitable. However, if there were to be action, counsel advised that the Society should stay in the driving seat. At that stage the view was that the case was capable of being lost. The estimate of the potential liability was £1.5 billion and the Society's actuaries considered that that would raise solvency issues. Counsel suggested that the Society should consult its auditors. Although it was not spelled out, a material consideration must have been that, if the case came into court before counsel's proposals for amendment of the benefits statements matured, the potential benefits of the amendments might be lost.

53. On 25 November 1998 the Society's legal advisers returned to the issue of litigation and the advantages of taking the initiative. The two main advantages of raising declaratory proceedings were said to be:

- (i) The Society could define the issues, at least initially. The Society's originating summons would be the first thing the Court read. The Society would have greater control over the conduct of the proceedings and might be able to limit discovery; and
- (ii) It would be a pre-emptive strike - the Society could choose its forum. The issue of proceedings would exclude jurisdiction of the PIA and Pensions Ombudsman in relation to future complaints. The solicitors said that the Society might get a better hearing if it went to Court first, rather than going to Court on appeal from an unfavourable Ombudsman's decision, a course which in any event would cause delay and significant public relations problems."

The solicitors advised that it would only be appropriate for the Society to consider taking the initiative if it did not succeed in taking the matter "off the agenda". The PR implications of litigation would have to be handled with great care. There was thought to be an advantage in the Society commencing proceedings rather than being named as defendant. The solicitors advised delay to see what happened in the press, then at the appropriate time issue proceedings but not serve them. They discussed the range of possible defendants. The advice remained that there should be two representing the classes already identified. It was agreed that the purpose of any litigation commenced by the Society would be to get a declaration from the Court on general principles. Questions were asked about the possible consequences for the Society, and about the Court's powers. The solicitors' advice was that the Society should not litigate unless it had strong reasons why it would be in its interest to do so, but should prepare the necessary papers to go ahead swiftly if need be.

54. Comprehensive preparations were discussed for the issue of proceedings with two defendants. By now discussions with the auditors were in hand. On 3 December Martin proposed that the Society should raise declaratory proceedings to ensure that the Society kept the initiative. Other directors remained undecided. They argued that the Society should not appear to be seen to be attacking the Ombudsman (e.g. by going to court), as he was viewed as the 'small man's friend'. Preparations proceeded nevertheless.

55. On 9 December 1998, it was decided that a final decision on proceedings would be taken on 14 December. Instructions sent by the Society's solicitors to counsel¹⁰ on 9 December discussed the merits of initiating litigation and the options open to the Society for dealing with the PIA complaints. The Society had decided that work should proceed on the drafting of proceedings, subject to counsel's recommendations on strategy. The view expressed to counsel was largely repetitive of earlier comment. The Society would be able to define the issues it wanted to put before the court. It would be in a much stronger position to limit discovery. It would have much greater control of the process and of its timing. It would not have to face a multiplicity of complaints to the PIA Ombudsman. And the Society might derive a benefit in terms of public perception. On the other hand, the Society appreciated that it would precipitate a high profile case.

56. The instructions informed counsel that there were other types of guarantees than the guaranteed annuity rates in respect of which the amount of final bonus allotted was reduced by the amount of the increase obtained by virtue of the guarantee, thus opening up the possibility of a wider dispute. It was suggested that the Society had always declared differential bonuses for policies with a guaranteed investment return. Instructions to junior counsel to draft proceedings were issued on 10 December. The instructions were open in relation to the scope of the litigation. The solicitors were unclear whether all guarantees should be covered "insofar as the Society in effect differentiates between final bonuses depending upon whether the policyholder elects to take advantage of those guarantees".

57. On 14 December counsel advised that the Society's case was solid. The advice encouraged litigation at the instance of the Society. The note of conference reflected the tone as well as the content of the advice given:

"1 Key issues

Mr Grabiner said that overall the matter presented to him in his Instructions was not one related to policyholders' reasonable expectations but was a matter of construction of the contractual relationship between the Society and the relevant policyholders. Whilst one could not be sure that there were no policyholders who could successfully allege that they were promised full fund x guaranteed rate, one would have to work on the basis that all the promises were contained in the policy.

On this basis the key issue was whether there was ever a promise to pay the full fund including final bonus and on this issue Mr Grabiner was clear that there was no such promise.

Equally, he was clear that the Society had never promised that all policyholders would share equally in bonus entitlement.

The contrary argument would be the "salesman's promise". However, any promise made would not normally be regarded by the court as an actionable representation as to the future conduct of the Society in relation to discretionary allocation of bonuses.

Policyholders' reasonable expectations based on the way in which the directors had exercised their discretion in the allotment of final bonuses were irrelevant to the construction issue. He thought that the directors had exercised their discretion properly and that their legal case was "solid".

The Society should, however, expect to be criticised about the way in which the Society had explained its approach in the past.

2. PIA Ombudsman

Mr Grabiner was firmly of the view that none of the existing complaints should be dealt with substantively by the PIA Ombudsman. Mr Grabiner said that the

¹⁰ Anthony Grabiner QC and Brian Green QC.

Ombudsman would not take account of the legal points to the extent that a court would, and was generally more favourable to the complainant than to the insurance company. In effect, it was a "merits tribunal".

Given this the options appeared to be:-

- (a) go to court for directions i.e. ask the Court how the Society should exercise its discretion in relation to bonuses for the future, and/or
- (b) go to court in relation to policies which had already matured (i.e. past issues as to what the Society had done).

Mr Grabiner recommended two test cases, one to deal with (a) and the other to deal with (b).

He was of the view that if the matter proceeded to court without delay there would be a decision from the High Court by the end of 1999 and, he hoped, earlier.

Mr Grabiner stressed that the Society must be full and very frank with the court in its explanations.

Leading Counsel said that they did not believe the PIA Ombudsman had jurisdiction in relation to the existing complaints because they related to bonus issues.

Denton Hall will draft a letter to the PIA Ombudsman giving a notice under clause 7 of the Terms of Reference and seeking the exercise of his discretion to cease to deal with the existing Complaints."

58. There followed a lengthy discussion of the classes of policyholder to be targeted in the litigation. Grabiner was keen to involve representatives of a wider range of classes. He thought that the Society would wish the court to approve:-

- (1) the basis on which the directors were proposing to allot or make available final bonuses for 1999 and future years;
- (2) the basis upon which the directors have exercised their discretion in the past.

Reserving

59. In addition to the dispute over the Society's terminal bonus policy, there was the issue between the Society and HM Treasury relating to the Society's practice in relation to reserving for annuity guarantees¹¹. The two topics inter-mingled in discussion. Grabiner's initial view was that the Treasury approach was nonsensical as they were apparently saying that the Board was bound to give the same bonus to all policyholders, which was clearly not the case. Headdon explained his view of the official approach, and the Society's response, that took account of anticipated take-up rates. The representatives of the Society outlined the courses open to them if the Treasury's view was allowed to prevail namely: -

- (a) to publish a barely solvent position as at 31st December 1998; or
- (b) to change their investment strategy which although less of a PR disaster than option (a) would nonetheless be a PR problem; or
- (c) not to declare a bonus as at 31.12.98 and only announce final (i.e. non-guaranteed) bonuses.

In practical financial terms, disclosure of the financial implications of the Treasury view would have further adverse public relations implications. If the Society reserved in full for the £1.5 billion involved, its free assets would be wiped out and there would be no funds from which bonuses could be paid.

¹¹ See paragraph 38 above.

60. Grabiner and Green commented that it was in any event nonsense for the Treasury to base its view on whether the policy promised an annuity with other options or promised some fund benefit with an option to take a guaranteed annuity. In the opinion of leading counsel there was no need to reserve for the entire risk since the regulations clearly allowed actuarial judgment to be taken into account. They could not comment on the actuarial judgment itself. Leading counsel advised that in view of the seriousness of this problem, an opinion should be drafted by them jointly which the Society should send to the Treasury in advance of a meeting to be arranged with the Treasury early the following week. Issues to be addressed in this opinion were then discussed. If the Treasury did not change their mind, the Society would have to consider judicial review.

61. Counsel indicated two possible bases for judicial review, first that the Treasury were misconstruing regulation 64 of the accounts regulations¹², second that the Society had a legitimate expectation that the Treasury would apply the regulations consistently and not change its stance given that the Society's returns from 1994 onwards had made it very clear that the Society had not reserved for guaranteed annuity rates on a 100% take-up basis. As to the misconstruction argument, the Treasury's argument that companies were supposed to work down regulation 64(3), starting with the "primary" benefit under the policy, was felt to have no justification. Headdon said that he had in mind an arrangement with two reinsurers in order to support the solvency position. If they came back with good rates, reflecting their assessment of the risk, it would support the Society's argument that there was no real risk. Counsel gave advice on specific questions supportive of the Society's position.

62. The advice received from counsel was uncompromisingly enthusiastic in its support of the Society's stance on each of the principal issues at the time. A formal decision to have the differential terminal bonus decided by the court was taken by the Board on 16 December. On the same day the Society's solicitors wrote to the PIA Ombudsman requesting that he cede jurisdiction. The joint opinion was issued on 18 December. It set out a comprehensive analysis of the facts as understood by counsel, analysed the arguments on reserving, and advised judicial review if the Treasury did not capitulate.

63. Preparations for the litigation at the end of 1998 and during the early part of 1999 explain the narrow basis on which the issue was put to the court in the first instance. The directors' decisions were based on strategic considerations discussed with counsel. Many of the potentially wider issues were excluded by the end of 1998, but re-visited. The draft originating summons settled on 18 December 1998 had six defendants. There were two with-GAR retirement annuity policyholders, one in pension and one prospective; two GAR individual pension plan policyholders, one in pension and one prospective; and two GAR group pension plan policyholders, one in pension and one prospective. There was no non-GAR representative. And the wider guarantees were not dealt with.

64. The representation of non-GAR policyholders was considered again on 4 January 1999. Counsel advised that it was not necessary to have a representative defendant for those whose policies did not include a GAR: it could lead to unnecessary complication and in any event the Society could put the points to be made in relation to such policyholders. Further, the Society had not made up its mind whether, should the decision go against it or should the Treasury decide on very onerous reserving requirements, the consequences should be borne simply by GAR policyholders or all with-profits policyholders. The Society wished to retain control of these issues: an independent view might not support its wishes.

65. Strategic decisions taken at this stage included:

- (i) reservation of the Society's position on ring-fencing the annuity guarantee liabilities if the primary case failed;

¹² Insurance Companies regulations 1994, SI 1994/1516.

- (ii) the progressive narrowing of the range of defendant interests to be represented; and
- (iii) the restriction of the issues to those relating to guaranteed annuity rates, excluding other forms of guarantee.

66. On 5 January the Society's solicitors wrote to Hyman informing him that it was proposed he should be the first of two defendants in the proposed action. Similar letters were sent to other prospective defendants. On 6 January the solicitors reported that it was the intention to proceed with two representative defendants. The solicitors wrote to the Society on 7 January 1999 sending a copy of the draft summons and a copy of a letter to the PIA Ombudsman. Hyman was now the only defendant, following the view expressed by counsel that the summons should not refer to the future allocation of bonus. The letter to the Ombudsman, sent on 8 January, informed him of the intention to raise one test case on the view that that would be quicker, simpler and cheaper. The solicitors informed the directors of the up-to-date position of the draft summons on 11 January. Earlier strategic decisions were referred to. The selection of Hyman appears to have reflected a decision that:

“... the representative defendant must be a PIA complainant, have taken his benefits and ideally have no other with-profits policies with the Society.”

It was said that there might be PR disadvantages in selecting an old man, one only of 600,000 policyholders, and no longer a policyholder with the Society. The Society was advised that it was now committed to litigation.

67. In a note of consultation with counsel¹³ dated 13 January 1999, the earlier suggestion that the Treasury approach to reserving for the annuity guarantees should be judicially reviewed was abandoned. Grabiner said that the logic behind the Treasury's argument that the Society should reserve in respect of guaranteed annuities was forceful. He advised that the Society should not go to court to challenge the Treasury's decision by way of judicial review. He confirmed that the usual tests for judicial review were not satisfied. This change of opinion did not undermine the general enthusiasm for declaratory litigation. Grabiner agreed with the solicitors that the Society should issue legal proceedings as soon as possible, even though the outcome of the application to the PIA Ombudsman to renounce jurisdiction was not known. He emphasised that if an action group issued proceedings first the Society would be defendants and lose control of the litigation.

68. On 13 January Hyman was put on notice that the Society intended to proceed, citing him as defendant. He responded by telephone on 14 January, initially leaving a message. Any apprehension that the Society had selected an 'old man' was quickly dispelled:

“The message said that he had received an extraordinary letter from the firm in relation to the Equitable. He had tried to speak to Alan Nash but “as you know” Alan Nash never answers a telephone call. Those he had spoken to were ‘paralytically incompetent and could not answer a single question’.”

The Society had not selected a compliant defendant. The PIA Ombudsman wrote to complainants on 15 January explaining his decision that the test case should proceed. A copy of the originating summons was sent to Hyman the same day.

69. On 28 January 1999 Norton Rose informed the Society's solicitors that they had instructed Sumption QC for the defendant. Parties' legal advisers thereafter resolved a number of technical issues relating to the proceedings. They negotiated the terms of a draft notice of appointment to hear the Summons. It was agreed that the issue was one of construction of the Society's articles. There were discussions about the form of relief to be sought by the Society. Hyman's solicitors wrote to the Society's solicitors on 16 February intimating the view of counsel as to the issues

¹³ Anthony Grabiner QC and Brian Green QC again.

raised and making proposals as to the directions that might be sought. Amendments were required to the originating summons. The hearing took place on 23 February following final negotiations between counsel. The necessary orders were agreed and pronounced.

70. The Society informed policyholders of the decision to initiate proceedings by letter dated 19 January. On 4 February there was further extensive discussion in conference about the scope of the litigation. The extent to which Sumption might agree specification of the issues; the use of the Society's literature; the risk that the judge would order a trial; the scope of discovery; the approach to exhibits; the timetable for the proceedings; clients' instructions; and contacts with action group solicitors were discussed in detail. The draft affidavit for submission by Nash was discussed, as were the terms of counsels' instructions. On 16 February 1999, there were two conferences. In the first timetable objectives were discussed. Those present, the solicitors and counsel, then discussed the form of affidavit, and went on to other matters:

"2. CIML [Cindy Leslie, solicitor for the Society] said that the Affidavit had been amended in order to make it punchier and to take some of the repetition out. As a result, our view was that the Affidavit was now in reasonable shape. AG [Grabiner] said that he had various comments on an earlier draft of the Affidavit and it was agreed that he and BG [Green] would now review the current version. ...

Exhibits

4. It was explained that we had produced a core bundle of exhibits comprising of two lever arch files for the purposes of the Affidavit. This was made up of a fair selection of the key documents. There then followed a general discussion as to what documents should be put before the Court and what effect that would have on an Issue Estoppel¹⁴ in the future. The concern was that by not placing a particular document before the Court but simply disclosing it to Norton Rose, that could result in an argument that strictly speaking that document was not subject to any Issue Estoppel. In that context, the documents in the main files were just as relevant as the documents in the core bundle which had been created. AG indicated that it was always a very difficult question as to whether a particular point had been in "issue". CIML and BG stated that our concern was to try to shut out as many future cases as possible. By including all the documents, that may assist in shutting out those cases on the basis that the documents had already been considered by the Court. ...

5. After a discussion, it was agreed that the best way of proceeding would be to exhibit the core bundle of documents to Alan Nash's Affidavit, and then to also exhibit all the policy and explanatory documents to an Affidavit to be sworn by CIML. The core bundle and main bundle would be paginated but then the core bundle documents would also include the document number used in the main bundle. CIML's Affidavit could contain words to the effect that the Society has given full disclosure of all documents in its custody, possession or power of which it is aware and that the vast majority of those documents were irrelevant.

6. In relation to the core bundle, AG said that it was important, as far as possible, to be able to read the documents in context so that it was not possible for the other side just to focus on wording on individual documents without seeing those in the overall context.

7. CIML explained that the main documents that the Society was concerned about were the Illustrations and some of the original marketing documents.

¹⁴ Issue Estoppel: rule of evidence whereby failure to raise an issue at an appropriate juncture in proceedings may prevent it being raised later.

The Originating Summons

8. CIML and AG discussed the issue of whether we should refer to the leaflets in the declarations sought by the Originating Summons. AG said that our case was that the explanatory leaflets had no force and were simply pieces of paper which were irrelevant. Our case was that the bargain was a bargain. Therefore, we did not need to refer to the leaflets in the paragraph in the Originating Summons.

9. AG also considered the wording concerning an Issue Estoppel in the Originating Summons. AG said that this amounted to a declaration of the self-evident and AG had no problem with including it. Whether the wording was included would have no impact on somebody trying to base a case on facts not before the Court.”

71. The tactical discussions at this stage extended beyond the declaratory issue. In particular, preparations to meet future challenge on the basis of issue estoppel had become a material factor in the Society’s litigation tactics. In the light of later events, the most significant factor identified in the discussions related to ring-fencing of the annuity guarantee liabilities should the Society fail in its principal contentions. Ring-fencing of annuity guarantee liabilities was referred to in Nash’s affidavit.

