Equitable Life Assurance Society
The Impact of the so called "20% and other Reductions" on Annuitants

2.1) Introduction

This analysis started as an attempt to understand and explain to other With-Profits Annuitants (WPAs) the impact of the so-called "20% reduction" in annuities that came into effect from March 1st 2003. That it was not 20% and whether it was applied equitably as explained by the Society was one of the primary drivers in the preparation of this report. In the course of the analysis, it became clear that there were other deeper, subtler, and more complex issues that needed exploration and understanding. This section, one of three, is intended to be self-contained, but where possible should be read in conjunction with the other two.

2.2) The Equitable Life Annuity

Regrettably in order to understand what follows, it is necessary to explain how the annuity system of the Society works. There is a more detailed analysis in Section 4 but the following is intended to be enough for this section

The Equitable Life Assurance Society (ELAS) produces With-Profits Annuity - Annual Statements every year for each annuitant and which in general contain the following information:

The Renewal Date
Basic Guaranteed Annuity (BGA)
Declared Bonus Annuity (DBA)
Final Bonus Annuity (FBA)
Total Gross Annuity (TGA)

Historically, the Society also produced another document and somewhat confusingly called the Bonus Declaration for the Year Ending 31 December 19NN, which contained references, amongst other things, to:

Anticipated Bonus Rate (ABR)
Overall Rate of Return (ORR)
Declared Bonus Rate (DBR)

There is one other abbreviation that must be introduced which is:
The Total Return for a Level Annuity (TRL)

N.B. In the footnote to each page is a summary of all the abbreviations used in each section as an aid to understanding.

Until July 1996, With-Profits Annuities contained a Guaranteed Interest Rate (GIR) of normally 3.5% per annum, which was to be allotted BEFORE any policy bonus. The GIR is NOT a bonus. It is a contractual entitlement similar in principle to the former GAR. All With-Profits annuities since mid-1996 are non-GIR.

For GIR annuities the TRL is the ABR x 1.035 and for non-GIR annuities the TRL is the same as the ABR.

At the outset of an annuity, the annuitant transfers a sum of money, the **consideration**, in exchange for a regular payment, the **annuity**. The annuitant agrees with the Society in advance an anticipated rate of return (ABR).

Very simply the annuity is calculated using a combination of the various interest rates, ABR, ORR, etc from the initial annuity value which is determined by the amount of consideration money and the rates for conventional annuities relevant to the policyholder. Each year the Society computes new values for each element of the annuity using two separate arithmetic series by using the ABR, TRL, DBR & ORR in different ways, so that the series in theory diverge.

Basic Guaranteed Annuity (BGA); Declared Bonus Annuity (DBA); Total Guaranteed Annuity for the year (NGA); Final Bonus Annuity (FBA); Total Gross Annuity (TGA); Anticipated Bonus Rate (ABR); Overall Rate of Return (ORR); Declared Bonus Rate (DBR): Total Return for a Level Annuity (TRL)

i) One series computes the BGA and DBA
ii) The other series computes the TGA.

The BGA and DBA are “guaranteed” under the terms of the annuity, which is not quite what it seems, not least because these two elements of a With-Profits Annuity do not give a constant annual guarantee. The BGA is a reducing guarantee, which is at the rate of the ABR, whereas the DBA can increase, remain level or increase depending on the relationship between the ABR chosen by the annuitant and the DBR for each year set by the Society.

The Total Gross Annuity (TGA) is increased each year by the effect of the ORR and decreased each year by the effect of the TRL. Thus if the ORR is greater than the TRL then the annuity will increase and if the ORR is less than the TRL then the annuity will decrease.

The FBA is the difference between the TGA and the sum of the BGA and DBA. However, the FBA is not guaranteed at all and can be withdrawn by the Society at any time.

In discussions with many WPAs, it is clear that they recognised that the Total Gross Annuity (TGA) might go down in ‘bad years’ and then it would recover in ‘good years’ and that the Society would do its best to even out these variations to provide a constant level of income. However, when the decision to make the 20% reduction was implemented, it was immediately clear for the very first time, not only how the FBA was derived, but that it was added at the discretion of the Society and, much more importantly, it could be removed in its entirety by the Society, also at its discretion with a devastating consequence on the TGA and the incomes and lifestyles of the With-Profits Annuitants.

