

HS 13/4/05

**The Equitable Life Assurance Society**  
v.  
**Ernst & Young**  
and  
**The Equitable Life Assurance Society**  
v.  
**R. Bowley and others**

**Second Supplementary Expert Report**

Prepared By

**M Arnold, FIA**

13 April 2005

E1-3.266

## Introduction

1. I have been instructed by Herbert Smith on behalf of the Society to assess the savings which the Society could have made had the DTBP been rendered unlawful but ring-fencing had been permitted.
2. Non-GAR policyholders would have been immune if ring-fencing applied, and the effects would have been contained amongst the group of GAR policyholders. When the DTBP was disallowed, GAR policyholders who had taken benefits in cash would have been overpaid and policyholders who had exercised the GAR would have been underpaid. This would have arisen because the final bonuses paid to the former group of GAR policyholders would have been greater than the equivalent final bonus payable in the absence of the DTBP, and vice versa for the latter group. Rectification would have been required for those who had exercised GAR.
3. In this report, I have estimated the costs of such rectification.

## Approach

4. The Rectification Scheme announced by the Society in December 2000 was based on the reduced final bonus rates which had been adopted by the board in October 2000 to apply retrospectively for this purpose. I understand that the logic underlying these revised final bonus rates was to produce a single final bonus rate which would give the same effect as the two rates which had applied under the DTBP. A degree of retrospection was allowed in the assumed rate at which GAR was exercised and I have adopted a similar approach in preparing my estimate.
5. In preparing my estimate of the costs of rectification, I have drawn upon figures contained in a note prepared by Mr Headdon which is in the Trial Bundle at C46.167-170. Mr Headdon's note outlines an approach to determining the cost in the case where ring-fencing does not apply and it is therefore not directly applicable to my assessment.
6. The only additional assumption which I have made in respect of 1998 and 1999 in deriving revised final bonus rates is that, in the context of these revised rates, 65% of benefits would have been taken in GAR form. As will be seen later, this assumption does not have a material effect on the estimated rectification cost since the cost is derived from the actual exercise rate (i.e., those who exercised the GAR and thereby suffered actual loss).
7. Mr Headdon's note does not contain figures in respect of 2000. A figure of £221 million for GAR claims to July 2000 has been obtained from C46.152 but no additional information of the type contained in Mr Headdon's note has been provided there. For the

purpose of this report, I have assumed an actual GAR exercise rate of 5%, an average final bonus content of 100% of Guaranteed Value and a GAR/CAR ratio of 1.34. I have also assumed that 65% of benefits would be taken in GAR form as in 1998 and 1999 in setting ~~the revised final bonus rate.~~

## Results

8. On the basis described above, I estimate that the cost of rectification would have been:

Year	Cost, £ million
1998	0.15
1999	1.51
2000	1.08
<b>Total</b>	<b>2.74</b>

9. Thus the total rectification cost would have been of the order of £2.75 million.
10. I have repeated the calculations outlined above on the assumption that 76% of GAR benefits would have been exercised rather than 65%. The cost of rectification in this case would have been £1.8 million.
11. I have also repeated the calculations using the actual GAR exercise rates shown in the Appendix as the expected rates rather than 65%. In this case, the cost of rectification would have been £9 million.
12. For completeness, I have also considered the position if it had been assumed that all the proceeds of the GAR policies were taken in GAR form (i.e., anticipating 100% exercise rate), although this is an unlikely position given the availability of a tax free sum of approximately 25% of proceeds. No rectification costs would have been incurred in that case, as the final bonus rate calculated would have been the same as the lower rate added under the DTBP, so that those who exercised GAR would have suffered no loss.
13. The detail of the calculations supporting the results in paragraphs 8-11 is shown in the Appendix.

**Expert's Declaration**

14. I confirm that this report has been prepared in accordance with the requirements set out in the Expert's Declaration in my first report.