72. There was a second consultation on the same day with officers of the Society¹⁵ present. There was discussion of policyholder expectations in the light of current queries. There was extensive reference to issues of current concern in correspondence with policyholders. Green drew attention to the possible answer to his contentions that GARs were, as a consequence of the primary argument, meaningless because what a policyholder got was entirely dependent on the size of the pot. There was extensive discussion of ‘asset share’¹⁶. More directly related to the issue before the court, there was further discussion of Nash’s affidavit. Green wanted to present the argument that this was a very simple case. It was purely a question of legal construction as to what the policies promised. He could then back that up with the concept of ‘asset share’. That would then put the burden on the other side to make the argument either that the background material was relevant or alternatively for them to say that the construction argument went the other way. The temptation of the Judge would be to view the position in strict legal terms.

73. Procedural issues were discussed. On the merits, Green said that both the policies and article 65 were perfectly clear. He had seen quite a lot of the relevant papers and his opinion was that it was a very difficult argument, on the basis of those documents, that the terminal bonus was guaranteed. He said that as a result, he thought the other side would come up with some other type of argument. Matthews’ concern was that policyholders could argue that they had an expectation that they would obtain the final bonus. Green thought that the expression ‘reasonable expectations’ was very vague. He considered that for a term to have legal effect, there needed to be a representation, contractual term or warranty as the basis for such an argument. Even if any such ‘reasonable expectations’ were implicit, they were not contractual. There was a huge difference between a contractual obligation and not coming up to policyholders’ expectations. The Society needed a judge who would “adopt an intellectually vigorous (sic) approach”. He repeated his view that, on what he had seen, there was no question of a legitimate expectation claim succeeding. The emphasis on strict contractual issues was now total, both generally and in relation to the scope for policyholders’ reasonable expectations of benefit.

74. On the basis of these discussions it might be that the Society’s officers were encouraged to entertain somewhat exaggerated expectations of success in the

¹⁵ Chris Matthews & Peter Wilmot, the secretary to the Society

¹⁶ See chapter 13 for further discussion of ‘asset share’ in the context of interpretation of policyholders’ reasonable expectations.

litigation. The strategy under development concentrated on the analysis of the factors supporting the Society and, it appears, gave inadequate attention to the risks inherent in any litigation process. The substance of some of the arguments advanced, such as those relating to policyholders' reasonable expectations, is considered in Part V of the report. But it appears clear that the tenor of the advice offered depended to a considerable extent on the issue being disposed of by what counsel considered a judge with an intellectually 'vigorous' or rigorous approach to the terms of the contracts in question. Subject to that requirement, it appears that, by this stage, a certain euphoria had become established.

75. On 18 February the solicitors wrote to Matthews setting out the procedural steps then anticipated. The first procedural hearing was listed for 23 February. Directions would be sought on a number of issues, including a direction that there would be no cross-examination of witnesses who provided affidavits. To an observer from a different legal system, this appears to confer undue authority on documents prepared with considerable legal input. But at the end of the day nothing turned on the Society's affidavits. Detailed preparations continued and were reported in similar vein. On 24 June a fact sheet was published informing policyholders of the likely timetable for the hearing at first instance. The issue for trial was stated in these terms:

"Since market annuity rates first fell below the guaranteed annuity rates in 1993, the Society has calculated different final bonuses where benefits are taken in guaranteed annuity form. The intention is to make the value of benefits so far as possible the same as if they had been taken in fund form to purchase an annuity in the market.

The Society is seeking a declaration from the Court that

- it has powers under its articles to allot different final bonuses in this way and;
- it has exercised those powers validly."

The fact sheet was sent to policyholders under cover of a letter dated 29 June 1999.

76. The case proceeded to a hearing. The Society succeeded before the Vice-Chancellor. On 16 September 1999 the Society wrote to policyholders expressing pleasure that the Vice-Chancellor had decided the case totally in the Society's favour, and that the decision had cleared the approach to policies containing guaranteed annuity rates. The letter reiterated the claim that the Society had acted fairly. It summarised the result of the decision as follows:

"The Vice-Chancellor's judgment is positive approval of our approach and confirms that:

- our directors have discretion "well wide enough" to grant final bonus of an amount depending on how the benefits are taken by a policyholder;
- there is no "policyholders' reasonable expectation" that the same rate of final bonus would be applied to all policyholders; and our approach does not involve "depriving policyholders of part of their asset share" as had been alleged.

The Vice-Chancellor also rejected suggestions that we had acted irrationally or unfairly. In fact, in the penultimate paragraph of the judgment he states: 'I can see no basis on which the manner in which the Directors exercised their ... discretion can be categorised as irrational. I can see no irrelevant factors that they took into account or any relevant factors that they should have taken but failed to take into account.'

The Vice-Chancellor had, however, granted leave to appeal. The Society said that it would meantime maintain its approach to bonus rates for with-profits policyholders.

77. The Court of Appeal reversed the decision. On 20 January there was a conference to discuss the result and the draft opinions then available. Green commented on the opinions. In his view it was significant that the two Chancery lawyers who had examined the issue, first the Vice-Chancellor and then Lord Justice Morritt in the Court of Appeal, had both sided with the Society in the result sought. However, he expressed disappointment that the Society's argument on 'related bonuses' had been rejected, especially by the Vice-Chancellor and Lord Justice Morritt.

78. The second major point made was that although finding against the Society, Lord Woolf and Lord Justice Waller were unable to agree with each other as to their reasons for allowing the appeal and reversing the decision of the lower court. Green discussed the weaknesses of Lord Woolf's opinion. Of the nine reasons given by Lord Woolf, it was said, some seemed irrelevant and the remainder were unconvincing. Lord Woolf did not understand the arguments put forward by the Society. Lord Justice Waller had adopted an extraordinarily legalistic approach to the whole exercise. In Green's view, the judgment bore the hallmarks of a judge unable to "see the wood for the trees".

79. Green advised that leave be sought to appeal to the House of Lords where he thought the Society would win. Since the matter originated in the Chancery Division, Green said it was likely that the panel would consist primarily of Chancery lawyers, who in his view would be heavily influenced by the fact that the two Chancery lawyers who had examined the matter to date had decided in the Society's favour. There was extensive discussion of the position pending an appeal to the House of Lords.

80. On 1 February the Society sent policyholders a further circular letter signed by Nash. It announced that the Court of Appeal had overturned the High Court decision by a majority of two to one. The letter followed counsel's advice, but cannot be paraphrased:

"Taking the High Court and Court of Appeal hearings together, two Judges have found in favour of the Society, and two against, with different reasoning being advanced in the case of the two judgments against us. I am disappointed by the Court of Appeal decision and am sorry that the clarification and certainty which we sought for our policyholders when we initiated this action have not yet been achieved. I am, however, pleased that the Court of Appeal has recognised the importance of this case by immediately giving the Society permission to appeal to the House of Lords and by agreeing that the matter should be dealt with urgently. The Court has also made it clear that the Society's current approach can be continued pending the result in the House of Lords. We shall therefore be maintaining our current approach to bonus rates for with-profits policies. ..."

81. The opinion of Lord Justice Waller, at paragraph 135, provided comfort to the Society where he stated:

"It is possible that because there is no contractual entitlement to a final bonus, and because as between different types of policy it is certainly, in my view, legitimate for the board to have regard to the value of the notional asset share of the different policyholders, the guaranteed annuity rate policyholders will not in actual cash terms do very much better than they have done under the differential bonus scheme. I see no reason why different bonuses may not be awarded to different types of policyholder and thus I do not understand why, for example, the board cannot in deciding what final bonus to award to G.A.R. policyholders, keep that bonus at a level which does not deprive different with-profits policyholders of their equivalent asset share..."

Thus the possibility of a ring-fencing solution was referred to in the judgment. In some later observations Equitable sought support for ring-fencing from certain observations in Lord Woolf's opinion. However, in the written case to the House of

Lords, in which counsel of necessity focused on the support that was available for the Society in the opinions of the courts below, Equitable correctly relied on Lord Justice Waller's observations alone.

82. On 26 January 2000, the Board decided, on the advice of the Society's solicitor, to change leading counsel for the Lords. The reason was said to be the change in the character of the case, which now related more to Chancery issues. On 16 February the Society's advisers and officers discussed the scope of the appeal to the House of Lords. Elizabeth Gloster QC had been appointed leading counsel, and the discussions covered the lines of argument available on the contract documents and the approach she wished to take in argument. Gloster was anxious to be able to found her arguments on the principle of mutuality, in her view: "the beginning and end of it", according to the minute. In a pre-meeting with the solicitors only, she also questioned, in the light of the Court of Appeal judgments, whether there could be any doubt that the Society would be able to ring-fence.

83. There was a further conference on 7 March. On 14 March and 23 March there was discussion of the statement of facts for the appeal. Dentons' attendance note of the meeting on 23 March contained observations of some materiality in assessing the approach adopted in the House of Lords. The note stated:

"1. There was some discussion as to the recent discussions with the Society as to the make up and running of the with-profits fund. It has become apparent that the Society do not consider there to be one with-profits fund in practice at all, rather, the fund is notionally hypothecated between its various constituent parts. What is more, different rates of final bonus are awarded as between the various separate notional funds and accordingly the asset shares of the members of each notional part vary.

2. ... EG raised the point that there is in fact a subdivision within the GAR class between those who take their benefits in GAR form and those who take their benefits in fund form. It is highly material whether Sumption is seeking to argue that the matter should be ring fenced to GAR policyholders or that final bonus should be averaged across the various classes.

3. EG said that in her discussion with AL [junior counsel] the previous week he had indicated that he believes Sumption is definitely arguing that the same level of final bonus should be awarded across the GAR and non-GAR classes. BG pointed out that throughout the case Sumption's arguments have tended to be somewhat ambiguous and he has not focused on the distinctions between the classes. EG wants to rely on Waller's point that he sees no problem with the aim of preserving asset shares provided the approach is consistent with the terms of the specific policies."

Mutuality across the with-profits fund had clearly become problematical in view of the Society's actual practices in managing the with-profits fund and discriminating between policy groups in relation to bonus allocation. It is not immaterial, in view of some later criticism of the House of Lords' decision, that Gloster's initial intention had been to emphasise mutuality as the core issue in the case. As the Society's practices were now understood, the scope for ring-fencing of annuity guarantee liabilities began to emerge as a significant factor.

84. Various procedural issues were discussed, including the scope of the representation order. Gloster thought that the order had been incorrectly drafted and that Hyman could not possibly represent both GAR policyholders who have taken benefits in fund form and GAR policyholders who had taken the GAR based annuity. There were in effect three classes of policyholder, not two. As the earlier narrative has shown, the number and classes of policyholder to be represented were issues that had been debated at length in the initial stages of preparation. Gloster's view was hardly new. But the more significant point is the appreciation, apparently as a matter of some novelty, that the Society had not been awarding bonus on a level basis across the with-profits fund, quite apart from the differential final bonus

policy. The point was taken up in a fax from the solicitors to counsel on the same day, 23 March:

“In this context I should add that during the discussions with the Society about the Statement of Facts, it has transpired that in deciding upon the different final bonus levels, regard is had to asset share in the light of the particular type of business being written. ... This has not been reflected in the proceedings to date. Since the Statement of Facts refers to different final bonus levels and different classes of policy, I suspect that either Sumption will refer to it in his Case or you may be asked questions about it by the House of Lords, assuming that no explanation is contained in our case.”

85. The topic was resumed on 30 March. The solicitors’ note of the consultation with counsel stated:

“1. EG said her primary concern was whether the affidavit evidence sworn at first instance misrepresented the position as regards the make up of the with-profits fund. Paragraph 3 of CPH's [Headdon's] note refers to four notional sub-funds. CPH confirmed that the Society's balance sheet consolidates the various notional sub-funds EG wondered to what extent the sub-funds are actually notional and CPH replied that the sub-division is never reported to the outside world. In terms of calculation of asset share however, certainly it is true that the sub-division is not notional.”

In addition, Headdon told counsel that separate actuarial tables were used for each fund, for example German actuarial tables were used in Germany. It appears clear that Gloster’s intention to rely primarily on mutuality had been undermined by the Society’s practice of creating sub-funds within the with-profits fund which, though described as notional, were in fact the basis of practical distinctions in relation to bonus allocation.

86. On 18 April, the ring-fencing issue came to the fore in discussion:

“6. Leading Counsel said that she definitely wanted the ring fencing point raised in the Case. If we are silent on the point in our Case we run the risk of the point being raised by one of the Judges in the Lords. If the point is glossed over and not dealt with at all at the hearing, there is a clear risk of further litigation, were a disgruntled policyholder to maintain that the Society, although having succeeded in the Hyman action, was not entitled to differentiate between GAR and Non-GAR policyholders.

7. Provided the point is raised then we can ... maintain issue estoppel in any future litigation. CIML mentioned that Andrew Lenon [junior counsel] was undertaking the task of checking through Sumption's Submissions and skeletons at first instance and in the Court of Appeal to confirm whether he had ever suggested that the Society cannot ring fence.”

87. By 6 June all was prepared: there was extensive discussion of tactics for the hearing, and of the lines of argument to be pursued. There was, in particular discussion of the ring-fencing issue:

“14. Next, CJM [Matthews] raised the ring fencing issue. He explained that obviously the Society were in the midst of their contingency planning. It seemed inconceivable to him that the Court could possibly hold that only one level of final bonus should be paid to all policyholders, irrespective of the class of policy held. Sumption had not indicated how this might be achieved. EG agreed that Sumption had developed the point in a weasely way. It would be interesting to see how he argued it in Court. He had of course made no cross-appeal directly from the Waller point (see paragraph 135 of his Judgment) to the effect that it would be perfectly permissible for the Society to ring-fence.

15. In this context EG mentioned that on further review she had noticed that paragraph 5(5) of Sumption's Notice of Appeal to the Court of Appeal in effect raised the ring-fencing argument. Moreover there were really two points-

first, whether it was permissible for the Society to pay a lower final bonus for all GAR policyholders and second, whether it was permissible for the costs of the GARs to be borne across the board. Obviously Chris Headdon's note detailing the commercial arguments should be very useful. This had been utilised in the Society's Case.

16. CIML thought that CPH had recently indicated that if ring-fencing in the desired manner was not permissible then as a fall back he would prefer to spread the cost of meeting the GAR pensions throughout the B1-9 class. CJM said that he did not think this was correct. He explained that there were serious differences between bonus rates for various categories of policy depending not only on investment terms but also on taxation. A good example was the personal pension plan which was untaxed business. An equivalent such as the personal investment policy (which was taxed business) received a lower bonus rate than the personal pension plan class. The difference arose because in the case of the personal pension plan, before the policyholder received his benefits he obtained an untaxed "roll-up". When he bought an annuity he would be taxed on a PAYE basis. Thus declared bonus for a PPP may be 12%, whereas for a personal investment plan it may be 10%.

...

18. It was agreed that come what may, the Society would like the ring-fencing point decided. It did not want to be left with the uncertainty which followed the Court of Appeal decision. Whereas it had then been possible to obtain a stay, it would not be practical for the uncertainty to continue now. EG thought that the fact there were a variety of reasons for differential bonuses, as brought out in the various resolutions, was a critical point which she fully intended to raise in opening. CJM said he was very pleased by this."

Resolution of the ring-fencing issue had come to be central to the Society's interests.

88. Nash had anticipated the possibility of a ring-fenced solution in his first affidavit: paragraph 750, where there was a statement of the Society's fall-back position on ring-fencing. Conscious as the Society's advisers were of the importance of laying a basis for issue estoppel, the observations were clearly not casual. Equitable were responsible for introducing this factor into the case, albeit not in the statement of the issues focussed in the originating summons. It is clear from Gloster's views at the conference on 18 April 2000 that she wanted the issue dealt with, and that remained the position until the hearing. The issue was focused in the written case to the House of Lords at paragraphs 117 to 121. It was dealt with briefly in the respondent's written case also.

89. At the end of the consultation on 6 June, Gloster repeated her opinion that the Society ought to win on the contract issue even if it lost on the 'related bonus' argument (see paragraphs 46 and 47 ante). She said that the inevitable problem with that argument was that Lord Justice Waller, a respected judge, was against the Society, and there were difficulties on the language of the contract. However, the Society should, she said, go on assuming that it would win.

90. The House of Lords rejected the appeal. On 2 August 2000 Nash sent policyholders a further letter. He stated:

"In essence, the House of Lords ruled that The Equitable is not entitled to give a different level of final bonus to those policyholders who take their benefits using GARs.

The ruling means that The Equitable is required to increase benefits for some policies with a corresponding reduction in the benefits of other policies. One of the aims of the sale of the business is to restore reduced benefits to the previous levels."

91. Because of the approach adopted in specifying the issues to be dealt with in the action, some questions of interest were not considered by the courts, even on the

facts agreed. The House of Lords did not consider how the Society had handled, or should have handled, situations in which an annuity guarantee policyholder elected to transfer benefits into other schemes, for example. Generally, the policy form selected for the litigation did not allow of debate on the earlier contracts, which might have been more favourable to the annuity guarantee policyholders. These and other limitations are inevitable where parties select the issues for debate. The Society sought seriously to curtail inquiry by careful definition of the initial issues, and by seeking to constrain Hyman. However, in the end Sumption's strategy and arguments prevailed.