2.3) The “20% Reduction”

In November 2002, the Equitable Life Assurance Society (ELAS) announced that it had to reduce the annuities of one class of its annuitants, the so-called With-Profits Annuitants (WPAs), who had not until then suffered any serious reduction as a result of the problems that beset the Society. The full text is attached to the end of Section 4. The following is an extract:

> *“Following the House of Lords' decision in July 2000, we had to reduce the value of with-profits policies. We did this, other than for with-profits annuities, by reducing the policy value by 5% at that time. We made significant further reductions in July 2001, April 2002 and July 2002. This means, allowing for bonuses, our other with-profits policyholders have suffered an overall reduction of about 20%.*
>
> *So far we have largely protected you from these falls. In fact, you and other with-profits annuitants have generally received a positive investment return of about 14% over the same period.*
>
> *As we have said, most other with-profits policyholders have suffered significant reductions in the value of their policies, whereas those who have with-profits annuities have not. We were able to do this because if you have a with-profits annuity, you cannot withdraw your funds. It was possible for us to phase the cuts to with-profits annuities in the hope of improved financial conditions. Unfortunately, because conditions have not improved we can no longer keep doing this.*
>
> *This basically means that with-profits annuities, like yours, are now out of line by about 30%.*
>
> ***Action we need to take now***
>
> *We now need to bring with-profits annuities back into line with other policyholders and we plan to do this over two years. We will be putting in place the following changes.*
>
> - *On your policy anniversary after 1 February 2003, we will reduce the value of your total annuity, which we would otherwise pay, by up to 20%.* *This action replaces the current approach of*

reducing the overall rate of return over the term of the policy. We will then reduce your income payment again in 2004 to regain any over payment, which may still apply."

With this document was one of a regular series from the Society entitled "How your With-Profits Annuity works". The relevant page of this document, also attached at the end of Section 4, included a table explaining the probable range of the reduction. The table and the headline "No more than 20%" appeared to be in contradiction with each other, though as set out below, the significance is now clear.

Both of these documents contain assertions, which are arguably either incorrect or confusing, not least 'that it was not possible to be precise about the amount of money to be removed'. The calculation is trivial even by hand and with the IT resources available to the Society, there is no reason why the precise amount could not have been announced for each annuitant in the November 2002 communication from the Society.

In addition the statement that "*we will reduce the value of your total annuity, which we would otherwise pay, by up to 20%"*could have been better expressed as "The FBA will not be reduced in this fiscal year by more than 20%, but in addition to this reduction, your total annuity, TGA by this definition, will be reduced as consequence of reductions to the BGA and DBA".

Further the assertion that the WPAs have '*generally received a positive investment return of about 14% over the same period.'* may mean something to the Society and one can be sure it is accurate but in reality, the annuitants in the same period have generally seen a reduction in their income from the Society. That is what counts to annuitants.

2.4) The "Other Reductions"

In the period between 2000 and 2003 the Society had made a number of changes that affected the income of the WPAs. These were:

1) The so-called "20% reduction" in annuities as described above.

2) A reduction of 1% in the published Overall Rate of Return (ORR) in 2000 & 2001 and a further reduction of 1.5% in 2002 and 2003 following the ruling from the House of Lords.

3) The Society reduced the ORR from its previous levels, which historically had been set at

Year	Effective	ORR
88/89	1/4/1990	
89/90	1/4/1991	12.0
90/91	1/4/1992	12.0
91/92	1/4/1993	10 (12)
92/93	1/4/1994	13.0
93/94	1/4/1995	10.0
94/95	1/4/1996	10.0
95/96	1/4/1997	10.0
96/97	1/4/1998	13.0
97/98	1/4/1999	10.0
98/99	1/4/2000	12.0
99/00	1/4/2001	7.0
00/01	1/4/2002	3.7
01/02	1/4/2003	2.0

As can be seen, in 2001 and 2002 the Society substantially reduced the ORR from its historical level.

4) In parallel to this action the Declared Bonus Rate has also been reduced as follows:

Year	% Rate
1997	7.0
1998	6.5
1999	5.0
2000	5.0
2001	0.0
2002	0.0
2003	0.0

The significance of the reduction in the DBR is NOT that it reduced the Total Gross Annuity since that is controlled by the relationship between the ORR and TRL but that it transfers more of the annuity from the guaranteed protected element of the annuity, the DBA and into the un-guaranteed, unprotected FBA. This is very significant.

There have been four reductions each of which has a cumulative effect:

1. The imposition of a 20% reduction in the annuity.
2. The imposition of a 5% reduction in the ORR, but spread over 4 years.
3. The decline from the ‘historic average’ ORR of approximately 10% to a much lower level.
4. The reduction of the Declared Bonus Rate (DBR) to zero since 2000.

