

FINANCIAL DIRECTOR

BRIEFING corporate governance**EQUITABLE LIFE REPORT HAS LESSONS FOR ALL DIRECTORS**

The Penrose report on the crisis at Equitable Life not only offers a unique insight into the workings of the board and the relationships between the directors, it also offers some compelling lessons for executive and non-executive directors everywhere.

The two-and-a-half year inquiry by Lord Penrose into the crisis at Equitable Life goes to great lengths to avoid allocating blame. But his report, published at the beginning of March, leaves no room for doubt that some of the underlying causes relate to the management and the governance of the society. In his letter accompanying his report to Financial Secretary Ruth Kelly MP, Lord Penrose says: "The picture that emerges is of a society that had deep-seated financial and management problems that predated the emergence of the annuity guarantee problem (though not perhaps its origin)." Penrose makes clear that, while the crisis resulted from the loss of its court case in the House of Lords, the decision in the *Hyman* case was not solely responsible for it.

Penrose found that the executive management decided after a dip in interest rates in about 1983 that, if necessary, guaranteed rates would be paid for by adjusting the terminal bonus policy so as to reduce the cost to the society. Penrose found no evidence that this policy was disclosed to the board until 1993 and was not disclosed to policyholders until 1996.

Executives

Penrose noted that a number of former directors refused to

co-operate with his inquiry in any way – and he had no power to compel anyone to give evidence – while others were constrained in their ability to co-operate as a result of the legal action being brought against them.

Penrose says that, in mitigation of the non-executives, it may be claimed that the board was dominated by **Roy Ranson**, who was the appointed actuary for 15 years from 1982 to 1997, the last five of which he was also the chief executive. Penrose says that in his view Ranson was "highly intelligent and articulate but manipulative. I was not persuaded that his memory was as inconsistent as he asserted." Penrose also notes Ranson's own assessment of his approach as "autocratic".

A great deal of financial and technical information was given to the board in the form of periodic reports "that were individually less than comprehensive. These failed fully to present the overall financial position of the society; in particular, the risks inherent in the policies that were pursued in relation to bonus allocation." The "deterministic projections" put before the board were inadequate for these purposes; rather, stochastic or other statistical analysis that examined the impact of a range of possible outcomes would have helped highlight the risks.

Penrose says Ranson did not inform the board of the business risks relating to some of the decisions regarding policies written by the society. Ranson rebutted this criticism during the Penrose report's 'maxwellisation' process, in which individuals who are to be

criticised are given the chance to comment before the report is finally printed. But Penrose found no board paper evidence to support Ranson's claim. Penrose concluded: "He [Ranson] has denied that the decisions were management decisions and at the same time contended that implementation was not something that merited report to the board."

Ranson also told Penrose that the society's position was clear on the returns to the Government Actuaries Department (GAD) and no questions were asked. "I prefer the evidence of the GAD witnesses who have pointed to the obscurity of the references in the returns," says Penrose. "The returns were opaque and uncommunicative."

In the early 1990s, **Chris Headdon** worked in the actuarial department. He succeeded Ranson as appointed actuary in 1997 and became chief executive in December 2000. In November 1993, Headdon identified two approaches to the GAR problem and advised Ranson of the implications of selecting the option that was "less likely to draw attention to the issue", Penrose reports. "That option failed to communicate fully the nature of the differential terminal bonus policy to policyholders. Headdon acquiesced in the implementation of that approach."

Headdon, for his part, told Penrose that there was no problem until the House of Lords decision in the *Hyman* case. Penrose concludes, however, that "there would have been no litigation if there had not been a problem". Headdon also claimed he had a "subordinate role, but he cannot

object to responsibility for his own advice," says Penrose. Moreover, Headdon continued with the bonus policy when he became the appointed actuary in 1997.

In 1997, **Alan Nash** succeeded Ranson as chief executive. Penrose notes that Nash failed to ensure there was a proper risk management system in place, an important failing because, though a qualified actuary, Nash did not have the experience to make a major contribution to the actuarial management of the society, which he therefore delegated to Chris Headdon. Nash resigned in December 2000 and was succeeded by Headdon.

Audit committee

The executive directors of the Society "acted on the basis that there were aspects of management that were outwith the scope of the audit committee's remit," Penrose says. "In particular, [the] core valuation of the Society's long-term liabilities." While members of the audit committee wanted more information on risk in 1996 and 1997, reflecting, Penrose says, their discomfort, the committee ultimately accepted what they were told by the management.

Penrose says that the minutes of an audit committee meeting in October 1997 – by which point the GAR problem was becoming increasingly onerous – show "diligence" in examining all the issues relating to the financial statements, "with one major exception: there was limited consideration of the valuation of liabilities". One non-executive director explained to Penrose: "There was at the top the appointed actuary and his team of actuaries. Then there were the executive directors, all of whom, bar one, were actuaries. Then there was the Senior Risk Management Group consisting of

senior executives. Then there was the chief accountant and his department. Then there were the auditors who had actuarial partners. Then there were the regulators – the Government Actuaries Department. And then there were the lawyers – Denton. None of these ever expressed to me as a non-executive director any concern as to the financial condition of the society until 1998

when the GAR problem arose.”

