The Equitable Life Assurance Society

Equitable Life 2002 and beyond

Following the successful Compromise Scheme, there are three important questions to answer for policyholders. What is the outlook now for your Society? What are our unresolved issues and how shall we deal with them? What can we do for policyholders to meet their reasonable expectations for the future?

I took over as Chief Executive only thirteen months ago. Although we have achieved a substantial amount, the investment climate has been very hostile, aggravating the problems we inherited and creating some new ones.

The Present Outlook

The Society is solvent but not financially strong

The fundamental uncertainties of GARs have been removed and the Compromise Scheme also improved the financial position in the Annual Report and Accounts by £1bn. These are real improvements compared to our pre-compromise position and they help underpin our solvency.

However, the investment climate and particularly the decline in the UK stock market have weakened the Society. Other with-profits funds have suffered similarly, reducing their final and annual bonus rates. Our year-end reviews also show that we need to increase provisions against potential claims beyond those set out in the Interim Accounts of 30 June 2001, which were considered appropriate at the time. The details will be set out in the Annual Report and Accounts. While of course there remains some uncertainty around these new estimates they are considered to be appropriate provisions against the potential claims. We shall do everything we can to control these costs which come directly from members' funds.

The majority by value of our policies contain a Guaranteed Investment Return (GIR) feature which adds 3.5% to guaranteed policy values each year. In addition we must reduce the impact on the fund from any further falls in stock markets. The effect of both of these is that, at least in the near future, we must continue to have a low proportion of the fund invested in property and shares (equity) and a high proportion in fixed interest investments such as government stock and corporate bonds. Doing this will enable us to honour these guarantees but it will also mean a relatively restricted bonus policy, with investment growth flowing through into final bonus rather than guaranteed bonus (other than for policies with the 3.5% GIR feature which will continue to get the 3.5% per annum increase in guaranteed policy value).

Dealing effectively with unresolved issues

Bonus Methodology

We have inherited a unique and unsatisfactory bonus methodology. The apparent clarity of 'policy values' creates a false sense of certainty. From the reaction to last July's announcement it is clear that Equitable Life's apparent transparency has, in fact, created considerable confusion. In a with-profits fund, 'policy value' only has real meaning when the contract reaches maturity or at an event during the life-time of the contract when benefits can be taken. At any other time 'policy values' can only give an indication of the approximate value of the underlying assets at a given moment. But this value cannot reflect the value of the assets at a subsequent date, the unrecovered costs or the impact on the fund of the behaviour of other policyholders.

Equitable Life 2002 and beyond

Certainly 'policy values' take no account of the active financial management which our with-profits fund needs in its current position because so many policyholders have great flexibility as to when they can take retirement benefits. That flexibility allows policyholders to take their benefits when the assets of the fund are depressed which is obviously to the disadvantage of continuing policyholders.

From our separate announcement on bonus policy set out in the letter that accompanies this paper, you will see that we have taken the first essential steps to change the bonus methodology to resolve this sort of problem. The final bonus will change whenever necessary to reflect the impact of the various factors affecting the fund including, most importantly, investment performance. This approach brings us much more into line with normal practice of other with-profits funds.

Surrender value methodology

We have also inherited a unique and unsatisfactory surrender value methodology. Currently the 'financial adjustment' applied to individual policies surrendered before maturity is not as refined as we would like. In addition, the system for group rather than individual policies gave apparently anomalous results. In the case of group schemes the recording systems set up by Equitable Life were more flexible than those applied to individual policies. This reflected the smaller number of group schemes which by their nature were likely to see significantly higher levels of contractual and non-contractual transactions.

Again we have taken the essential first steps to eliminate these problems. Group and individual surrenders have been brought more into line with generally the same level of financial adjustment. We have commissioned an external survey of the group approach to see if further changes are necessary, and intend to review the individual system for surrender values later this year. We will then have a clear basis for removing any anomalies that remain.

The outsourced administrative service arrangements with the Halifax

We need for our members and policyholders a reliable, supportive, high-quality, low-cost service so that we can return to being a low-cost, high-quality Society. This is the intent of the original deal with the Halifax (now HBoS) which the new Board inherited. While we are grateful for the hard work of many individual staff members we are talking to HBoS to improve the present outsourcing arrangements by setting and agreeing specific performance targets.

We need to resolve any outstanding claims and the uncertainty they bring

Our aim is to ensure that fair, well-founded claims are paid with a minimum of fuss and expense. We intend to resist opportunistic claims and those based on hindsight. Clearly those who walk away from an investment contract because the market has fallen should not be paid compensation from members' funds for that market fall and we shall resist those who take this approach.

Meeting policyholders' reasonable expectations

We need a period of consolidation

Our strategy is to keep moving the with-profits fund closer towards being a conventional with-profits fund. The current investment climate makes this more difficult. While the current weak performance of the equity markets means that other with-profits funds are also showing negative returns, there is some unavoidable risk of our fund getting locked into having a very low equity content if markets fall substantially further due to our need to meet contractual guaranteed growth commitments and the flexibility of when policyholders may take benefits.

We need to introduce a fairer bonus and surrender value system

We have taken the first steps as explained above and will continue to eliminate anomalies and improve fairness as quickly as possible.

Examining what can be done for long-term policyholders

With all of the legal constraints that now surround how the fund is managed, our room for manoeuvre is limited in the immediate future. The low equity content of the fund may not be a disadvantage in the short term - it has not been in 2000 and 2001 – but we need to find a way to restore a higher equity content over the next few years.

If this cannot be done by investment growth (e.g. because the fund has too little invested in equities) we shall need to investigate how to achieve the result by another route. One possibility worthy of examination could be to allow policyholders to opt to swap their existing contract for a new form of contract with higher equity backing. This, of course, would have to be done in a way that did not disadvantage the continuing policyholders who had decided not to change. We shall work on this.

Helping with-profits annuitants

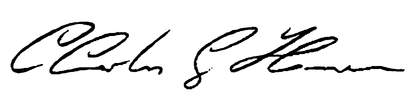
It has not proved possible to produce any options that are likely to be particularly attractive to large numbers of with-profits annuitants without disadvantaging other policyholders. However, given these constraints, we are writing to with-profits annuitants to gauge their interest in the limited options that are available to rebase their annuity, so providing a lower income for a number of years but higher income in the longer run.

Conclusion

We inherited a company that had been run in a unique way. It had a unique advantage in its low costs but it had many other features that make its financial management challenging.

It is very easy to be wise with hindsight, but the aggregation of risks within the Society is something that should have been of serious concern. The extent and depth of these risks has been a great challenge to the new Board. We wish that these risks had been recognised and remedied prior to our appointment. That said, in the interests of continuing policyholders we shall take action both to resolve these risks and, where appropriate, to seek redress. The process of dealing with the past is likely to last for years. However, we will move with all possible speed.

The significant achievement of the Compromise Scheme, changed bonus methodology, greater sophistication in our financial management, work on reducing costs and improving service levels and the approach taken to managing outstanding claims all mark important progress towards our goal of securing the future of the with-profits fund and managing it for the benefit of all of our policyholders.



Charles Thomson

Chief Executive