There are so many variations and possible combinations in ways that the impact of these reductions can be assessed, that it would only serve to confuse the point to illustrate them all but:

a) If the ORR had maintained a level of 10%, then my annuity, for example, would be approximately 4% higher than it is today.
b) If the 5% reduction had NOT been imposed **&** the ORR had maintained a level of 10%, then my annuity, for example, would have been approximately 15% higher than it is today.
c) If no reductions had been imposed, then my annuity, for example, would have been approximately 42% higher than it is today.

No attempt has been made to make parallel comparisons for other annuitants but taking a 15% reduction in my annuity payments as a benchmark (and making adjustments for life expectancy and relative size of my annuity to the average), that is equivalent to taking approximately **£600 million** from the annuitants over the remaining lifetime of the policy.

As mentioned above, the headline “No more than 20%” has caused widespread misunderstanding as it was not clear that this only applies to the FBA and that the normal reductions that apply to everyone’s annuity were in addition.

The other ‘normal reductions’ are as follows:

1. BGA is reduced each year by your chosen ABR. If the BGA last year was £7,629 and the ABR was 7.0%, then this year’s BGA will be 7,629 / 1.07 or £7,130

2. The DBA is reduced in a slightly more complex manner since it is a function of both the ABR and DBR. However, for the last 3 years the DBR has been set to zero by the Society, so in effect the DBA is reduced in the same way as the BGA. If last year’s DBA was £1,817, then this year’s DBA will be 1817 / 1.07 or £1,698.

So in other words, even before the Society has started on the “20% reduction”, the annuity in this example has reduced by £618 or to 94.3% of last year’s value. (That is 1.00 / 1.06 = 0.9434)

Next the reduction is only and can only be applied under the terms of the With-Profits Annuity to the FBA. The Society has advised that the calculation is as follows:

1. Take 20% of last year's TGA.
2. If this number is less than this year's FBA, then reduce this year's FBA by that amount and leave the balance as the new FBA.
3. If this number is greater than this year's FBA, then reduce this year's FBA to zero. In which case this year's TGA becomes the sum of this year's GBA and DBA.

That may look complicated but the very real consequence is that some annuitants, who had a large FBA received a very high reduction. In the above example, the reduction is approximately 27%. Other annuitants with a relatively small FBA, suffered a much lower reduction, in some cases as low as 13%! This neither looks or feels fair, but it is an inevitable consequence of the ABR chosen by the annuitant under quite different conditions and for quite different reasons many years previously.

This skirts the serious question whether WPA's who chose a high ABR, in effect their TRL, understood the implication that a higher percentage of their annuity would be un-guaranteed and unprotected. This is difficult enough for the non-GIR annuitants but for the GIR annuitants, their situation was even worse as their effective TRL was their ABR multiplied by the 1.035% guaranteed interest rate!

The 'guarantee' unquestionably increased the starting level of the annuity for GIRs but exposed them to a much higher risk in the event of a reduction in rates of return and more exposed as a greater percentage of their Total Gross Annuity (TGA) was un-guaranteed.

However, what must NOT be over-looked is that in the years preceding the "20% reduction", which can ONLY be applied to the FBA element, the Society had massively increased the amount of money in the FBA element by reducing the DBR to zero. Whatever, the reason or justification for that action, the amount of money that could be removed by the Society had been significantly increased since 2000.

On the basis that there are approximately 65,000 WPA's and that the weighted average reduction in annuity is approximately £31,000 per annuitant, the Society has removed approximately **£1.5 billion** from the pockets of its annuitants that it was otherwise committed to paying over the lifetime of the annuities.

In communication with one annuitant the Society responded and with his permission the following extract is included:

> "Following my father-in-law's death, we wrote to ELAS and received a reply from which I quote: "The planned reduction under your policy is between 22% and 28%, 20% of the reduction will be taken on the anniversary of 28 June 2003 and the remainder (between 2% and 8%) will be taken on 28 June 2004. The reduction will apply to each benefit."

In this particular annuitant's situation the FBA is zero for all three annuities, so it is not legally possible for the Society to reduce the annuity further, so what the Society intended to say or what the Society understood by its own letter is not clear. But what it implies is that for all those annuitants who have some residual FBA the Society also plans to reduce that to zero. This means that with this action the Society will remove a further **£350 million**.