Contingency Planning during Hyman

92. Throughout the proceedings, the Society prepared contingency plans, seeking to identify the range of possible results and to prepare to respond to them. The assessment of the probability of one result as against the others engaged the attention of management and of advisers alike. It is relevant to note in this context one course of action that was proposed and rejected at the outset. On 28 January 1999 Cindy Leslie of Dentons wrote to Matthews. She proposed that the Society should consider setting up a new ring-fenced with-profits fund to receive new money in relation to new policies and, possibly, existing policies. The letter stated:

"I have been pondering what additional steps could be taken by the Society to make new investments in the Society more attractive to existing and prospective policyholders. Of course I appreciate, as John Weller forcefully pointed out at Tuesday's meeting, that criticisms of the Society in the media and elsewhere inevitably cause anxiety and/or uncertainty amongst some policyholders as well as a reluctance on their part to invest more money.

Apart from a general reluctance as referred to above, policyholders who do not have GARs and who think that the Society might lose the test case may fear that new money put into the Society will be used to finance unfair final bonus payments to GAR policyholders. Alternatively policyholders, whether with or without GARs, may think that if the test case is lost, their final bonuses will be cut.

I appreciate that the Board is currently of the view that if the existing "equalisation policy" is held by the Court not to be a proper exercise of the Trustees' discretion, the adjustments to final bonus which will have to be made should, as a result, only apply to GAR policyholders. However, as I mentioned at Tuesday's meeting, it is possible that the Court may not agree that differentiating between GAR policyholders and non-GAR policyholders in this way is proper.

In order to seek to mitigate the effect of these points, may I suggest that the Society gives consideration to setting up a new ring-fenced with-profits fund to receive new money in relation to new policies and possibly (subject to what is said below) existing ones as well. If, contrary to your legal team's view, the test case were to be lost, that fund would not be affected by the decision of the Court. Only the existing with-profits fund would be so affected, whether as regards all policyholders or simply GAR policyholders. Ring-fencing of new investment could be a useful selling point. It could also provide a measure of reassurance to new policyholders, and perhaps existing policyholders as well.

Such a step could of course be seen as a weakening of the Society's confidence in its case. I hope, however that the true rationale for such a move can be put across successfully to the media and to policyholders direct. I assume it would be too much to hope that it be accepted as yet another initiative by the Society to ensure fairness of treatment among policyholders. ..."

93. The proposal was referred to further by the solicitors at later stages. It was not pursued by the Society. It is material to the interests of some policyholders that the

issue was focused for the Society at this early stage, and in such clear terms. The Society's solicitors had offered a possible solution to the problems that were eventually to emerge in the case of late-joiners and others who made late contributions to the undifferentiated with-profits fund. There would have been difficulties implementing the proposals, but, in the event, contingency planning took a different route, reflecting the confidence of the Society in the strength of its case.

94. On 18 February 1999, Headdon wrote to Dentons setting out a range of contingencies and proposing procedural and substantive steps in response to them. The solicitors responded on 12 March 1999. There were further exchanges on 12 April 1999 and 17 June. In July the general form of the final range of scenarios identified while the case was at first instance emerged.

95. Six scenarios were identified, which were:

1. Complete success;
2. Success but with some adverse comment in judgment;
3. Directors had discretion but had incorrectly exercised it on technical grounds, eg PRE, but the Court did not interfere because the error would not alter Board's decision;
4. Directors have discretion but had not considered or given sufficient weight to the right factors, or had considered irrelevant factors, and the Court considered that they might, if they did so, reach a different conclusion;
5. The Society's approach to equalisation of benefits in the interests of fairness was invalid and that final bonus rates on cash and annuity benefits on policies with GARs must be equal, but that the Board still had discretion to set differential rates as between GAR and non-GAR policyholders as they deemed appropriate (ie the option of 'ring-fencing' would be available); and
6. The Society's approach was invalid and that final bonus rates on cash and annuity benefits must be equal in relation to all relevant with-profits policies, whether with or without GAR provisions in them.

In the first 3 scenarios there would be no need to change the bonus policy, although the prospect of a surge in retirements and surrenders was noted under most scenarios. Scenario 4 would require an immediate reduction in final bonuses to nil until new rates could be determined or the previous rates confirmed. There were proposals for dealing with those who retired in the interim. Should the Board decide to change its bonus practice, then the action would be as for scenario 5 or 6.

96. Following on the description of the scenarios, work was being undertaken by ACTV (the actuarial valuation team) on reasonable bases for new bonus rates to be applied back to the date of the judgment in the event of scenarios 5 or 6. Work was also underway to identify all the relevant GAR cases that had retired under the differential terminal bonus policy with a view to compensation.

97. The contingency plan had been reduced to the six scenarios that, broadly, remained intact thereafter while the case was at first instance. Some collateral issues had been omitted. In addition, particular potential problems had arisen for discussion. In June 1999 the risk of mass 'surrenders' or transfers was discussed. The Society was advised by its solicitors by letter dated 17 June 1999 that the policies did not entitle the policyholder to transfer, and that, unless the Society had stated otherwise so as to create PRE, the Society therefore had control of timing, and of transfer value.

98. Alternative scenarios to test the Society's response were proposed and revised. An important issue was the risk of high volumes of transfers by non-GAR policyholders. Market value adjustments were discussed. The calculation of surrender values was discussed at length.

99. Following the Vice-Chancellor's decision at first instance, policyholders' reasonable expectations became a more significant issue. At a conference on 11 November 1999, counsel commented under reference to the judgment of the Vice-Chancellor in the *Hyman* case:

“Counsel explained that the Vice-Chancellor's judgment is the only judicial interpretation of the role of PRE in the exercise of discretion by the directors of a life office and its interplay with policyholders' contractual rights. What the Vice-Chancellor appears to be saying is that policyholders have legitimate expectations above and beyond their contractual rights that the life office concerned will act reasonably and with consistency according to its own past practice and general past practice in the industry. Reasonableness and consistency are therefore two key watch-words to be drawn from the Vice-Chancellor's judgment. If the life office acts reasonably, fairly and consistently, the court will not interfere with the exercise of the directors' discretion. In considering whether a particular course of action is indeed reasonable, fair and consistent, Counsel emphasised that he is able to advise only as to his view of the relevant parameters. The decisions that are ultimately taken are matters for the Society.”

100. The Vice-Chancellor's decision did not require further planning on the main contingencies identified, and there is little evidence of the topic engaging the Society or its advisers prior to the decision in the Court of Appeal. The Board considered the decision of the Court of Appeal at a meeting on 21 January 2000, the date on which judgment was delivered. At that meeting it was reported that the Court had agreed that the Society could maintain its current approach to bonuses. The Society's solicitor stated that Counsel were confident of success in the House of Lords, although no guarantee could be given. The directors acknowledged that there were risks, but concluded that an appeal should be made to the House of Lords. The board resolved to continue its pre-existing terminal bonus policy, aware that if it lost in the House of Lords there would have been excessive payments to some policyholders that could not, in practice, be reclaimed by the Society, and that there would be a liability to make up the shortfall in payments to others. The minutes stated:

“Final Bonus Rates

The General Manager - Finance and Appointed Actuary, Chris Headdon (CPH), ... commented that, at the Society's request, the Court of Appeal had agreed that the Society could maintain its current approach to the allocation of bonuses until the outcome of the House of Lords ruling had been obtained. This avoided the adoption of a change of approach which might subsequently be proved to be unnecessary. The Society had given an assurance that, if the House of Lords agreed with the Court of Appeal and that meant that any policy maturing between the present time and the House of Lords' ruling would have received higher benefits, additional sums would be paid in relation to such a policy. CPH confirmed that it was his firm recommendation that the appropriate course of action at the present time was to maintain the current final bonus rates. Although no Board resolution was required to put this into effect, it was important that the Board had fully considered the matter and affirmed or otherwise their agreement to his recommendation.

There was discussion of CPH's recommendation. It was recognised that, should the Society succeed in the House of Lords as it expected, revision of the Society's approach at the present time would have been unnecessary. It was noted, however, that should it be necessary to revise the Society's approach following the House of Lords ruling, any sums paid out to policyholders in excess of those which would have been derived under the revised approach could not, in practice, be reclaimed by the Society.

Recognising that, in the Society's view, its current approach to setting final bonus rates was designed to ensure, as far as possible, that each with-profits

policyholder received his or her fair asset share, and taking into account the matters discussed, the Board affirmed that current final bonus rates should be maintained.”

101. On 26 January 2000, the Board proceeded to declare bonus rates in respect of the year ended 31 December 1999 at the same level as applied for 1998, with a total growth rate of 12% for United Kingdom pension business and equivalent rates for other classes of business. Contingency planning progressed on 28 January, when Headdon sent to Leslie a more developed ‘fall-back’ position for speedy implementation if the House of Lords ‘sided’ with the Court of Appeal. In his covering letter, he wrote:

“I have been giving further thought to our likely fallback position should the House of Lords side with the Court of Appeal. I believe, on this occasion, it is vital that we have a well-developed approach 'on the stocks' ready for speedy implementation. That indicates the desirability of tackling that now so it does not conflict with the hearing preparation at a later date.

In the attached note I have tried to set out the issues where I feel we need advice. ...”

102. The appendix to the letter set out the fall-back position:

“1. The Court of Appeal ruling has led the Society to consider in more detail than previously a possible fallback position. The indications given by L J Woolf and L J Waller of the way they might expect the Society to react, have concentrated attention on a route which was first considered several months ago. We intend now to develop that in more detail. The purpose of this note is to set out some initial issues on which legal advice is required.

The approach in summary

2. The approach can be summarised as having 2 main elements:

- (i) the setting of the common rate of final bonus at the lower level which currently applies if benefits are taken in GAR form and
- (ii) offering those GAR policyholders who do not want to take benefits in GAR form an 'opt-out' whereby their policies are endorsed effectively to remove the GAR and, thereafter, they receive the 'fund' level of final bonus (as applies to personal pensions and other comparable contracts without GARs).

3. That approach has the following advantages:

- (i) there is no additional cost falling on other policyholders
- (ii) GAR policyholders can continue to have alternative benefits of full value (albeit with a little less freedom of choice than previously)
- (iii) if a significant proportion of policyholders choose the opt-out the additional statutory GAR reserves would be substantially reduced
- (iv) such a course would support the contention that all that is 'wrong' with past claims is that policyholders not selecting the GAR have been 'overpaid' and there is, accordingly, no question of compensation.

The disadvantages are essentially of a PR nature and are not relevant to this note.

4. It has been assumed that the opt-out would need to be for a limited period only because a running option would effectively give the same position as at present and would seem to be a blatant contravention of the will of the court. Advice is sought as to whether or not that assumption is correct. If it is, advice is sought on the appropriate length of period during which to offer the opt-out - from a practical point of view a period such as 6 months would be

reasonable. [As an aside it is worth noting that a limited period is attractive to the Society as it is likely to maximise advantage 3(iii) above.]”

Clearly this fall-back depended on ring-fencing being an option that it was open to the Society to adopt. He proceeded to analyse the form of bonus resolution required to implement the proposals, commenting on the notes that would be required, and proposing draft terms for them. He invited comments. The questions focused by Headdon were commented on briefly by the solicitors on 10 February 2000, but the substantial issues were left over for discussion at consultation planned (according to the agenda) for 16 February. Item 3 on that agenda raised the possibility that the House of Lords might strike down ring-fencing.

103. Meanwhile Martin, the vice-president, wrote to Headdon on 12 February raising concerns about contingency planning. He warned of the unpredictability of the outcome of the House of Lords’ case. As an experienced lawyer, he reflected a proper appreciation of the scope for variations of view, and warned of the need to consider different practical consequences from those elaborated by the actuarial team. He was apprehensive that Nash had made statements to the media that underestimated the risk.

104. A reply was delayed until after the next meeting. As mentioned in paragraph 82 above, on 16 February there was a lengthy consultation with counsel. At a pre-meeting with the solicitors, counsel queried whether there was any doubt that the Society was entitled to ring-fence GAR policyholders as a class. She had taken it as a given in the Court of Appeal’s judgments that the Society was entitled to differentiate between GAR and non-GAR policyholders. This was agreed. However, it was said to be a different issue entirely whether policyholders realised the significance of this. It was understood that another case could theoretically be launched calling into question the discrimination between classes. .

105. Equitable’s management explored with counsel the risk of damages claims against the Society. Counsel warned that the House of Lords would not be interested in ‘cheap’ arguments that focused on the impact on the Society of an adverse decision. There was detailed discussion of the legal bases on which claims might be made. The discussion then covered the possibility of unravelling annuities already in payment. Headdon told counsel that approximately 80% of those who had taken their benefits had chosen an alternative annuity with the Society as opposed to taking benefits elsewhere. In relation to the minority, the advice was that Equitable could not assume that other insurers who had received funds from the Equitable would be willing to repay those funds (less expenses) in the event of the Society maintaining that they had been overpaid, as had happened in another case. In the absence of a similar concession from third party insurers, the Society would not be able to rescind or avoid the previous transfer of funds. The issue remained live only in respect of the Society’s own annuitants. The advice was that they had a range of defences open to any claim, and the PIA might in any event intervene.

106. Discussion at the meeting then turned to a proposal by Headdon that annuity guarantees be removed by agreed endorsement. It appears that the motivating factor in proposing the endorsement was the desire to reduce reserves for GAR policies. Legal advice indicated that it would be very difficult for any given policyholder to make an informed choice until he or she reached selected pension age. The Society’s solicitors proposed an alternative form of endorsement. Gloster strongly advised that no endorsement should be brought into effect until after the House of Lords had ruled on the matter. It was possible that the Lords might find that directors had exercised their discretion for an improper purpose. That could undermine the implementation of any endorsement of the type envisaged.

107. On 22 February, Leslie commented on Martin’s letter of 12 February. She discounted most of his concerns. If Equitable won the case, there would be a revival of earlier claims and others might surface. Most of them would be without substance. The House of Lords would not be able to reject the ‘asset share’ theory. It was a relevant factor for the Society and the industry as a whole. She stated that

Gloster had advised that the decision would have direct affect only in relation to annuity guarantee policyholders. Final bonus would remain a matter for the directors.

108. On 17 March 2000 the solicitors wrote with a fresh statement of the scenario planning pending the House of Lords case. There remained six categories, generally along earlier lines, but with grater specification of the action required in response. The covering letter indicated that the probability of some of the scenarios had diminished.

109. There was a meeting on 24 March to 'brain storm' the position in regard to possible endorsements to alter policy conditions and other issues that would arise should the Society lose in the House of Lords. The revised scenarios were discussed starting with scenario 6:

"The point was raised as to how the cost of guaranteed annuities should be spread (on the assumption that the House of Lords might say that when setting final bonus rates the Society is not entitled to allocate this costs to the GAR policy holders alone). The initial thought was to spread it amongst the "B9" class of UK pension policies. Chris Headdon queried why this should be the case rather than applying it across all with-profits policies on the basis that it was a cost of the business and therefore it should be born by all the members. However, the wider the burden is spread the less the reduction for each GAR policy and thus the better GAR policy holders do as their own final bonus is reduced less. The more the argument was taken forward the more it seemed absurd that the Court should be permitted to stipulate how the cost should be born. There were many current examples of specific costs/benefits being born by/attributed to particular subclasses of policyholders for example the "minor profits" class, the class of policy holders who are in a tax free fund and therefore will receive a higher share of profit based on the tax free fund and the "loan back scheme" policies. It seemed that we could construct sufficient arguments (should the Court be invited to think about specifying how the discretion should be used) to show the absurdity of the potential result which could be ultimately to throttle the ELAS business. In addition where would the Court's directions on discretion stop? If the Court held that the cost should be borne in a particular way and the final bonus had to be reorganised accordingly would this for example preclude the Directors in future years allocating a lower rate of final bonus to GAR policy holders than to other pension or with profit policy holders on the basis that the GAR policies included other favourable terms (namely the GARs)."

110. A range of other consequential issues arose for discussion. There was apparent confusion over some issues:

"There was a discussion before Chris Headdon arrived as to how the "GIR" [guaranteed investment return] worked and the fact that it was not taken off declared bonuses but adjusted in final bonus which meant that (a) the annual statements were incorrect or misleading when they refer to eg declared bonus of 1.5% when they mean 5% but a lower final bonus, (b) if final bonus is cut to zero the policy PAV [premium accumulation value?] may be uncomfortably large, (c) is the reduction to 1.5% mentioned at (a) correct anyway, given that the 3.5% GAR relates only to contributions paid not to the whole guaranteed fund would include declared bonuses added over the years."

Even at this late stage, the Society's procedures had failed to avoid, or dispel, totally an aura of mystery so far as the advisers were concerned.

111. The possibility of directors having to resign in the event of failure in the case was raised at conference on 18 April 2000. Gloster said that she saw no legal reasons for the president or the directors to resign. She said that the Board had acted entirely properly throughout. The representative proceedings were issued in a thoroughly reasonable attempt to obtain legal clarification of the position. The fact

that they had proceeded without legal advice on the issue until 1998 was neither here nor there. Whether there were commercial reasons compelling a "sacrificial lamb" was another matter entirely on which she said she could not comment. The process that led to the departure of Alan Nash had begun.