**M Arnold**  
**Fellow of the Institute of Actuaries**

**13 April 2005**

Appendix

Rectification costs if no DTBP but ring-fencing allowed

For GAR claims, 65% of benefits assumed to be taken in GAR form

Year	Payouts on GAR policies		Proportion of benefits assumed taken in GAR form	Average value of GAR/CAR	Final bonus (With DTBP) FB	Final bonus (No DTBP) FB'	Proportion of benefits actually taken in GAR form	Cost of rectification
	Guaranteed funds	Final bonus						
	(A) £m	(B) £m	(C) %	(D)	(E) %	(F) %	(G) %	(H) £m
1994	249.0	129.2	65.00	1.029	51.89	49.08	-	-
1995	357.0	164.0	65.00	1.033	45.94	42.87	-	-
1996	415.0	176.0	65.00	1.059	42.41	37.15	-	-
1997	439.7	235.3	65.00	1.126	53.51	41.89	-	-
1998	346.6	260.4	65.00	1.283	75.13	47.92	0.30	0.15
1999	210.3	218.7	65.00	1.352	103.99	66.01	3.50	1.51
to July 2000	110.5	110.5	65.00	1.340	100.00	63.80	5.00	1.08
<b>Total</b>	<b>2,128.1</b>	<b>1,294.1</b>						<b>2.74</b>

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Appendix

Rectification costs if no DTBP but ring-fencing allowed

For GAR claims, 76% of benefits assumed to be taken in GAR form

Year	Payouts on GAR policies		Proportion of benefits assumed taken in GAR form	Average value of GAR/CAR	Final bonus (With DTBP)	Final bonus (No DTBP)	Proportion of benefits actually taken in GAR form	Cost of rectification
	Guaranteed funds	Final bonus						
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)
	£m	£m	%		%	%	%	£m
1994	249.0	129.2	76.00	1.029	51.89	48.61	-	-
1995	357.0	164.0	76.00	1.033	45.94	42.37	-	-
1996	415.0	176.0	76.00	1.059	42.41	36.30	-	-
1997	439.7	235.3	76.00	1.126	53.51	40.10	-	-
1998	346.6	260.4	76.00	1.283	75.13	44.13	0.30	0.10
1999	210.3	218.7	76.00	1.352	103.99	60.94	3.50	1.00
to July 2000	110.5	110.5	76.00	1.340	100.00	58.93	5.00	0.72
<b>Total</b>	<b>2,128.1</b>	<b>1,294.1</b>						<b>1.82</b>

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Appendix

Rectification costs if no DTBP but ring-fencing allowed

For GAR claims, incurred rates taken in GAR form

Year	Payouts on GAR policies		Proportion of benefits assumed taken in GAR form	Average value of GAR/CAR	Final bonus (With DTBP) FB	Final bonus (No DTBP) FB'	Proportion of benefits actually taken in GAR form	Cost of rectification
	Guaranteed funds	Final bonus						
	(A) £m	(B) £m	(C) %	(D)	(E) %	(F) %	(G) %	(H) £m
1994	249.0	129.2	0	1.029	51.89	51.89	-	-
1995	357.0	164.0	0	1.033	45.94	45.94	-	-
1996	415.0	176.0	0	1.059	42.41	42.41	-	-
1997	439.7	235.3	0	1.126	53.51	53.51	-	-
1998	346.6	260.4	0.30	1.283	75.13	74.98	0.30	0.51
1999	210.3	218.7	3.50	1.352	103.99	101.51	3.50	5.04
to July 2000	110.5	110.5	5.00	1.340	100.00	96.66	5.00	3.51
<b>Total</b>	<b>2,128.1</b>	<b>1,294.1</b>						<b>9.06</b>

## Appendix

### Sources of data and calculations

- (A) Trial bundle ref C46.167 ("Scenario 6, Compensation Scheme - Quantum", paragraph 4)
- (B) Trial bundle ref C46.167 ("Scenario 6, Compensation Scheme - Quantum", paragraph 4)
- (C) Assumption
- (D) Trial bundle ref C46.167 ("Scenario 6, Compensation Scheme - Quantum", paragraph 4)
- (E)  $(E) = (B) / (A) * 100$
- (F)  $(F) = \{ [(A)+(B)] / [ (C)/100*(D) + (1-(C))/100 ] * (A) ] - 1 \} * 100$
- (G) Trial bundle ref C46.167 ("Scenario 6, Compensation Scheme - Quantum", paragraph 4)
- (H)  $(H) = (G)/100 * (A) * [ (D)*(1+(F)/100) - (1+(E)/100) ]$

### Assumptions made for 2000 figures

- Total payouts are £221m to 30 June 2000 (Trial bundle ref C46.152, paragraph 2)
- 5% of benefits for GAR claims taken in GAR form
- Final bonus = 100% of guaranteed value
- GAR/CAR = 1.340