In total it appears that the Society plans to remove every element of the WPAs income that it can argue to be permissible under the terms of the annuity, irrespective of the financial needs of the Society or the exigencies imposed on the persons least able to protect themselves and their financial interests. Just on the actions announced by the Society so far this adds up to approximately **£2.5 billion** – an astonishing amount of money transferred from people's investments for their old age by a Mutual Society set up to protect their interests.

Whilst some may have other income and annuities with other Life and Pension companies, looking at the actual incomes of the WPAs prior to the reductions, it cannot be said that they are wealthy or even comfortably off and that any reduction in their income represents a major loss of lifestyle, plus fewer essential things purchased or the ability to purchase services, such as a cleaner or a gardener, when age related infirmity precludes such activity. After a lifetime of saving and investment, these annuitants have Policy Holders Reasonable Expectations (PREs) as set out in the insurance legislation that they should be free of money worries from policy reductions imposed by the Society. (See Chart 1)

It has been stated that it is possible that many annuitants have other sources of income but surely nobody is arguing that it is acceptable to reduce someone's income just because they have other sources. In any event, people develop a lifestyle to meet their income. Pensioners in general are careful to manage their affairs carefully as they are only too aware that even low inflation gradually erodes their income, which in normal situations is fixed for their remaining lifetime. The whole objective and attraction of With-Profits Annuities was to provide some protection against the corrosive effect of inflation on people with fixed incomes. In other words, the WPAs will have budgeted to modify their homes for old age, or set aside reserves if they need to go into a Retirement Home or into a Care Home. Thus any reduction is a very real loss even if it may seem to be quite small.

It must also be emphasised that there is a big difference between income and discretionary income. A reduction of say £3,000 p.a. from an income of say £30,000 p.a. may not appear so bad. However, the majority of the income may be committed is non-discretionary to pay Income Tax, Community Charges, Utilities, Insurance, Hire Purchase, Rent or Mortgages, bills that have to be paid come what may. The rest of the income can be defined as discretionary for items one can choose to buy or not, though note that by this definition, discretionary income includes food! An annuitant's discretionary income may be as low as 30 to 35% of the total income, or say £10,000. A loss of £3,000 p.a. in this situation has a very much larger impact and will require a significant and difficult change in lifestyle and plans. (See Chart 2)

Based on the data received from the annuitants, the overall loss of income over the remaining lifetime of the annuitants or the amount of money transferred from the pockets of the annuitants to the funds of the Society is approximately £2.5 billion pounds. Even allowing for statistical uncertainties this is an enormous transfer of wealth, made without discussion or with any form of justification and from people who are least able to make up the difference with future earnings. (See Chart 3)

These annuitants who are suffering these major reductions in income are at an age when they can do little to make alternative arrangements to boost their income and thus have limited, if any, opportunity of recovering these losses through paid work. (See Chart 4)

2.5) Summary

The Society appears to have taken substantial sums of money from the present and future income of its WPAs who legally cannot transfer their annuities to another life company or make any other changes and are completely at the whim of whatever the Society decides it is able to do at its own discretion and under the terms of polices that were never intended to cover this type of contingency.

There have been or will be three reductions:

1) The initial reductions made as a result of the House of Lords ruling and the lowering of the ORR are costing the WPAs approximately **£600 million** over the life-time of the annuitants, transferred from their accounts into the funds of the Society.

2) The Society did not mention and did not make clear that the 20% reduction was in addition to the normal reduction the annuitant has agreed each year as a result of the bonus rate that was chosen by him or her at the start of the annuity. Thus if you have a 7% bonus rate, then the reduction had to be close to 27%!

What is also less clear but implicit in this method of calculation was that those annuitants whose Final Bonus Annuity was large, had a larger reduction than those annuitants whose Final Bonus Annuity was relatively small. This is neither just, nor fair nor equitable

There is no correlation between the age and size of the annuity and only a limited correlation on the bonus rate chosen at the start of the annuity that was more often than not strongly influenced by the Society's sales force.

On the basis that there are approximately 65,000 WPA's and that the weighted average reduction in annuity is approximately £31,000 per annuitant, the Society has removed approximately **£1.5 billion** from the pockets of its annuitants that it was otherwise committed to paying over the lifetime of the annuities presumably to fund its other liabilities.

3) It is clear from the letter written to an annuitant that next year the Society it intends to remove any remaining FBA even though the inequality of reduction between annuitants will be even larger at the end of this process. This will result in a further transfer of approximately **£350 million** from the annuitants.

The total transfer is an astonishing sum of money and one that deserves a detailed explanation from the directors, and the regulatory bodies involved, one that so far has not been forthcoming.