112. On 20 June, there was a conference following the hearing. Scenario planning was now concentrated on numbers 5 and 6. As updated, Scenario 5 dealt with the situation where the Society lost but the Lords permitted "ring-fencing" of the cost of any additional benefits within the GAR class of policyholders. Scenario 6 reflected the position where no ring-fencing within the GAR class was allowed, but the Society was permitted to contain the cost within the class of policies falling within the B9 bonus resolution. Leslie added that a further scenario - scenario 7 - was being added, whereby the Society lost and was not permitted to contain the cost within B9: Sumption had argued for a scenario 7 outcome. As before, the actions required in response to the various scenarios were not intended to cover ancillary matters such as PR, reinsurance, demutualisation or any changes to the articles.

113. In other respects, there was extensive discussion of the implementation of scenarios 5, 6 and 7. The setting of a new final bonus level in scenario 5 would require justification. The Society was to consider proposed policy endorsements, in particular to allow annuity guarantee policyholders to opt-in to the present differential bonus system. Approval from the Revenue had been obtained in relation to endorsements of the two most popular policies and was awaited on the others. The legal advisers all expressed concern about the legal viability of this route. Their concerns were that in offering the contractual variation to the annuity guarantee policyholder class the directors might be found to have exercised their discretion in order to favour one category of policyholders over others and produced a situation where there were differential final bonuses within the annuity guarantee class. Leslie explained that Brian Green and Simon Brown had advised on the point in general terms, but before the hearing before the House of Lords. It was agreed that a written opinion should be obtained from Green.

114. Claims by those who had taken benefits since the equalisation policy was implemented in 1993 were discussed. Approximately 35,000 policies had matured in the material period and of these, in only around 1,500 cases had individuals elected to take benefits in annuity guarantee form. Quantification would depend on the revised final bonus rates. Cindy Leslie emphasised the importance and urgency of clear legal guidance as to the Society's legal position if scenarios 5, 6 or 7 applied. It was therefore agreed that counsel would prepare advice on:-

- “(a) the various type of claims which may be brought against the Society by individual policyholders, whether in contract, under statute or otherwise;
- (b) potential defences to these claims which may be available to the Society (e.g. contractual defences such as accord and satisfaction, limitation defences);
- (c) quantification of damages in each category of claim;
- (d) whether it may be possible in theory for the Society to claw back overpayments to certain policyholders; for example those taking benefits in fund form may have been overpaid.”

It was understood that the PIA Ombudsman would be likely to insist on a scheme of compensation to be devised in the event of an adverse judgment, and in any event the Society would wish to set out a formulation for a compensation scheme as soon as it could, subject to the various defences open to it. This laid the foundation for the development of the 'rectification scheme' proposals dealt with separately in this report¹⁷.

¹⁷ See chapter 8, paragraphs 9 to 32.

115. For present purposes, a scheme of compensation was seen as an essential element of the response to failure, independently of what other steps were required. Leslie advised that if the result were adverse, the Society should produce, and be seen to be able to produce, its plans for compensation in a coherent, comprehensive and appropriate way, and to use the Court to seek approval for its plans so that all relevant policyholders would be bound by them. At this initial stage a court-approved scheme was envisaged. It was generally agreed that at all events compensation issues would be better dealt with under the umbrella of the existing proceedings rather than under new proceedings. Apart from keeping Hyman and his legal advisers in place for as long as possible, in order that the benefits of continuity were obtained, there was the added advantage that it might enable the Society to ask the PIA Ombudsman to defer reactivating claims currently stayed. Moreover, for a compensation scheme to have any value it should be made subject to binding representation orders which required remitter to the Chancery Division. The Society and its legal advisers now expected failure in the case, and prepared for the future on that basis.

116. On 4 July, Peter Sedgwick, deputy chairman of the Society, contacted Michael Foot, managing director responsible for authorisation and supervision at FSA, to report “straws in the wind” that the Lords “would like to find against the Society”. He said that the main concern was the level of sacrifice that might be needed. John Sclater, the chairman, and Nash wished to resign if the decision went against the Society, but Sedgwick was concerned that this might be unnecessary if the House of Lords were not critical of the Society’s conduct, and might reduce the ability of the executive to deal with whatever transition was necessary. Having consulted his own chairman and the head of insurance at FSA, Foot responded the following day to say that FSA agreed that there was a concern about continuity, though the situation would depend on the detail of the judgment. But on what they knew at that point, it was “unlikely that the FSA would be throwing brickbats at Equitable Life”.

Conclusion

117. As I said in the foreword, it cannot be for an inquiry like this to review the decision of the House of Lords, as many of those who have approached the inquiry have sought to persuade me to do. The courts settle the questions before them, on the basis of the arguments that are put to them. It is for the parties to select the grounds on which they choose to contest issues. The questions posed inevitably change and develop in focus in the course of the litigation. Within the framework of the written case counsel react to the approaches adopted by opponents and to the Court. But, at the end of the day, the decision of the House of Lords was final on the issues that were referred to the Appellate Committee for judgment. That is the nature of our civil justice system, and those affected by the decision must accept it.

118. In view of the many representations I have received, in particular during the maxwellisation process, to the effect that the *Hyman* decision was wholly unexpected, and could not have been anticipated in any way, it seems appropriate to say that any impression that the industry as a whole supported Equitable’s stance, or that legal opinion was universally in favour of the Society, is wrong. I am satisfied that I have reliable information that within the industry there were those who considered the position adopted by Equitable, and the few other offices who adopted similar practices in relation to differential terminal bonus, to be quite untenable. There were also lawyers, not involved in the case, who expressed views contrary to the advice Equitable received, before the House of Lords delivered judgment. I offer no view on the merits of the respective contentions. But I must dispel the notion widely advertised by the representations made to me, and in the public domain, that *Hyman* was a decision beyond reasonable contemplation.

119. The House of Lords decision can be reduced to a relatively simple proposition. No discretion granted to the directors in the constitution of the Society could enable them to frustrate the clear terms of their contracts with the GAR policyholders:

explicit contractual benefits could not be overridden by the exercise of managerial discretion. Those who have been critical of this judgment, and I have received many critical representations, need to consider whether they would have been prepared to purchase a pension if they were informed that the management might from time to time sell policies with different terms that potentially gave members of the same fund sharply divergent interests, and that should it emerge in the future that there were members of the same fund who had less advantageous terms (in the circumstances of the time), the terms of their own contract could be overridden at the absolute discretion of the board. Most potential policyholders might pause before entering into such a contract if the realities were fully explained. The decision in the case was never likely to please all interested policyholders. But disappointment at the outcome of litigation, never an exact science, is not a valid basis for criticism of the result.

120. The Board of the Society has been criticised for entering into and prosecuting the litigation. I can see no reason to criticise the Society's Board or executive management for taking steps to test the legal issues that had arisen. There were real issues to try, and one would have been concerned rather by refusal to confront them, and by any attempt to avoid exposing them to debate before the competent civil courts. There was a degree of surprise expressed within the industry at the final ruling. But professional opinion was divided even before the case was finally disposed of. Had the Society ignored the issues, and been brought into court by a policyholder, one must assume that the same result would have been arrived at: the law does not vary according to who initiates the case although the formulation of the issues may.

121. The legal advice the Society obtained at some stages did highlight certain risks. For example, the solicitors highlighted at an early stage the lack of disclosure in the policy conditions that the differential terminal bonus policy would apply, and the failure to distinguish between 'related bonuses' applying to guaranteed and current annuity rates. As I have noted, the assessment supplied by Dentons to the Society on 7 September 1998 was a reasonably balanced view of the issues likely to confront it in the course of the litigation. However, the tenor of the advice throughout was that the Society had a strong case and when the litigation was initiated, there was a sense of real confidence.

122. Once the litigation was underway, however, it became increasingly apparent to counsel that some of the grounds on which the Society might have sought to defend its position had been made untenable by its own practices in relation to the management of the with-profits fund and, in particular, the allocation of bonuses.. The argument that, within a single fund, equivalent benefits should accrue to equivalent investment, taking account of variations in contractual terms, might have been held to be an essential part of mutuality, a principle that the Society had long claimed to be guided by, if the argument had been available. But it appears that that was just one of the myths promulgated by the Society about itself that have become evident in the course of this inquiry. In practice, for example, German policyholders had been given returns reflecting the performance of German assets, when otherwise the business was treated as part of a single with-profits fund, a practice that appears to have been adopted for marketing reasons rather than reasons of high principle.

123. The *Hyman* case focused issues that could only be resolved by a court of competent jurisdiction. They were issues of law about which competent and experienced lawyers could entertain and express differing opinions. It is important to observe that these issues did not arise in a vacuum, nor as matters of theory. They arose from the actual practices of the Society in dealing with the rights and interests of policyholders in the economic circumstances that confronted management. The issues had to be resolved.

124. Actuaries, whether the Society's actuaries or the actuarial profession as a whole, were not competent to adjudicate on the issues that emerged. If there is any

criticism of the Society's management it is that they did not confront the legal issues much earlier than they did. The development of policy, in relation to product specification, the ascertainment of surplus and distribution in particular, are dealt with later in this report. There were many stages in the Society's developing business at which the issues eventually dealt with in *Hyman* could with advantage have been tackled and resolved. Had the Society acted earlier, the problem might have been contained and managed. Many policyholders might have been spared loss. In the next chapter, I shall identify some of the stages at which the issues might have been raised.

CHAPTER 2: ORIGINS OF ANNUITY GUARANTEE ISSUE

1. The story of how the Society arrived at the position in which it found itself in July 2000 has many aspects. It is appropriate to discuss in this chapter the evidence available on the origins of annuity guarantee policies, the Society's annuity guarantee policy forms and premium bases, and the evolution of the differential final bonus policy, as topics that bore on the issues in the *Hyman* litigation.

Origins and Nature of the Annuity Guarantees

2. In general terms, retirement annuity contracts written by life assurance companies and approved under the provisions of Finance Act 1956 section 22 and successor provisions had to have as their main object the provision of a life annuity for the contributor in old age. The Act gave effect, in part, to the recommendations of the Tucker Committee¹. Evidence before the Committee favoured tax relief on contributions made to secure a deferred life annuity². Most representations to the Committee suggested that the provisions should permit tax-free commutation of one quarter of total benefits³. Tucker recommended that relief should be available for contributions securing a specified amount of annuity at a specified future retirement age⁴. The report also proposed that limited tax-free commutation should be permitted. Insurance offices should be free of tax on the profits of the fund.

3. The commutation proposals were not carried into effect in the 1956 Act. But the basic requirement of the legislation was that the contract provided for an annuity. Approval of a retirement annuity contract provided by 'a person lawfully carrying on in the United Kingdom the business of granting annuities on human life' was competent so long as the contract did not:

“(a) provide for the payment by that person during the life of the individual of any sum except sums payable by way of annuity to the individual; or

(b) provide for the annuity payable to the individual to commence before he attains the age of sixty or after he attains the age of seventy; or

(c) provide for the payment by that person of any other sums except sums payable by way of annuity to the individual's widow or widower and any sums which, in the event of no annuity becoming payable either to the individual or to a widow or widower, are payable to the individual's personal representatives by way of return of premiums, by way of reasonable interest on premiums or by way of bonuses out of profits; or

(d) provide for the annuity, if any, payable to a widow or widower of the individual to be of a greater annual amount than that paid or payable to the individual; or

(e) provide for the payment of any annuity otherwise than for the life of the annuitant;

and that it does include provision securing that no annuity payable under it shall be capable in whole or in part of surrender, commutation or assignment.”⁵

Section 22(3) provided for the discretionary relaxation of the strict requirements of sub-section (2) in circumstances that are not of central importance for present purposes.

¹ Report of the Committee on the Taxation Treatment of Provisions for Retirement, February 1954 (Cmnd 9063) –the 'Tucker Report'.

² Tucker Report, paragraph 320.

³ Tucker Report, paragraph 326.

⁴ Tucker Report, paragraph 372.

⁵ Finance Act 1956, section 22(2).

4. An annuity is, in essence, an annual payment of a sum of money, a defined income stream, for life or for a defined period. The Act did not adopt the language of Tucker and stipulate a 'specified' annuity. Contemporary evidence indicates that by 1959 there was widespread use of with-profits annuities, and more limited use of variable annuities such as index-linked or unit-linked annuities. There were also trust-based arrangements. It seems likely that the paradigm in 1956, in the case of an insurance contract, was a specified annuity. That did not exclude other forms. None of the provisions of the Act, in its original form or as amended, and no practice of the Inland Revenue, stipulated how insurance companies were to compute or quote for the provision of the annuities they sold.

5. The Inland Revenue had discretion to waive certain of the requirements of the Act, and concessionary practices developed that relaxed those requirements. For example, strictly, retirement annuity contracts required to be written as annuity contracts. But the Inland Revenue had no objection to policies written to provide a cash fund provided that at maturity the fund was paid as an annuity. It was expected that the contract would show a primary form of annuity benefit payable if none of the policy options was exercised. In relation to guarantees, the official internal instructions stated:

"The contract may specify a guaranteed minimum annuity rate, but need not do so."

The nature and extent of the Inland Revenue's use of discretion were generally characterised as allowing some leeway in the strict interpretation and application of the legislation, making it clear where the Board of Inland Revenue could not depart from the law. The use of discretion was concentrated on the form of the benefits provided or the scope for making contributions.

6. The review carried out by the Inland Revenue for the inquiry did not uncover any papers indicating that the Inland Revenue had any influence over the creation or development of, or conditions attached to retirement annuity contracts that guaranteed annuity rates, expressly or implicitly. Despite repeated assertions in correspondence that the Inland Revenue did influence life offices in this respect, no evidence has been offered to the inquiry, or found by the Inland Revenue or the inquiry in reviewing the literature, to support this contention. Nor is it evident what reason they might have had to do so.

7. The Inland Revenue has, rightly in my view, hesitated to assert that there never was any statement that might have had some bearing on the use of guarantees in retirement annuity contracts. The inquiry related to events from 1956 onwards, and the most comprehensive review of extant records could not guarantee that nothing had been missed. But I am satisfied that, having regard to the scope of the legislation, and the record of contemporary practice referred to below, the contention that annuity guarantees were required by the Inland Revenue has no substance.

8. So far as Equitable is concerned, the problems that have arisen in relation to annuity guarantees are directly referable to the decisions of the Board and management of the Society from time to time to offer annuities incorporating guarantees that became progressively more costly. The selection of the implicit valuation factors, and the values attributed to them, were at all times a matter for the Society to determine in a competitive environment. They were not required by the legislative structure, nor influenced by Inland Revenue practice.

9. The advanced study group of the Insurance Institute of London began to study the industry's problems with the implementation of the 1956 Act in the autumn of 1956, and published its report⁶ in 1959, reflecting the findings of the group at January 1959. The report contained valuable research data and findings on contemporary life industry practice. Generally, it appears that apart from elements

⁶ Report of the Insurance Institute of London, No 140, 1959.

of policy and practice that were dictated by the language of the legislation, there was wide variation in the forms adopted by different offices. The report described the policy forms that had been devised by offices in the period of study. The contracts were, of necessity, deferred annuities on the life of the person claiming tax relief. The annuities were non-commutable and non-assignable. Subject to that it was found that all types of deferred annuity were available, with return or without return of premiums on death during deferment. With return contracts were issued with return of premiums either without interest or with interest. There were varying commencement dates, varying adjustments of rates according to age at commencement, varying guaranteed periods of payment, varying periods of payment and varying provisions for flexible premium contributions. The business was highly competitive, and even in 1959, the terms offered were attractive and appeared to allow little margin for possible improvement in mortality.

10. In respect of contributions, the group found that single premium contracts were common. Some offices made provision for the payment of occasional single premiums. It found that most single premium contracts carried no rate guarantee, i.e. the terms upon which any further annuities could be purchased by single premium would depend upon the rates of premium in force when the additional premium was paid. But practice varied, and in some cases rates were guaranteed for limited amounts, or for limited periods, or even without qualification. Equitable fell into the final category.

11. In respect of with-profits business, the group identified the sources of profit as being: (a) expenses; (b) interest; (c) investment returns; and (d) mortality. Observations on these factors reflect an objective assessment of the risks associated with retirement annuity business from an early date:

“The loading for expenses involved in these contracts would appear to be small so that any contribution to profits from this source must also be small. In present investment conditions a source of profit probably exists under (b), but it must be remembered that retirement annuities are long-term contracts. It is no doubt expected that careful management will lead to a profit under (c). Whether (d) will result in profit or loss depends upon the future trends of mortality. Further improvement in mortality rates beyond that allowed for in the premium basis could result in loss to the life office and accordingly it is necessary for actuaries to take a cautious view of future trends when deciding premium bases for retirement annuities; if the actuary is over-cautious, however, a profit from mortality may result. Competition for this business is, however, fierce and exercises a restraining influence so far as possible profit margins are concerned.”

One has a clear impression of a market place in which practitioners had, or, after publication of the report ought to have had, a full and proper appreciation of the areas of risk associated with writing retirement annuity business. However, the market was highly competitive, and the risks may not have been fully acknowledged in practice.

12. The sense of well-understood commercial risk was heightened as the report proceeded to analyse practice. There was implicit criticism of one of Equitable's practices:

“In most cases the annuity only participates in profits during the term of deferment but this is not an invariable rule. At least one office allots a final bonus of an increased amount when the annuity commences as some compensation for the fact that the annuity then ceases to participate in profits. Annuitants who live longest tend to cause the office a loss and therefore it may seem anomalous that annuitants should continue to participate in profits after the vesting date; ...”

The report acknowledged the attraction to the policyholder.