Penrose adds that, “at no time between 1994 and 2000 did the audit committee consider in any detail the assumptions on which the liability valuation was based, nor did it concern itself with the basis or justification for the actuarial assessment of the liabilities.”

One non-executive director told Penrose that, with the benefit of hindsight, it would have been

helpful to the non-executives if there had been a liabilities committee. Penrose agrees but adds that the question of liabilities was always one for the audit committee as far as statutory returns (ie, the accounts for Companies House) were concerned, and, from 1996, for the returns to the regulator as well. “The position appears to be that the [audit] committee was totally

dependent on the actuaries for advice on what was material as well as advice on the solution of any problems that arose.”

Risk management

Penrose observes that risk management began to emerge as a significant issue in the early 1990s. In 1992, the auditors said that the increasing complexity of the society was increasing the risk of error or fraud remaining undetected. They recommended an independent systems and controls review or the establishment of an internal audit function.

Ranson pushed through the former option – he is said to have been against the creation of an internal audit function – and established a systems and controls review unit that would report to the general management team. Ranson also issued a memo saying it was for the general management team to decide which risks were acceptable and which needed attention.

Mutuals

Penrose’s scorching criticism on governance concludes that mutual life offices are “a form of organisation managed by a self-perpetuating oligarchy, selected on an unaccountable basis by current directors as their successors in office... [The] professional actuaries... are answerable, if at all, only to those same directors who are fundamentally dependent on their advice.”

Andrew Sawers

A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

1762	Equitable Life founded as the Society for Equitable Assurances on Lives and Survivorships
1870	Life Assurance Act 1870 to protect policyholders after unprecedented level of insolvency of life insurers. Gives responsibility to the Board of Trade
1913	Equitable Life starts to sell pensions
1957	Equitable Life sells its first retirement annuity containing Rates of Guaranteed Annuity
1973	Insurance Companies Amendment Act 1973: introduces the prospect of failure to meet reasonable expectations of policyholders and potential policyholders as a trigger for regulatory action
Oct 1975	Equitable increases the guaranteed rate of interest (GIR) to 3.5% (was 2.5%) and the interest rate in possession to 7% (was 4%)
Autumn 1982	Current annuity rates fall below guaranteed annuity rates for a short time
May 1986	Professor Roland Smith becomes chairman
Oct 1987	Black Monday. Largest one-day fall in the stock market since October 1929
April 1988	Financial Services Act 1986 comes into force, establishing the Life Assurance and Unit Trusts Regulatory Organisation (LAUTRO), answerable to the Securities and Investments Board (SIB)
March 1989	<i>With Profits Without Mystery</i> , presented by Roy Ranson and Chris Headdon to the Institute of Actuaries in London
Sept 1992	Black Wednesday. Sterling exits European Exchange Rate Mechanism
Dec 1992	Publication of the Cadbury Report, ‘The Financial Aspects of Corporate Governance’
Oct 1993	Guaranteed annuity rates “in the money” for a short time
Jan 1994	Equitable’s audit committee established
Feb 1994	The Systems and Controls Review Group (SCRG) set up
May 1994	Roland Smith retires as president; replaced by John Sclater
July 1994	Personal Investment Authority (PIA) replaces LAUTRO
April 1995	Guaranteed annuity rates “in the money”. The GAR liability becomes increasingly onerous for the Society from this point
July 1995	Publication of the Greenbury Report on directors’ remuneration
June 1996	GIR for new Equitable pension business reduced to 0%
May 1997	Chancellor announces creation of a single regulator
July 1997	Ranson retires, replaced as MD by Alan Nash and as appointed actuary by Chris Headdon
Oct 1997	Securities and Investment Board (SIB) becomes the Financial Services Authority (FSA)
Jan 1998	Publication of the Hampel Report on corporate governance
Jan 1998	Responsibility for supervision of insurance companies transferred from DTI to HM Treasury
July 1998	First complaints received by PIA Ombudsman about policies with guaranteed annuities
Jan 1999	HM Treasury’s role as insurance regulator delegated to FSA
Sept 1999	Equitable Life wins case in the High Court. Mr Hyman granted leave to appeal
Jan 2000	Equitable Life lost case in the Court of Appeal; appeals to House of Lords
May 2000	Publication of the Combined Code: Principles of Good Governance and Code of Best Practice
July 2000	Equitable Life loses appeal in the House of Lords. Society put itself up for sale
Dec 2000	Equitable closes to new business. Nash resigns as MD. Headdon nominated chief executive and appointed actuary
Feb 2001	Sclater resigns as president. Vanni Treves becomes chairman
March 2001	Headdon resigns as CEO and appointed actuary; replaced by Charles Thomson as chief executive and by Peter Nowell as appointed actuary
March 2001	Publication of review of institutional investment by Paul Myners
July 2001	Equitable announces a 16% cut in the value of with-profits pension policies
Aug 2001	Penrose inquiry launched by the Economic Secretary to the Treasury
Dec 2001	Financial Services & Markets Act 2000 comes into force (N2). FSA replaces PIA as regulator

Useful links

- Penrose Report is available at www.hm-treasury.gov.uk/independent_reviews