13. The report analysed policy forms into standard clauses, reflecting the requirements of the legislation and Inland Revenue concessionary practice, and non-standard clauses developed by individual offices. The standard clauses did not include a requirement for a guaranteed annuity rate. In relation to annuity benefits, the Report stated:

“It is in respect of the benefits provided that the greatest degree of variation was found among the policies studied by the Group. It can be said that no two offices use exactly the same approach to the drafting of this section of the policy...”

The group reported finding participating and non-participating deferred annuities. There were varying provisions for conversion to paid-up status. There were varying options available at maturity. There were varying death benefit provisions. A principal variation highlighted was between pure life annuities and life guaranteed for a period. Some offices wrote all policies to ‘mature’ at a fixed age. Some provided flexibility of varying degrees. Many offices showed tables of the annuities that would be secured at alternative ages, either as actual amounts or percentages of the scheduled rates. For present purposes, the lack of any comment on implicit or explicit guaranteed annuity rates is significant. The publication of tables of rates, which was assumed as a norm from which variations were identified, might imply an implicit conversion rate in possession. But it appears not to have attracted attention.

14. The range of policy types found by the group, in early 1959, demonstrates that there was not an Inland Revenue requirement for annuity guarantees, either as to duration or as to amount at maturity. Those were features within the discretion of the office, and reflected the competitive position the office sought to develop. Equitable’s initial implicit guarantees were of low value, both in respect of guaranteed investment return and the implicit interest rate component of the conversion rate in possession. The Society increased the growth and conversion rates implied in its retirement annuity contracts in October 1975, and maintained the new rates for new contracts until June 1988, and thereafter as rate guarantees in continuing contracts written in and after October 1975. The highest levels of uplift in policy values in the compromise scheme submitted to members in the Autumn of 2001 related to business written in and after October 1975. It was in relation to that business that the Society’s annuity guarantee problems arose. The rate levels for earlier business were considerably lower, and the resulting problems less material. The reasons for increasing the rates in October 1975 were related to the Society’s competitive position in the market⁷.

15. In the 1950s and 1960s retirement annuity business was not a major component of the Society’s total long-term insurance book. That was dominated by business written under the Federated Superannuation Scheme for Universities. Pensions business generally and retirement annuity business in particular became more significant at the end of the 1960s and into the 1970s. The improvement of the Society’s competitive position in the pensions market in the mid-1970s, and the resulting guaranteed annuity rate problem in the 1990s, were wholly the product of management decisions as to the levels of guarantees and the marketing of the products. They were not dictated by legislative or other external factors. I shall deal with this aspect of matters when discussing the Society’s pursuit of growth in the 1970s.

⁷ In their representations in response to the maxwellisation process, two of the former executive directors, David Thomas and Roger Bowley, have said that in about 1975 there were low equity markets and very high gilt yields of around 16%. That might explain the use of high guaranteed rate components at that time for current business. It makes it more difficult to understand accepting a commitment to an unlimited premium guarantee for new business reflecting those rates, and especially difficult to understand why the Society persisted in writing new business reflecting those rates until 1988.

Premium Bases for Annuity Guarantee Products

16. At the time of the *Hyman* case and subsequently, officers of Equitable contended that the guaranteed annuity rates had not been charged for, that a charge was appropriate, and that it could be exacted from the terminal bonus otherwise payable at maturity, effectively retrospectively, if the policyholder required payment on the guaranteed basis. Alternatively it was envisaged that the cost of the guaranteed annuity rates could be charged against the funds attributable to policies with annuity guarantees generally, the basic ring-fenced solution. In this, as in many aspects of the issue, there are questions of terminology.

17. It appears likely that in their use of the expression 'guaranteed annuity rate', Equitable's officers had in mind the conversion rate in possession only; there was no discussion of the guaranteed investment roll-up rate also implicit in the annuity guarantees. If this is a valid inference, it implies that in some way the guaranteed investment roll-up rate was charged for: otherwise that also should have been the subject of a charge at maturity. Alternatively, it implies that a distinction was drawn in practice between two factors contributing to the annuity guarantees in the policies without any obvious logical basis. By the late 1990s the Society sold a number of products with no or zero roll-up rates of investment return: the treatment of the guaranteed investment return was not a theoretical issue.

18. Between 1962 (the first declaration of bonus after the introduction of retirement annuity contracts) and 1973 the Society declared the same reversionary bonus rate for all existing classes of major with-profits business. Minor with-profits contracts were dealt with in a different way. Corley⁸ states that the terms for the retirement annuity contract were set so as to enable the same reversionary bonus rate to be used as for the then existing major classes of business. That was what happened in practice, and Corley's observation coincides with evidence I have received. From 1957 until the triennium ended 1973, retirement annuity maturities were awarded a form of final bonus. An earlier maturity bonus on endowment business had been discontinued in 1962. Until the end of the 1971-73 triennium there had been no other terminal bonus system in operation since 1962. The initial rating of the business could not have had regard to the terminal bonus element in the total benefits structure that was to come into effect in and after 31 December 1972 in terms of the 1973 declaration. The limited form of final bonus allotted to retirement annuity maturities was intended to align retirement annuity payments with the Society's current immediate annuity rates, which reflected anticipated profits over the term of the annuity.

19. Later assertions that it had 'always' been the intention of the Society to recover the cost of guarantees from terminal bonus cannot be true in any absolute sense. Such a policy could not have pre-dated the introduction of the general terminal bonus in 1973, by which stage the principal elements of the structure of the retirement annuity contract had been fixed. The introduction or application of the original final bonus, designed to increase the annuity yield on retirement annuity maturities, would have been inconsistent with an intention to reduce policy value in respect of the guarantees. It would have operated against the interests of the rest of the with-profits fund if it implied favourable differential treatment instead of achieving parity with those purchasing immediate annuities.

20. The inquiry has not recovered the premium books used in the 1950s. But the general information available indicates that there were implicit guarantees in with-profits business generally, dominated in 1957 by endowment and whole life business. The use of common reversionary bonus rates across the major with-profits fund until the triennium ended 1973 ignored the distinction in tax treatment between gross and net funds. A balance had been achieved to the satisfaction of the Society's actuaries that was not disturbed in practice until 1973. At that time the

⁸ Report of the Corley Committee on Inquiry regarding the Equitable Life Assurance Society, Faculty & Institute of Actuaries, September 2001, Appendix 2 paragraph 3 (vi).

taxation differential was taken into account, and a higher reversionary bonus rate was declared thereafter on gross funds. There was no suggestion that the premium bases had become mutually inconsistent for any other reason.

21. Barry Sherlock, who was general manager and actuary of the Society from 1972 to 1991, and appointed actuary from the introduction of that office until 1982, told the inquiry that when his predecessor, Maurice Ogborn, introduced the retirement annuity contracts in 1956–57, he made the guaranteed terms marginally less favourable than those available on pre-existing policy classes to protect the existing classes from the possibility that holders of the new policies would take an unfair share of surplus. While it would be speculative to suggest a causal relationship in the absence of specific evidence of rates, the use of a final annuity adjustment would have been consistent with compensating for any unfairness arising from this difference in the light of experience down to maturity. Sherlock told the inquiry that the purpose of the final bonus was to correct potential unfairness of applying the guaranteed rate without adjustment to the current equivalent immediate annuity rates which were geared to current fixed interest returns.

22. The first edition of the Institute and Faculty of Actuaries' guidance note 1 (GN1) was issued with effect from 1 May 1975. It provided that the financial position of the office, on which the appointed actuary had a statutory duty to report, was particularly affected by:

- (a) the premium rates on which existing business had been, and current new business was being, written, and
- (b) the nature of the contracts in force and currently being sold, with particular reference to all guarantees

among other factors. Failure to apply the guidance in GN 1 was prima facie evidence of unprofessional conduct. It would require clear evidence to infer that despite the guidance Equitable was writing business after 1 May 1975 on premium bases that did not cover guaranteed liabilities without there being a report by Sherlock, as appointed actuary, that highlighted this deficiency. It appears on the information available to the inquiry that the Society's premium bases were loaded for profit in excess of the guarantees, in the case of retirement annuity business as with other major with-profits business.

23. The Society did charge explicitly for certain guarantees at the time the retirement annuity contract was introduced. The Society's standard contract for university teachers under the Federated Superannuation Scheme for Universities (FSSU) was written as an endowment policy, payable in cash or convertible into an annuity at current rates at maturity. The Society made available as an option a guaranteed conversion rate in substitution for the current immediate annuity rates. For that option a separate charge was made. It is clear that the benefit of that guarantee was not a characteristic of FSSU business generally, for which the standard premium bases might have made provision, but was and was seen to be an additional and optional benefit which the policyholder might elect to take, and for which there was a price. The Society might have adopted a similar approach to retirement annuity business, promising a level of annuity dependent on immediate rates at maturity with an optional guarantee for which there would have been payment. However it did not do so in the case of retirement annuity contracts, though it did adopt that approach in other pensions contracts as mentioned below. In the case of retirement annuity contracts, the policyholder paid a premium appropriate to the benefits secured by the policy, and the guarantees were explicit elements of those benefits.

Equitable's Guaranteed Annuity Rate Contract Forms

24. Equitable wrote policies containing annuity guarantees in a number of forms. At the reference date the Society had in issue four groups of such policies: retirement annuity contracts, individual pension contracts, group pension schemes and transfer plan contracts. The forms of the contracts varied, generally reflecting

differing statutory requirements for approval for taxation purposes. No new business with annuity guarantees was written after 30 June 1988, but in certain group schemes there were contractual rights to introduce new members to existing schemes that subsisted until 1993. Existing policyholders generally had the right to pay additional contributions without revision of the rates of benefit stipulated in the original contract.

25. The annuity guarantees fell broadly into two categories which can best be distinguished and illustrated by reference to examples. Most retirement annuity policies were written with the annuity as the primary benefit with an option to convert the benefit into a cash fund for application in the purchase of alternative benefits within a specified range. The individual pension and group pension schemes were written with a cash fund as the primary benefit for application in the purchase of specified benefits, underpinned by the annuity guarantee.

26. The earliest form of retirement annuity contract recovered was first issued in 1957. It provided for a premium-based guaranteed annuity, with-profits, expressed as follows:

“[T]he Society will pay to the Grantee an annuity of the amount shown in the Schedule hereto (increased by such amounts if any as shall under the rules and regulations of the Society have been allotted by way of addition to or bonus thereon) or as may be agreed under Proviso 3 according to the age at which the annuity is to commence ...”

In structure, and in language, this policy conferred a contractual right to, and imposed on the Society an obligation of payment of, the guaranteed amount, as increased by such additions and bonuses as might be ‘allotted’ under the rules and regulations of the Society. The policy did not specify the form of allotment, or define restrictively a relevant class of allotments. The schedule set out a ‘Table of Guaranteed Rates of Annuity’, varying according to the age of the policyholder at the date of payment of the premium, payable on maturity at age 70. The annuity that the Society was obliged to pay in accordance with the Schedule reflected (a) a discount for expenses; (b) a guaranteed roll-up rate of interest; (c) a guaranteed interest rate in possession; and (d) a mortality factor appropriate to the maturity age selected. However, none of these computational elements was specified. Additions and bonuses increased the annuity directly, and were in the form of additional annuity payments.

27. The contract form provided options: (1) to pay further premiums on the same terms and conditions subject to Inland Revenue limits; (2) to take benefit earlier than the prescribed age; and (3) to take benefits in alternative forms, including a surviving spouse’s annuity and an annuity for qualifying dependants, all subject to Inland Revenue limits. The option for early retirement did not provide explicitly for the adaptation of the contractual rates of annuity to rates payable at an earlier age. The grantee and the Society had to agree a specific sum for effective selection of a retirement age under 70. The mechanism envisaged was that the substituted rate would be agreed and inserted in the policy. The same approach applied to subsidiary annuities such as those for surviving spouses and dependants. As a matter of construction the options were dependent for effectiveness on agreement being struck at the material time. In practice on early voluntary retirement between 60 and 70 the annuity was determined arithmetically⁹.

28. The interpretation of the policy document, in the light of the Society’s articles of association, would have left much unsettled without reference to extraneous facts and circumstances. In the case of a single life, uncomplicated by renunciation and subordinate annuities, the policy promised a specific annuity rate per £100 of premiums, increased by additions and bonuses, if any. Bonuses would have accrued, if there were profits, to the date of maturity and no further. Leaving aside

⁹ Corley Appendix 2, paragraph 3 (ii). The observation relates to the later 1975 form, but appears to reflect earlier practice.

mechanics, and assumptions based on the operation of the with-profits system generally, the policyholder was entitled to participate in profits to maturity. Article 65 provided for regular bonuses at valuation, and, in paragraph (2), provided for interim or additional or special bonuses between valuations. The smoothing of returns, by averaging to ensure steady distribution rather than making an immediate distribution of the returns of the current period, and the reserving of surpluses would have depended on views as to the scope of the directors' general discretionary powers in the determination of amounts available for distribution.

29. The form of contract was amended from time to time. For present purposes, only the most significant amendments need to be mentioned. Partial commutation of retirement annuities was permitted by the Finance Act 1971. The Society adopted a new form of retirement annuity contract incorporating a commutation option in that year. The commutation option was written as a proviso to the primary obligation to pay the annuity, which remained in the same terms. The proviso, in clause 6 of the policy form, was effective at the pension age selected by the policyholder, and was that:

“the Grantee may elect ...:

(a) to be paid on attaining the selected age by way of commutation of part of the annuity payable to the Grantee hereunder a lump sum calculated in accordance with the Commutation Table endorsed hereon but not in any event exceeding three times the amount of the annuity remaining payable to the Grantee after such commutation”

30. The table of guaranteed rates of annuity was in structure the same as that in the 1957 form. The commutation table contained a note in these terms:

“The amounts of annuity to be commuted shown in this table will be increased by a percentage equal to that by which the annuity is increased by any final bonus (which expression shall mean any amount which shall under the rules and regulations of the Society be allotted by way of addition to or bonus on the annuity at the selected age and which shall be described by the Society as a final bonus).”

31. Typically, the retirement annuity forms provided:

“This Policy shall confer right ... to participation in the profits of the Society up to the date on which the Grantee attains the selected age and no longer.”

As mentioned above, when bonus was first declared on retirement annuity policies at the 1961 quinquennial valuation, the Board adopted a policy of paying a final bonus on this class of business, on the advice of the Society's principal actuaries. In a report to the Board dated 22 March 1962, on the valuation, the actuaries stated:

“This is the first occasion on which participating policies in the pension annuity fund will receive bonus additions... Since, ... these contracts participate in the profits of the Society up to the retirement of a member but no longer, there is the special problem of the profits that may subsequently emerge while the annuity is in course of payment. We recommend that compensation for the anticipated profits should be given by means of a final bonus, allotted at the time of retirement. This takes the form of a special interim bonus applicable to pension annuities...”

The advice is examined in more detail later in the context of the Society's bonus policy. For present purposes it is sufficient to note that it was recognised at this early stage that there had to be a unique adjustment to the guaranteed rates of annuity for which the policyholder had paid premiums to lift the annuity to current annuity rates.

32. The final annuity bonus was only available to the extent that the benefits were taken in annuity form. The provision in the 1971 commutation table was intended to ensure that the uplift was not reflected back into the commutation process, so

increasing the cash amount available. The uplift was available only as a supplement to the annuity. Subject to that, the ‘annuity payable’ reflected all additions and bonuses allotted to the policyholder. The final bonus, in particular, was described as a sum allotted under the rules and regulations of the Society with a specified description.

33. Section 26 Finance Act 1978 allowed an open market option to be provided in retirement annuity contracts, allowing the cash equivalent of pension benefits to be applied in purchase of an annuity from a different office. In May 1979 the Society adopted a radically different form of contract. The primary obligation of the Society was now expressed in these terms:

“The Society hereby covenants with the Grantee that ...

(a) if the Grantee shall survive to the Selected Pension Date the Society will pay to the Grantee the Annuity increased by Related Bonuses (if any) ... upon and subject to the terms and conditions set out in this Policy”

‘The Annuity’ was defined as ‘the Annuity purchased by the premium specified in Endorsement 1 and calculated in the manner specified in the Sixth Schedule’. There was provision for the purchase of ‘Further Annuities’: subsequent premium payments purchased equivalent benefits. The contract included an ‘Illustration of Benefits’ in endorsement 1. Paragraph 3.0 of the fourth schedule provided a commutation option in general terms, and subject to agreement, without arithmetical expression. The commutation table had been removed from the form.

34. ‘Related bonuses’ meant: ‘in relation to the annuity such amounts (if any) as shall under the rules and regulations of the Society have been allotted by way of addition or bonus thereon.’ The mechanics specified continued to envisage bonus annuity additions. The only limitation was that the amounts had been ‘allotted’ under the rules and regulations of the Society. As with the older forms, the provision did not apply exclusively to declared reversionary bonuses. By endorsement the Society imported the reference to ‘related bonuses’ into the older contract forms, where it had to include the special final bonus. One might criticise the drafting of the endorsement, but what is important is that the Society saw the use of the expression ‘related bonuses’ as appropriate in the older and new forms without differentiation.

35. The sixth schedule provided for the computation of the annuity in two stages: first, the determination of the accumulation value of the premiums applying table A, and thereafter the determination of the annuity by applying table B. There were provisions for determining a cash fund value by applying table B in reverse, effectively providing that the accumulation value of the residual annuity after the exercise of other options would be the measure of that sum. Paragraph 1.5 of the sixth schedule provided that:

“Having ascertained the Accumulation Value at the Selected Pension Date of the premium paid in respect of the Annuity ... in accordance with the preceding paragraphs of this Schedule the amount of the Annuity ... shall be the amount of the annuity attributable to such Accumulation Value at the Selected Pension Age by reference to Table B.”

The basic rights had not changed in character. The right conferred was a right to an annuity arrived at by using annuity rates. The mechanism had changed from the earlier forms, in respect that in response to the open market option there was specification of an intermediate stage in the calculation, but there remained only one measure of the annuity right.

36. It can be deduced arithmetically that in the 1979 form the implicit discount for expenses and the guaranteed investment return were reflected in the calculation of the accumulation value. The mortality factor and the interest rate in possession were reflected in the conversion rate set out in table B. By 1979 the Society’s bonus

practice had developed to include terminal¹⁰ bonus payments. The only mechanism by which such bonuses could affect the amount payable was by including them in 'related bonuses' so that they entered into the calculation of the annuity in terms of the sixth schedule. That remained the structure of the retirement annuity policy thereafter.

37. In the Society's group schemes, the table of retirement benefits expressed the benefits as cash sums assured. The proceeds payable at maturity had to be applied to purchase an annuity from the Society from among the classes of annuity then offered. In the 1979 form, which was typical, paragraph 1.2 of the fifth schedule provided:

"Any annuity ... shall be purchased from the Society at the rates used by the Society at the date of purchase for an annuity of the same class provided that the Society guarantees that the rates used will be calculated on bases no less favourable (*mutates mutandis*) than those used to calculate the examples of rates set out in the Table of Examples of Guaranteed Annuity Rates contained in the Seventh Schedule. ..."

The examples covered retirement at 60, 65 and 70, and annuities on a level basis and increasing at 3% per annum, for single male and female lives and for a male life with a surviving widow's benefit at half rates. In this case, there was an example of a guaranteed conversion rate, in Corley's terminology. The basic contractual right was to an annuity at the current annuity rates appropriate for the class of benefit selected subject to a guaranteed minimum level of benefit. The contrast with the retirement annuity forms is clear. The Society was able to distinguish the benefits on offer for different classes of business, and had readily available forms to reflect such distinctions as were intended.

38. In further contrast to the retirement annuity forms, group pension policies provided for revision of terms for future contributions. The 1979 form achieved this by conferring a qualified option to pay further single premiums on the premium day, in order to secure proportionate benefits to those set out in the table of guaranteed rates of retirement benefit. The qualification on future payments was in these terms:

"Provided that the Society may once in each of the successive periods of five years the first of which commences on a date four years from the Date of this Policy revise the rates contained in the said Table of Guaranteed Rates of Retirement Benefit upon such basis and in such manner as it shall in its absolute discretion think fit upon giving the Trustees three months notice of its intention so to do.."

excluding retrospective effect.

39. The variation provision would have allowed the Society to change its rates to accommodate changes in any of the actuarial assumptions implicit in the premium bases, once in every five-year period. The benefits structure was fund based, with the primary obligation of the Society to provide an annuity at current annuity rates subject to a guaranteed minimum level. Later forms of this type were to the same effect. Again it is to be noted that the Society had available clauses that could have been adapted to introduce similar limitations in the case of retirement annuity business if that had been desired. It was never done.

40. The Society's final salary policy adopted a different mechanism. The primary obligation of the Society under this form was to pay an annuity of the amount payable in accordance with the employer's pension scheme rules agreed with the Society in return for the contributions paid. The cost of the annuity was to be based on the Society's current annuity rates, subject to a guarantee that the cost would not exceed the amount brought out on an application of the guaranteed rates set out in the schedule. The mechanism was different from the AVC/group model, but the

¹⁰ Later subsumed into 'final' bonus.

effect was the same. The rates set out in the tables were variable at the instance of the Society once in every successive five-year period.

41. At the time retirement annuities were introduced, favourable tax treatment was already available for retirement benefits schemes promoted by employers which qualified for exception from the operation of section 386 Income Tax Act 1952 under which schedule E tax applied to the premiums. A common form of scheme was the 'top hat' variety meeting the requirements of section 388 of the 1952 Act.

42. The inquiry recovered an early form of Equitable contract of this type dated 30 January 1976. By then the relevant legislation was contained in section 323 Income and Corporation Taxes Act 1970 and Finance Act 1970 Part II Chapter II. The grantee of the policy, the beneficiary's employer, had an open-ended option to purchase further retirement benefits on the terms of the policy, subject to maintaining the conditions of eligibility for exemption. Benefits were expressed as a cash fund. The total retirement benefits, being the aggregate of the retirement benefits sums assured, and specified in the second schedule to the policy and later endorsements had to be applied in the payment of such cash benefit as was required under the rules or in securing an annuity or annuities with the Society or under the open market option. The sixth schedule provided tables of guaranteed rates of retirement benefit sums assured, depending on whether payment of the premium was before or after 1 June 1976, a table of guaranteed annuity rates applicable to the total retirement benefits, and a table of reductions for early retirement.

43. In July 1988 the Society wrote to group pension scheme clients intimating an intention to amend the contracts in respect of new members. The note stated, so far as is material:

"Guaranteed annuity rates are withdrawn. The policy already offers an 'open market option' to the Trustees enabling them to buy pension from the most competitive source in the market place. The protection of the guaranteed annuity rate is no longer appropriate."

44. The letter and note were accompanied by a formal notice of change. In October 1988 the Society distributed the endorsements and other documents intended to give effect to the changes and advised administrators to amend their explanatory booklets, offering to provide inserts for the purpose. The Society's intentions were not fully realised: trustees resisted the attempted changes, insisting on the right to introduce new members to their schemes for a further five years. The reason offered for the changes may not have withstood scrutiny. Two of the group scheme forms in existence at the relevant date were issued after the open market option was introduced in 1978. The changes became fully effective in 1993.

45. The Society altered the form of its Finance Act 1970 individual pension plan documents in December 1987. The brochure published at that time no longer contained provision for guaranteed returns. The 'form of benefits' section was in these terms:

"Although a particular form of benefits may have been in mind when the plan was set up, the form in which retirement benefits from The Equitable's plan are actually taken is not decided until the time comes. Then, based on the fund available, any combination of benefits may be chosen provided that Inland Revenue limits are not exceeded...."

Currently the Society offers a level pension, a pension whose value is related to the change in the Retail Prices index and a pension whose value is related to the profits of the Society..."

The annuity guarantee contained in the earlier form had been withdrawn.

46. The various policy forms differed in structure and language from each other. They also differed in effect, and gave rise to differing actuarial considerations. They differed to a greater extent from other with-profits business written from time to time that did not contain similar guarantees. It is impossible to avoid the view that the

Society's policy forms were carefully crafted to meet the perceived requirements of the relevant market sector targeted in each case.

47. With effect from 1 July 1988 the Finance (No 2) Act 1987 changed the taxation regime applicable to pension business. The Act ended the sale of new approvable retirement annuity contracts. From that date, existing contracts could remain fully in force, and additional contributions could be made within the terms applicable. Ongoing premiums continued to qualify for tax relief. New contracts had to meet the requirements introduced for the regulation of personal pension business. The new rules applied on transfer to a different office. If an individual with an existing retirement annuity contract wished to change his pension provider, he had to transfer into a personal pension scheme. In practice the Inland Revenue also permitted transfer to an occupational pension scheme by concession. Similarly, by concession, switching between funds was permitted without change of provider.

48. From July 1988 until July 1996 the Society sold personal pension policies with an express guaranteed investment return of 3.5% but without a guaranteed conversion rate in possession. The Society received legal advice from Dentons, the Society's solicitors, on a range of forms prepared at the time, following the introduction of the LAUTRO¹¹ rules, and the prescriptive code for disclosing product particulars. There was extensive correspondence relating to the Society's proposal to issue a composite form of booklet covering a range of related products of different classes. The solicitors were involved in detailed scrutiny and drafting of the Society's policy documents and booklets. They commented on ancillary issues, such as tax, when occasion demanded that. They considered the operation of with-profit clauses in many of the situations discussed. The inquiry has not uncovered evidence that their advice was sought on any risk of conflict between the interests of the new-type policyholders and the pre-existing retirement annuity class.

49. The Society published its personal pension plan policy booklet in July 1988. It provided for the identification of policy segments with separately defined rights. For a with-profits segment the provisions for calculation of the sum assured and related bonuses were:

“(a) The Sum Assured secured by a With-Profits Segment shall be a variable sum equal at any particular date to 95.5% of the total of the premiums which have been attributed to such Segment each such premium having first been increased by compound interest at the rate of 3.5% per annum calculated from the date of payment of such premium to the said particular date with yearly rests.

(b) Related Bonuses are also variable and will be calculated by the Actuary at any particular date in accordance with the rules and regulations of the Society.”

Bonuses depended on the exercise of discretion. The basic guarantee was of an investment roll-up rate of 3½% on premiums discounted for expenses at 4½%. This form remained in use until July 1996 when the policy form was changed to exclude any guaranteed rate of investment return.

50. At the inquiry reference date of 31 August 2001 there were therefore in issue pension contracts (a) incorporating an implicit guaranteed roll-up investment rate of return, an implicit fixed expenses deduction, and a guaranteed conversion rate in possession comprising a fixed rate of interest and a pre-determined mortality factor; (b) incorporating an explicit guaranteed investment rate of return and an explicit expenses deduction; and (c) without guaranteed rates of any kind. In the remainder of this section discussion relates to the pensions business, with particular reference to retirement annuity contracts, since that was at the heart of the *Hyman* case and was thought to lie at the roots of the Society's difficulties at the reference date.

¹¹ Life Assurance & Unit Trust Regulatory Organisation, one of the self-regulating organisations recognised under Part I, chapter III of the Financial Services Act 1986.

However, there were guarantees in other classes of business, and contrasts within similar groups of business. For most of the relevant period, endowment assurances reflected implicit guarantees of investment return in the guaranteed sum assured. Premium scales were constructed by adding together a charge for the basic benefit and a loading for profit participation. In contrast, in 1990 the Society introduced recurrent single premium life contracts with no guaranteed growth at all. Most business of this kind was sold in the form of single premium bonds. The variety of contractual rights among policy types participating in the with-profits fund was considerable.

Evolution of a Differential Terminal Bonus Policy

51. Analysis of the Society's various retirement annuity policy forms shows that all bonus additions allotted to the policyholder required to be taken into account in arriving at the annuity payable. In some forms, particularly the later forms, options were based on accumulation values that excluded the value of the conversion rate in possession. But for the policyholder taking an annuity in terms of the contract, computation assumed that all allotted bonuses and other additions were taken into account in arriving at the annuity.

52. As discussed above, the Society adopted a policy of allotting a final bonus for retirement annuity business from the beginning. At the 1962 valuation when the policy was first implemented, the Society discontinued its previous practice of paying a maturity bonus on endowment policies and revised the basis of its reversionary policy declarations. Making particular provision for retirement annuity business distinguished it from other classes. The early practice was to be relied on in the late 1990s when the Society sought to defend the controversial differential final bonus policy that resulted in the *Hyman* case.

53. The joint reports of the actuaries and the course of discussions that followed the 1962 report indicated nothing that was particular to the retirement annuity form of contract and that engaged the interest or attention of the Board at this time other than the implications of the stipulation that the policyholder ceased to participate in profits when the policy matured¹². The authority for the policy adopted was the absolute discretion of the directors in respect of distribution rather than any specific term of the contract. The directors had the comfort of the Society's solicitors' advice obtained at the time that their discretion was ample, subject only to moral obligations generated by policyholders' expectations in the light of earlier representations, and the possible qualification of their right to convert maturity bonus into reversionary bonus as an aspect of the revision of bonus practice in relation to endowment business. The approach to retirement annuity policyholders' rights was seen in this general context as primarily a matter of the directors' discretion absolute subject only to the obligation to act bona fide and for the benefit of the Society as a whole.

54. The inquiry has not uncovered any evidence that the directors sought legal advice on their powers in relation to bonus at any time thereafter until the Society was embroiled in the dispute that resulted in the *Hyman* case. For many years there was no practical financial issue for the directors. With the exception of a period in 1982 and 1983, none may have been anticipated throughout the period between 1957 and 1993. Current annuity rates were consistently higher than the implicit guarantees. New contract forms were adopted apparently without board involvement, as a matter of management discretion.

55. The first contractual reference to the practice of making a final bonus adjustment was in 1971, when the expression 'any final bonus allotted' appeared in the commutation table introduced in the light of Finance Act 1971 (see paragraph 29 ante). In the 1975 form the expression 'final annuity adjustment' was introduced

¹² Proviso 11.

into the statement of the Society's primary obligation. By that date the terminal bonus policy had been introduced. There was nothing inherent in the drafting of the provisions, nor in the records, to suggest that legal advice was taken on the implications of the changes of language. Similarly the substantial re-drafting of the form in May 1979 appears to have been carried through without significant concern about the wording.

56. When terminal bonus was introduced generally it coexisted with final annuity adjustment practice, with the change of terminology in 1975 differentiating the specific uplift from the general terminal bonus. That practice subsisted for a period. In the case of retirement annuity contracts, the Society allocated terminal bonus at a level rate (as was its practice in relation to major with-profits business generally at that stage) on a sum already increased by the final annuity adjustment, indicating that the benefits were cumulative in character. The final annuity adjustment was not a contribution towards or an element of terminal bonus. It cannot be accepted that it was 'always' the intention to recoup the 'cost' of the annuity guarantees from terminal bonus in any way associated with the original final bonus, or final annuity adjustment. The two elements were distinguished in terminology and in substance.

57. In the autumn of 1982 interest rates fell for a time below the interest rate in possession implicit in most retirement annuity contracts. The actuary noted the fall, and commented on the implications for bonus rates generally in a report to the board dated 24 November 1982. He advised that interest rates might remain at their current lower level, in which case the board needed a strategy that would enable bonuses to fall to the new lower level in an orderly fashion and at a pace that would seem acceptable to existing policyholders. If interest rates continued to decline the pace of reduction of bonus rates would need to be rather faster. If interest rates reverted to a higher range, current bonus rates would again be earned and the current fall would be seen to be a fluctuation downwards similar to the fluctuation upwards to very high interest rates in 1974. Those fluctuations were normally smoothed and not reflected directly in bonus rates. The actuary recommended that, in the light of the uncertainties about the future because of interest rates, it seemed appropriate in considering declared, interim and terminal bonus rates to avoid recommendations at either extreme.

58. There was concern over the implications of the annuity guarantees in relation to low interest rates that persisted into the New Year. The primary concern revealed was that there was a danger of large single premiums being paid at or before retirement to take the benefit of the annuity guarantee. With the GARs nearly in or in the money, it would have been open to a policyholder, subject to Revenue limits, to make substantial top-up contributions on guaranteed terms. Ranson proposed that a clause be designed to remove large single premiums from guaranteed terms.

59. An endorsement or additional term for new contracts was drafted by a member of the actuarial staff to meet Ranson's requirements in these terms:

"The "Average Premium" from time to time is the annual average of retirement benefits premiums paid in the period, ending on the preceding policy anniversary, of ten years or the duration of the policy, whichever is the shorter.

Where a premium is paid so that the total of premiums paid in the policy year exceeds twice the Average Premium the benefits secured by that excess will be based on annuity rates current at the date the benefits are taken and the annuity rates guaranteed in this policy shall not apply. Such excess premiums will not be included in the calculation of the Average premium in respect of future policy years."

The return on excess payments was to be limited to current annuity rates.

60. The specific risk arose because the contribution would have attracted the annuity guarantee directly, irrespective of any bonus allocated to the policy. The inquiry has not uncovered any other contemporary documentary evidence of

investigation or discussion of the implications for annuity guarantees at maturity in other circumstances. However, there is evidence that discussion did take place at least at executive level, and one indication of discussions by the board. In paragraph 3.2.11 of *With Profits Without Mystery*, the paper presented to the Institute of Actuaries by Ranson and Headdon on 20 March 1989¹³, it was stated that the implications of reduced interest rate levels were discussed with the board after the fall in interest rates in the Autumn of 1982. In his evidence to the Treasury Select Committee, item 5, Headdon said that the board did look forward in the 1980s to an environment of much lower interest rates, and that: “The course of action that was determined to cope with that was to have a different final bonus rate to reflect the different value of the guarantees on the policy.” He told the Treasury Select Committee that such different bonuses would be paid “consistent with the type of bonus approach that we have described to our members”. In oral evidence to the inquiry Headdon confirmed that the intention to make compensatory adjustments to terminal bonus, that in due course came to be reflected in the differential terminal bonus policy, was discussed at about this time.

61. At a meeting of executives of the Society arranged to discuss the annuity guarantee issue in the autumn of 1998, Headdon gave a presentation on the background. He gave further information about the origins of the practice. He stated:

“that internally the current argument (i.e. linking of guarantees) has been the consistent view for the last 15 years.”

Fifteen years would have taken the discussion back to 1983 soon after the fall in interest rates in the autumn of 1982. The guaranteed annuity was briefly in the money at that time. Headdon’s account has been consistent since, and is acceptable as reliable evidence. It is consistent with the manuscript notes referred to: specific provision for a situation that could not be dealt with by a differential final bonus scheme would be more likely to reflect a belief that the more usual contingency had been dealt with than that it had been overlooked. I consider that it has been established that a differential guaranteed annuity terminal bonus policy was conceived at the latest in 1983, and in a context in which discussion would have been appropriate. It would follow that it was understood when the change to personal pensions took place. The evidence supports the view that the Society’s actuaries were conscious of the implications of a long-term fall in interest rates from 1982, or, at latest, early 1983, and that there would be implications for bonus, both reversionary and terminal. The precise form that the differentiation would take in case of need was not defined at that time, so far as the evidence has disclosed.

62. The inquiry has uncovered no evidence that the Board considered the interpretation of the contract documents at any time between 1982 and 1993, or had regard to the question whether the policyholders had legal rights that might bear on the scope of the directors’ discretion in relation to bonus payments to retirement annuity policyholders generally or in the context of falling interest rates. Nor is it clear how far the views discussed by Headdon were communicated to staff.

63. The inquiry has recovered documents that appear difficult to reconcile with general knowledge of a settled policy of the kind suggested. The inquiry was given a letter dated January 1985 to a policyholder. The letter explained illustrations sent in response to a request for information. It said:

“I have pleasure in enclosing some illustrations showing the benefits on survival to pension ages 60 and 65. The fund figure shown against basic benefits is the amount that is guaranteed under the policy. You will also note that existing declared bonus figures are shown and as these bonuses have been declared they are yours and cannot be removed again. In addition, you will note that a calculation for future bonuses has been made on the assumption that current bonus rates continue. Naturally, these bonuses have

¹³ See chapter 4.

still to be earned. The total projected fund formed by these figures is then enlarged by a projection on the assumption that the existing level of terminal bonus will continue. The projected fund can be taken either as an annuity or as a tax free cash sum and a reduced annuity, and these figures are expressed under current immediate annuity rates - which means under present day conditions - or should interest rates be low at the time you take the benefits, then certain annuity rates are guaranteed in the policy to apply to ensure that you enjoy an attractive level of benefit.”

64. In the form common at the period, the statement set out the basic benefits, existing declared bonuses, the additional bonus if current bonus rates continued up to the pension date, excluding any terminal bonus, to bring out the total projected fund excluding any terminal bonus. It then stated the total projected fund if, in addition, terminal bonus at the current rate applied at the pension date, and gave values for the alternative benefits payable on guaranteed rates and current annuity rates. The illustrations, read with the covering letter from which the quotation has been taken, gave no basis on which the policyholder could have identified an intention to recoup the cost of providing an annuity at guaranteed rates from what would otherwise have been the terminal bonus.

65. The evidence of the origins of the differential terminal bonus policy appears cogent enough. It is clear that communications with policyholders did not disclose that policy. It appears that the member of staff sending the letter to the policyholder last mentioned did not understand that there was a need to qualify the information by indicating that terminal bonus might be restricted should interest rates be low at maturity.

66. In 1986 the actuarial department carried out a retrospective analysis of the Society's premium basis rationale. It appeared that there had been a fall in market interest rates in March 1986. That had led to a review of current immediate annuity rates, having regard both to the interest component and to mortality assumptions. The paper did not suggest that there was any similar review of the retirement annuity guarantees even though the maximum affordable interest rate had fallen to a level at which the implicit conversion rate in the later (1975 onwards) retirement annuity policies was problematical.

67. There is some documentary evidence that the annuity guarantees were a focus of attention at the stage of preparation for and implementation of the change from retirement annuity contracts to personal pensions on and after 1 July 1988. The new form of contract included an explicit guarantee of an investment return of 3½%, but did not provide for a guaranteed conversion rate to be applied to the accumulated fund at maturity. As noted above the Society took steps to withdraw the guaranteed annuity rate from group schemes and AVC schemes for new members from 1988.

68. The change in policy form provided an opportunity for review of bonus policy, and may have dictated such a review. It would have been obvious that the creation of a new policy type, superseding so far as new business was concerned the entire retirement annuity class, required management, if not the board, at least to consider the inter-relationship of the old and new policy types, and whether there might be problems arising from including both in a single with-profits fund, especially if the differential terminal bonus policy had not already been anticipated. The differences in policyholders' contractual rights might have required an assessment of the relative positions of members of the new and old classes. It was at this stage that a new bonus class could have been created if that had been thought appropriate, either for the personal pension, or for all business other than retirement annuities, if that could have been agreed, or for some intermediate solution. In addition, there were wider economic considerations, such as the likelihood, at that time, that long-term interest rates would decline.

69. An outline specification for the new personal pension contract form, initialled by Ranson, in the PIT papers for 1 May 1987 set out the principal elements of the

new class of business. The intention was that all business would be written on a recurrent single premium basis, even if the formal arrangements were that a new contract was effected each year. Each premium would buy a fund at pension date (premium $\times 0.955 \times (1.035)^n$: that is discounted by 4.5% for expenses and rolled up at 3.5% interest per annum). It was stated that no annuity rates would be guaranteed. It was envisaged, however, that the premium basis would be essentially as it was for 'section 226' contracts¹⁴. No record of discussion has been recovered. There was an indication in the PIT papers for 22 December 1987 that Ranson considered that pension fund business was not a matter for the team. But the item in the specification excluding guarantees was marked with a manuscript star. The decisions on guarantees and on the premium basis for the new business appear to have been taken by 1 May 1987.

70. Treating the premium bases for the two classes of business as equivalents is consistent with a pre-existing view, in the minds of the Society's actuaries at least, that a mechanism existed to ensure that policy proceeds at maturity in each case would be broadly the same notwithstanding the difference in defined policy benefits. By the end of the 1980s long-term interest rates were beginning to fall. One would expect that well-informed fund managers of life offices would have been aware of trends, and would have taken action in planning investment and distribution strategies to respond to them. The actions at the time support the view that a differential terminal bonus policy had already been developed as Headdon explained.

71. The Corley report suggested that the differential final bonus policy was devised in about 1988. That is inconsistent with the evidence reviewed by the inquiry. On either view, the paper *With Profits Without Mystery* is an important document, probably prepared in 1988 or in 1989, and instructive of the authors' thinking or lack of thinking about differential terminal bonus practice in the context of bonus 'philosophy' generally. It may reflect only the private views of the authors in a substantial sense. Corley reports that his inquiry team were "not aware of the extent to which this view was communicated to directors".

72. In paragraph 2.2.2 of *With Profits Without Mystery* the authors distinguished non-profit and with-profits business. At paragraph 3.1.3 it was stated: "We have not had to face up to inadequate premium bases (on interest grounds) for a generation. If those circumstances arose again, we should need to consider whether to allow the losses to emerge as they are incurred or to take the expected loss immediately." Paragraphs 3.2.12 and 13 show that by December 1986 the trend towards lower interest rates was firmly established in the authors' view. At paragraph 3.2.11 the authors stated: "The implications for bonus rates of the sharp fall in interest rates in the autumn of 1982, if the lower level had persisted for any length of time, were discussed with the board. Various plans were considered as to how to move to a lower bonus rate climate if that became necessary. Those early discussions, and reference back to them from time to time, subsequently eased the path in 1987 and 1988 when reduction] in declared rates were recommended." It is not clear how far the authors had in mind the differential terminal bonus policy at this time: that remained a mystery. But the comments were not inconsistent with a policy of that type.

73. An internal memo dated 23 October 1991 from the head of the business systems department to Matthews of APD (described subsequently within the Society as part of, or the result of a policy guarantees review) enclosed a revised 'Contract Guarantees' document with an amended section on the 'Circumstances in which the guarantees take effect'. This amended section said:

"The guarantees could take effect in two circumstances;

- (i) if on death before benefits are taken, the full value of the fund reduced as if the life assured had retired on the date of death is less

¹⁴ The description of the superseded retirement annuity form typically used the Taxes Act reference as shorthand. Section 226 of the 1970 Act was the current relevant provision.

than the value, at the date of death, of the guaranteed funds and declared bonus attaching to the policy.

(ii) when annuity benefits are taken

$$\text{Fund Value x CAR} < \left[\begin{array}{l} \text{GCF purchased by all} \\ \text{premiums paid and} \\ \text{attaching DRB} \end{array} \right] \times \text{GAR}^{15}$$

This shows clearly that, by 1991 at least, the differential terminal bonus policy had been formalised within the business systems of the Society.

74. Some observations that have been made by commentators suggest that it was in December 1993 that the directors, confronted by the change in market interest rates in October 1993, adopted a novel approach to the calculation of terminal bonuses on annuity guarantee policies. In my view the evidence as a whole demonstrates that the policies underlying the actions taken at the end of 1993 and the beginning of 1994 were established internally by early 1983 at the latest.

75. These policy decisions were not made public. At least from the introduction of the open market option until December 1993, it appears that terminal bonuses on maturing retirement annuity policies were calculated on the same basis as for other with-profits pensions policies. One might have expected that after the differential terminal policy had been adopted, in any form, it should have affected policy illustrations prior to maturity for policies with annuity guarantee terms. It would have been material to policyholders and potential policyholders to have information about the risk that terminal, later final, bonus might be reduced if the contractual annuity guarantees were taken. Such information would have been material in the 1990s when policyholders had the options of entering into draw-down schemes, and staged retirement plans, and generally whenever the approach to calculation of lump sums under their policies was under consideration. The inquiry has not uncovered any example of a communication that did make the policy clear.

76. Paragraph 1.4.1 of the Baird report repeated uncritically Equitable's position that the 1990s practice reflected the Society's 'established' approach to distributing surpluses. There appears to have been no recorded reference at board level to a differential terminal or final bonus policy until 22 December 1993. This is a matter that has engaged not only this inquiry, but also the parties to the current litigation at the instance of the Society. At least so far as disclosed to the inquiry no party has uncovered any evidence that the policy was placed before the board in any way until December 1993. There were very full actuarial reports to the board, there were marketing reports and investment reports. At management level there were PIT minutes, and there were actuarial project team papers. Despite extensive search among the documents, the only material evidence recovered is as set out above in this chapter.

77. On 27 January and on 10 February 1993, the board considered actuarial reports on bonus. There was no reference to differential final bonus depending on the benefits selected. In November 1993, the board received the usual autumn actuarial report on bonus policy and principles looking forward to the next distribution. Headdon commented on the apparent high level of earnings; the impact of lower interest rates; the likelihood of capital gains being dissipated in future; and the strengthening of the balance sheet. He proposed that: "This year we can focus predominantly on fundamentals ...". A differential terminal bonus was not mentioned.

78. In a manuscript memo to Ranson on 29 November, copied to Matthews, Headdon wrote:

"1. Following recent conversations I thought it would be helpful to summarise how I understand we are proceeding.

¹⁵ 'GCF' refers to the guaranteed cash fund, and 'DRB' to declared reversionary bonuses.

2. Currently we are resisting pressure to pay total fund x GAR and are relying on the detailed wording of the formal statement of bonuses as a first line of defence. If we ran into difficulty you would be reasonably relaxed about paying total fund x GAR on the grounds that final bonus rates are marginally too low.

3. If we decide to increase final bonus rates w.e.f. 1.1.94 the approach will be:

- (i) for contracts without GARs a rate of 12% for 1.1.93 – 1.1.94 and a rate of 10% from 1.1.94 onwards
- (ii) for contracts with GARs a rate of 10% throughout from 1.1.93.

(The 2% margin broadly covers the difference between GARs and CARs at the moment.)

4. From 1.4.94 the final bonus rates will be described in a way which explicitly allows the cost of the GAR to be met from the final bonus. That is full fund x CAR will be paid unless (fund ex final bonus) x GAR is greater. Literature such as the Bonuses leaflet will make this approach clear.

5. One further thought since we spoke is that, if we are adjusting final bonus rates w.e.f. 1.1.94, we could move to an approach as in §4 immediately. That might draw less attention to the existence of the GARs than the approach in §3. The disadvantage is that presumably we will not be updating any literature in respect of a change to final bonus rates and so clients might feel that we had been a bit underhand in ‘sneaking in’ this change. Whatever we do, however, there is quite a fine balance to strike between being open and not drawing attention to the existence of the GARs.

6. Please could you confirm how you wish to proceed.”

79. The issue of presentation of the Society’s position was focused. However, Headdon’s note disclosed that Ranson and he had in contemplation two options for recovering annuity guarantee costs from final bonus. The first envisaged differentiation in the rate allocated in the annual roll-up of policy values, the 2% margin referred to as covering the current difference between GARs and CARs. The second was the differential final bonus scheme that was implemented. The decision to deal with the issue wholly in terms of adjustment at maturity served to avoid drawing attention to the annuity guarantees as Headdon anticipated.

80. On 22 December 1993 the board passed a resolution in these terms:

“The Board approved the changes set out in the statement attached to the paper.”

The paper on which the board had proceeded had proposed a range of changes in bonus rates in the light of experience to date, and stated:

“The attached amendment to the formal Statement of Bonus agreed at the 10 February 1993 Special Board makes that change...”

Among the detailed material was a new paragraph to be included in the notes to retirement annuity bonus notices relating to differential bonus policy: paragraph 7. The narrative of the report made no reference to this, and there was nothing in the record to suggest that particular attention was drawn to it. The note stated:

“Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate to the cash value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time the benefits are taken to the cash value of the benefits before such reduction.”

81. In a television interview for Channel 4 News on 27 May 2002, Peter Martin stated that the 'solution' devised by the actuaries was presented to the board in December 1993 and approved. He told the inquiry:

"In 1994, when the DTBP [differential terminal bonus policy] came up, I recall Alan Tritton asking whether we were 'OK on contract' (having been assured we had article 65 *vires*), and that Roy Ranson had said 'Yes'. Headdon wrote a very comprehensive document on bonus policy in November 1993 and it was most certainly discussed. The DTBP was not presented as a matter for major policy decision; rather it was presented as a routine matter. There was no excitement factor in it. Annuity rates were reported as falling, asset shares would become un-equal, and we had to take steps to ensure asset shares were being paid out and not exceeded, this is how we would do this. It was presented in a mechanistic way."

82. Tritton told the Inquiry that he does not recall any discussion in 1993 about what came to be called the differential terminal bonus policy. No documentary evidence has been recovered that supports Martin's account. Since I have not been able to obtain the oral evidence of many of the directors involved, I have not been able on the total evidence available to form any firm view on what the Board knew of the policy at this time. The report by Headdon of November 1993 which is available to the inquiry does not deal with differential terminal bonus rates. The report for the board meeting on 26 January 1994 making firm proposals for bonus did not deal with differential terminal bonus rates. The board resolved to reduce declared rates. Headdon's report commented on the need to strengthen reserves in the light of the sharp reduction in yields, and on the risks associated with a failure of interest rates to revive. The report was fairly full, fairly technical and appears to have contained nothing relevant to the annuity guarantees issue. The draft directors' report reflected the decisions, and noted that final bonus was not guaranteed and might be varied at any time before payment. It seems that this was the formula developed at the time to give notice that there might be variation of final bonus but without specification of any particular policy. In the light of the decisions taken, it would hardly qualify for plaudits for frankness.

83. After December, when the previous year's notes were altered, the issue was raised next in the formal valuation and bonus declaration for 1993 placed before the board on 9 February 1994. Note B7, the note quoted above as amended¹⁶, reflected the differential final bonus policy. The statement was approved by the board. Note B9, dealing with reservation of the directors' right to reconsider final bonus rates at any time was specifically referred to in the minutes of the meeting: the board resolved to reserve the right. Note B7 was not specifically referred to. The issue was clearly before the Board. Martin's assessment of the matter as routine and mechanistic would reflect the treatment of the issue as recorded.

84. If it had been possible to accept Martin's statement that the actuaries' solution was approved by the board without qualification, that would have implied full complicity of the board (a) in adopting the policy, and (b) in authorising its application. The policy was not advertised in communications with policyholders. The actuary's letter to retirement annuity policyholders relating to the 1993 bonus is referred to later in the wider context of bonus policy. There was a further marked shift from reversionary bonuses: (a) there was an absolute reduction of 1%; and (b) there was a larger relative shift towards unguaranteed final benefits. But there was a failure to make any comment on the decision that adverse current annuity rate conditions could be compensated for by differential final bonus allocations to policyholders who exercised annuity guarantee rights. The letter states:

"In summary, therefore, we have substantially increased total policy values, but with a smaller increase in the guaranteed element than in recent years. We feel this is the proper response to events in 1993."

¹⁶ See paragraphs 94 and 96 below.

The “events in 1993” had included the first sustained fall in current annuity rates below the levels guaranteed.

85. In evidence to the Treasury Select Committee, Equitable stated that the decision to adopt a “differential final bonus practice” was taken at the end of 1993 on the advice of the appointed actuary. The board papers do not disclose this advice, only the note of the changed language. In a circular to policyholders dated 24 June 1999 Nash wrote:

“Since market annuity rates first fell below the guaranteed annuity rates in 1993, the Society has calculated different final bonuses where benefits are taken in guaranteed annuity form.”

This implied a consistent application of the differential terminal bonus policy from 1993 onwards, but it was neutral on the origins of the policy. In a wider context, on 30 November 1993 there was a meeting between Ranson and GAD. The note of that meeting included the following comment:

“Pensions business has a guaranteed annuity rate at about 7% but this was not as onerous as it appeared since, because ‘old’ policies had been given the benefit of more modern features and options, it would be reasonable (in his view) for the allocation of final bonus to be conditional on the waiving of this guarantee.”

If this note is accurate, (and it fails fully to reflect contemporary manuscript notes of the discussion at the meeting) a number of issues arise, for the Society and the regulator. It appears to express the issue in terms of waiver, and therefore of contractual rights not being enforced. ‘Waiver’ is a materially different concept from failing to exercise an option. But it reflects the view that full final bonus would not be available where the guarantee was not waived.

86. Meanwhile discussion of the alternative approaches continued within the Society’s management. Soundy, an actuary in the APD¹⁷, prepared a note for Ranson in which he noted two disadvantages to the differential terminal bonus policy. The first concerned integrity; the office was “effectively renegeing on its guarantees”. Clients, he noted, “will expect that the full value of the fund will be available at retirement to provide benefits. This is not consistent with having one fund value if GARs are used and another higher value if they are not.” The longer that interest rates remained low, the greater was the likelihood that complaints would become serious. “The worst scenario is that we are forced to change our practice and to compensate those who have already taken benefits.” The second disadvantage was that the amount of final bonus might not always be sufficient to cover the cost of the guarantee.

87. Soundy then went on to discuss the alternatives. The basic issue was who should bear the cost of the guarantees. He observed that the current approach meant that the cost was borne by those who chose to invoke the guarantees. The alternatives were the whole class of GAR policies or all with-profits pension policyholders. He assessed the impact of the alternative options in detail, dealing with the technical analysis of the cost of the options and the relative reputational implications..

88. The note was copied to Headdon on 13 January 1994, and he responded the following day. He commented that the

“general exposition of the advantages and disadvantages of the current approach seems fair and to provide a good basis for discussion. I am, however, less happy with the financial analysis. There is also little discussion of the disadvantages of your alternatives.”

Headdon thought Soundy had underestimated the impact on bonus rates needed to achieve ‘self-financing’ by the class and questioned the logic of the mathematical

¹⁷ See chapter 1, paragraph 8.

approach adopted. More fundamentally, perhaps, he thought that the approach “pays lip service to fairness without looking through to the underlying position”. He was concerned that the result would be that in 20 years the pension would be 15% lower than under the current approach, and 30% lower for clients who did not want to take the guaranteed annuity. “How do we cope with that?”, he asked, “What are the implications for surveys of competitive results?” Headdon also said that he could see no reason for policies without a guarantee to join in subsidising those that did, though he accepted that where the final bonus was insufficient to cover the cost, the shortfall should be met by the business as a whole. On the other hand, he agreed that

“... vigorously defending the current position and then changing it is highly undesirable. Accordingly, there is an urgent need to confirm our long-term approach to this issue.”

He suggested a discussion with Ranson, to whom he copied his response.

89. Soundy responded on 17 January. He had looked further at the cost of honouring the GARs, and challenged some of Headdon’s figures. He calculated that the business spread over at least the next 30, rather than 20, years, and that the approximate averaged cost (if interest rates remained permanently below 6%) was 1% p.a. But the uncertainty over the likely future costs highlighted a basic problem with funding the GARs in advance. There was no statistical basis to do so. Any reserve was bound to be too low or too high. If it were too high, the reserve would become surplus for the benefit of a future generation. Alternatively a later generation might need to make up a shortfall. In addition, it was “not consistent with what we have done (or not done) in the past”. Instead he proposed

“... that the most sensible course is to charge for the GARs on a ‘pay as you go’ basis. That means that in any year the reduction in bonus rates for the class is calculated to be sufficient to cover the likely cost of honouring GARs for maturities in that year only.”

He discussed the treatment of annual deficits or surpluses and the possible need for “some form of short term smoothing”. But in terms of fairness,

“I believe that this may be the best way forward and is ‘fair’. The philosophy is that all GAR type policyholders have joined the ‘GAR club’. By doing so, all have implicitly agreed to bear some cost, if necessary, for the benefit. When GARs bite, all then existing GAR policyholders subsidise the maturities then taking place.”

90. This memo clearly raised ideas that would subsequently have a bearing on the resolution of the issue in the Hyman litigation, most particularly the notion that the GAR policyholders had implicitly agreed to bear the cost of the guarantees. Soundy ended his memo by offering to arrange a meeting with Ranson. He told the inquiry that he remembered a meeting taking place with Ranson and Headdon, but could not recall what transpired. Soundy commented in his statement to the inquiry that:

“It was hard for me to have a significant influence in that discussion as they had all the financial information needed, and I was also junior to them.”

The ‘pay as you go’ approach was not adopted.

91. At the meeting of the Board on 23 February 1994 there was no recorded discussion of differential terminal bonus. The position was the same at the March and April meetings. The board set up an audit committee in 1994. The committee met on 14 March. The subject matter of the meeting was the 1993 accounts. This minute contained nothing of significance on the annuity guarantee issue. There were references to pensions mis-selling, which was described as ‘the only major judgmental area’.

92. Yet it must have been about this time that the decision was taken not to inform policyholders of the differential terminal bonus policy, if that was done. It is

stated in the Corley report¹⁸ that the Society's board "confirmed a 'differential final bonus practice' to equalise the benefits in GAR and cash form", and that some policyholders who retired in the winter of 1993-4 may actually have been credited with a reduced terminal bonus. It is also stated¹⁹ that the directors were preparing to communicate the policy of selective reduction in terminal bonus in the spring of 1994 when the market changed again. Corley paragraph 64 says:

"We understand that the Equitable was preparing a communication explaining the policy of selectively reducing the terminal bonus to go out with the bonus notices in the spring of 1994. When market annuity rates rose above the GAR again, the Equitable decided not to issue the communication."

The inquiry has not recovered minutes of any meeting that covered the developments mentioned by the Corley report. The timing of the suggested discussions coincides generally with the preparation of the actuary's annual 'dear policyholder' letter, which would have provided an appropriate context for intimation of the differential terminal bonus policy. But it is clear that the communications with policyholders at the time did not disclose the policy.

93. The format of the customary actuary's letter accompanying the bonus notice remained broadly similar to the previous year's, concentrating on the Society's general bonus policy, economic conditions, and the amount of overall return. In terms of detail the letter was considerably less explicit than the previous year's. There was no table analysing the application of the overall return, for example. Critically there was no reference to the treatment of annuity guarantee policyholders who had elected to take the guaranteed rate over the winter of 1993-94.

94. In the notes distributed with the retirement annuity policyholders' annual statement of bonus for 1992, note 2 stated:

"The final bonus addition reflects current investment conditions and is not guaranteed. It can be expected to vary in the future."

For 1993, the note, issued in February 1994, was developed to read:

"The total fund values include amounts of final bonus which are not guaranteed and may vary up or down. The fund available at retirement on or after 1 April 1994 may therefore be less than the total value shown, but would not be less than the guaranteed value."

95. By February 1994 the decision on differential terminal bonus had been taken in respect of the final quarter of 1993 and for 1994. The variations, omitting reference to current investment conditions, and the express reference to the final sum being less than the value shown, must reflect the decision on terminal bonus, and it would be understandable if there had been an intention to circulate members to provide more information.

96. The Society's formal Statement of Bonuses approved in special meeting in February 1994 contained at B7 the form of note agreed in December with a related note dealing with the cancelling out of the benefit of guaranteed interest rates and other additions in certain circumstances:

"Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1993, or such later date of purchase of benefit as applies, to the date of payment of benefits, the amount of final bonus allotted... is reduced by the amount of any such increase.

Where benefits are taken in annuity form and the contract guarantees minimum rates for annuity purchase, the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by

¹⁸ Corley, page 13, paragraphs 62-63.

¹⁹ Corley, page 14, paragraph 64.

applying the appropriate guaranteed annuity rate to the cash fund value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time benefits are taken to the cash fund value of the benefits before such reduction.”

The Society’s retirement annuity policies did not provide a guarantee of “minimum rates for annuity purchase...” The policies were drafted in terms of a guaranteed rate of annuity for a given premium. Some group pensions business and AVC plans did contain provisions that could be described in such terms. But the expression was not accurate as a generality.

97. The form adopted for the 1995 declaration was:

“The total fund values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee. The fund available at retirement may therefore be less than the total shown, but would not be less than the guaranteed value.”

Again, the retirement annuity cannot be described as providing terms on which annuity benefits could be secured.

98. The ‘dear policyholder’ letter did not disclose the policy or the reasons for its adoption. The bonus notices issued to policyholders did not reflect the terms of the differential final bonus in 1994 or 1995. It was to be in 1996, with the bonus notices for the 1995 declaration, that there was direct disclosure to policyholders of the nature of the adjustment.

99. In March 1997, the results for 1996 were intimated. Again the ‘dear policyholder’ letter was silent on the issue of the differential final bonus policy. The notes to the annual statement of benefits provided:

“The non-guaranteed final bonus addition is the difference between the total value and the guaranteed value. The total values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee.”

The surrounding presentation had changed, but the relevant language remained the same.

100. The notes issued in 1998 for the 1997 declaration, appended to the annual statements issued in the spring of 1998, did not mention the differential terminal bonus policy at all. But, by the end of the year policy illustration material explicitly described the policy in action. For 1997 the note stated:

“The non-guaranteed final bonus is the difference between the total value and the guaranteed value. The amount of final bonus payable is not guaranteed and may vary. The actual amount payable will be determined when benefits are taken.”

101. It appeared that the issue began to make an impact during 1997. The first complaints to PIA Ombudsman were intimated in July 1998.

102. In the 1998 declaration it stated:

“Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1998, or if later the date of application of the individual purchase, to the date of payment of benefits, the amount of final bonus calculated ... is reduced by the amount of any such increase.

If the contract guarantees minimum rates for annuity purchase the aggregate final bonus otherwise applicable is reduced when benefits are taken by the

amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate after such reduction, is equal to the annuity which would be secured by applying the Society's annuity rate for an equivalent annuity in force at the time benefits are taken to the cash fund value of the benefits before that reduction, subject to a minimum value for the final bonus after such reduction of zero.

If the contract guarantees minimum rates for annuity purchase and a reduction has been made under the immediately preceding paragraph, then were benefits are not taken in a form to which those minimum rates apply an additional amount of final bonus will be made available to the policyholder at the time benefits are taken equal to the reduction if any made under the immediately preceding paragraph. Such additional amount of non guaranteed final bonus will not constitute a "related bonus" or bonus allotted under the contract."

103. The bonus notice was adapted again. The note stated:

"This policy contains guaranteed rates of annuity which apply to with-profits benefits secured by contributions paid. At retirement, such benefits under the policy may be taken in guaranteed annuity form, or the total value of the benefits available, if taken in fund form, may be used to purchase an annuity from the Society on current rates or may be taken under the open market option to purchase an annuity from another provider.

The value of benefits in guaranteed form will never be less than the total value of the with-profits fund available at retirement and, depending upon financial conditions, may exceed that total value. That is because the annuity payable will be at least as high as that produced by applying the Society's current annuity rates to the total value. ...

The non-guaranteed final bonus is the sum which the Society would need to allocate to the policy by way of addition to the guaranteed value to produce the total value of the benefits available if taken in fund form and used to purchase an annuity on current rates. The actual amount of any final bonus will be the sum which the Society would need to add to the guaranteed value at retirement in the financial conditions prevailing at that time in order to produce the then actual total value. If the policyholder takes benefits in guaranteed annuity form, and if guaranteed annuity rates are higher than current annuity rates, the amount which would be needed to be added by way of non-guaranteed final bonus in order to bring the value of the benefits under the policy up to the stated total value will be less than that required if current rates were applied, and could be nil.

The actual amount of any final bonus is entirely a matter for the Board of the Society in the exercise of its discretion and it not guaranteed under the policy..."

The Board had taken legal advice from the Society's solicitors and counsel in respect of this year and that was reflected in the new formulation²⁰.

104. The varying terminology used in communications with policyholders over the period from early 1994 to early 1999 in relation to the differential final bonus policy is perplexing. On any view the policy went to the heart of the Society's business. From the board papers, it would appear that the issue was not clearly focused in formal reports or in recorded discussion until 1998, and then only when counsel became involved. For the board meeting on 28 January 1998 Headdon prepared a paper on bonus. In the principal paper and its appendix he proposed that apart from adjustment to rates, 'all other terms, conditions and rules' for final bonus should be the same as at 12 February 1997. There was nothing of note. Thereafter nothing significant occurred until counsel's advice re-interpreted the Society's past

²⁰ See chapter 1.

practice and led to the significantly reformulated notes incorporated into the declaration and notices for 1998 published in 1999. The board appear to have had no relevant information until the briefing meeting on 9 September 1998 to deal with adverse publicity.

Maintaining a single with-profits fund

105. Another significant issue thrown up by the annuity guarantee issue and, in particular, the failure of the ring-fencing proposal arose from the Society's consistent practice of publishing financial information with reference to a single undifferentiated with-profits fund. The issue was dealt with in the joint opinion by Warren and Lowe dated 10 May 2001. They explored ways in which it might be suggested that the Society could have established separate funds. The advice stated:

“[We] have no doubt that it would have been possible to create a separate fund out of the contributions of the new non-GAR policyholders and for the rights of participators in that fund to be defined in such a way that the profits derived from that fund could be dealt with, so far as concerned terminal bonus, in such a way to give effect to the bonus policy actually adopted by the Society once the annuity which could be purchased with a given sum of money applying the current annuity rate ("CAR") fell below the annuity which could be purchased with that sum applying the GAR. It is absolutely clear that the Society did not do this. ..”

106. However, the mechanics would have required the creation of a separate fund for the new with-profits business pursuant to Recital (F) and Article 57 of the Society's Memorandum and Articles of Association. Recital (F) provided for the creation or setting aside of a special fund or funds and for the giving to any class of policyholder or annuitant special rights over the fund so created. That power could only be exercised, by virtue of Article 57, with the sanction of a Special Resolution of the Society. As Mr Warren and Mr Lowe observed, the Society did not take that course. Indeed it appears that the possibility was never raised. The focus of the Society's attention was different: far from contemplating a segregation of with-profits funds, the unity of the fund was emphasised in published statements, with a view to marketing advantage. The notional hypothecation of the fund into sub-funds circumvented the provisions of the articles by treating the matter as a management issue.

107. On 24 June 1987 Ranson presented a paper to the Board on the new personal pension, then expected to be introduced from 4 January 1988. The paper did not identify features of existing business that would be departed from. It stated, however:

“ A strategy document was formulated by the end of March and agreed by the senior management team. A major component of the strategy was to make use of existing products, as much as possible, in order to minimise the changes needed to existing administrative and computer systems, and to enable the Society to exhibit an unbroken track record of past performance.”

108. The new form of business was to be aligned with the superseded retirement annuity contract to ensure that previous performance records could be used with reference to the new contract. This explanation has been consistently offered by the management. The brief prepared for TSC hearing in 2001 said:

“It was very important for the Society at the time to maintain continuity of past performance. That necessarily meant that a separate bonus series could not be produced for PPPs, since it would no longer have been able to be possible to use the past performance for the GAR policies when explaining the benefits of the new policies.”

109. Whatever the theoretical possibilities, formal segregation of funds at 1 July 1988 was not considered. It appears clear that had management expressly

considered the issue, it would not have thought it to be necessary: the decision to recover the cost of adverse annuity guarantee experience from terminal bonus would have provided a solution to the risk of falling interest rates, and no other remedy would have been thought to be required.

Conclusion

110. On the evidence available to the inquiry, the differential terminal bonus policy was the established policy of management from about 1982 or 83. The inquiry has uncovered no evidence to indicate that the policy was widely advertised to staff until about 1998. Similarly, apart from the general comment in *With Profits Without Mystery*, there has been no evidence that the board were informed of the policy before December 1993. The policy was first implemented in 1993-4.

111. It also seems clear that the critical decision not to split the with-profits fund at the point that personal pensions were introduced was taken (whether explicitly or not) on the basis that the Society intended to market the new policies as a simple development of the existing policies, relying on the investment record and returns to policyholders of the existing fund, and minimising the administrative burden for the Society. Management at least had recognised the potential value of the annuity guarantees within the existing policies, and are likely to have relied, implicitly, on the differential terminal bonus policy in making that recommendation. But there is no record that the inquiry has found to suggest that this was an explicit consideration so far as the Board was concerned.

112. It would be consistent with the inquiry's general findings on corporate governance that in the contexts of valuation of liabilities, product design, and the computation of policy benefits, executive management exercised a wide discretion unconstrained by active board supervision. It is this that enables the inquiry to conclude that the differential final bonus policy was developed in 1982-3, and influenced matters such as the treatment of personal pensions after 1 July 1988, the amendment of group and AVC contract forms, leaving retirement annuity contracts unaltered, the application of level premium bases to apparently incompatible classes of business, for example, without the Board of the Society being actively involved in the development of the policy and its implications for business generally. It appears unlikely that most members of the Board knew of the differential terminal bonus policy or its implications until the autumn of 1998, or that those who knew anything of the policy understood that it could have serious implications for the Society.

113. The House of Lords' decision in *Hyman* heralded the final phase in the Society's life as an office carrying on an active long-term business. Why that should have been the case requires a close examination of the Society's financial position over a long period of time. Superficially claims of £1.5 billion should not have brought down a Society with funds of £32 billion. A movement in liabilities of about 5%, though a significant injury, perhaps, should not have rendered the Society moribund.