Finally, the Society states that we must all suffer equally, which is at least questionable even within the group of clients called the With-Profits Annuitants, WPAs.

But the fact is that the WPAs are **NOT** equal to other groups of the Society's clients.

1. They are not protected from further losses.
2. They cannot recover these losses by seeking employment, even if age and infirmity do not preclude such an activity, since employment for people of pensionable age is not easily found.
3. They cannot transfer their funds to another life office in order to obtain greater stability and certainty of income.
4. The reductions can never be recovered no matter how well the With-Profits Fund performs in the future as the WPAs capital has been partially wiped out by the actions or inactions of the Society.

It is a superficially appealing argument that, though convenient and easy for the Society to enunciate, is in fact without ethical or logical merit at all.

The following charts are based on data extracted from information supplied by the annuitants and summarised. The vast majority of the annuitants have supplied their policy numbers, so that if necessary, the data can be confirmed by third parties, though that will only be done with the express consent of the individuals involved.

Chart 1: **The Size of the Annuity Payments**

This chart illustrates the range of annuity payments BEFORE the reduction. The chart shows that 76% of the annuitants have an income that is less than £10,000 p.a. from the Society. The average annuity in the sample is approximately £8,600 p.a.

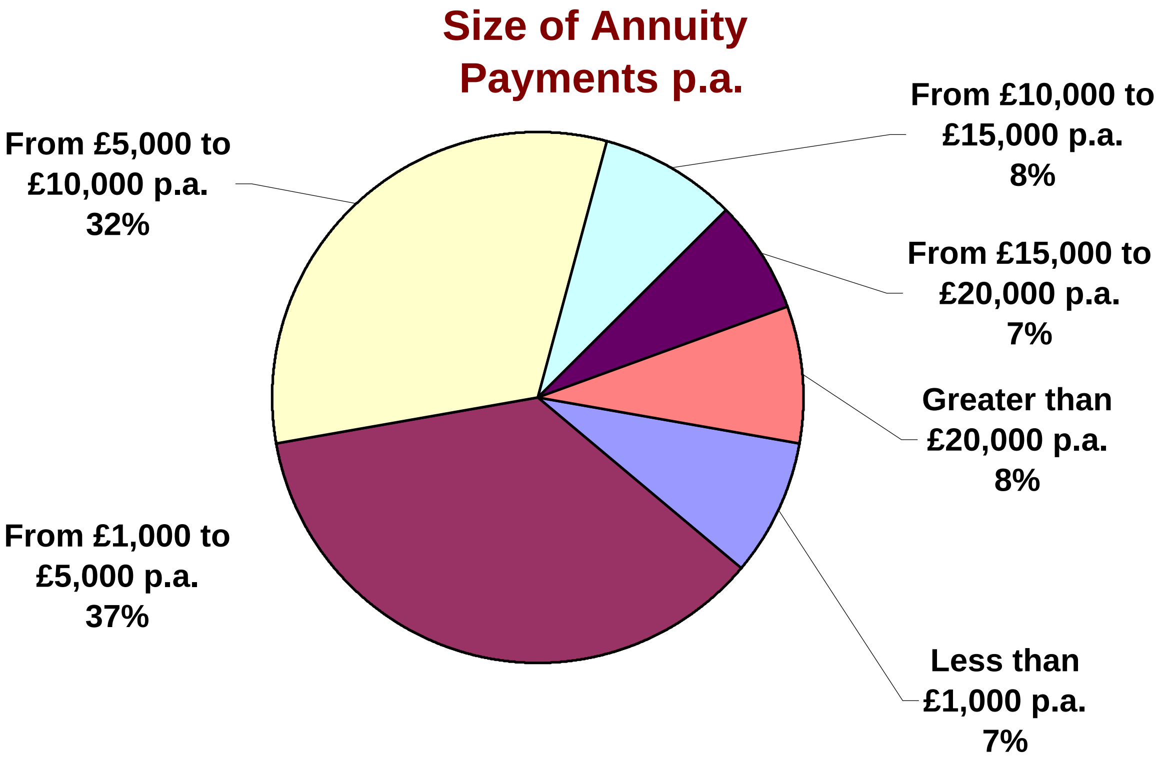


Chart 2: The Actual Reduction in Annuity payments

There has been significant reductions in the income annuitants receive from the Society that, whilst they may not appear large, do have a significant impact on annuitants' lifestyles, bearing in mind that the average annuity is approximately £8,600 p.a.

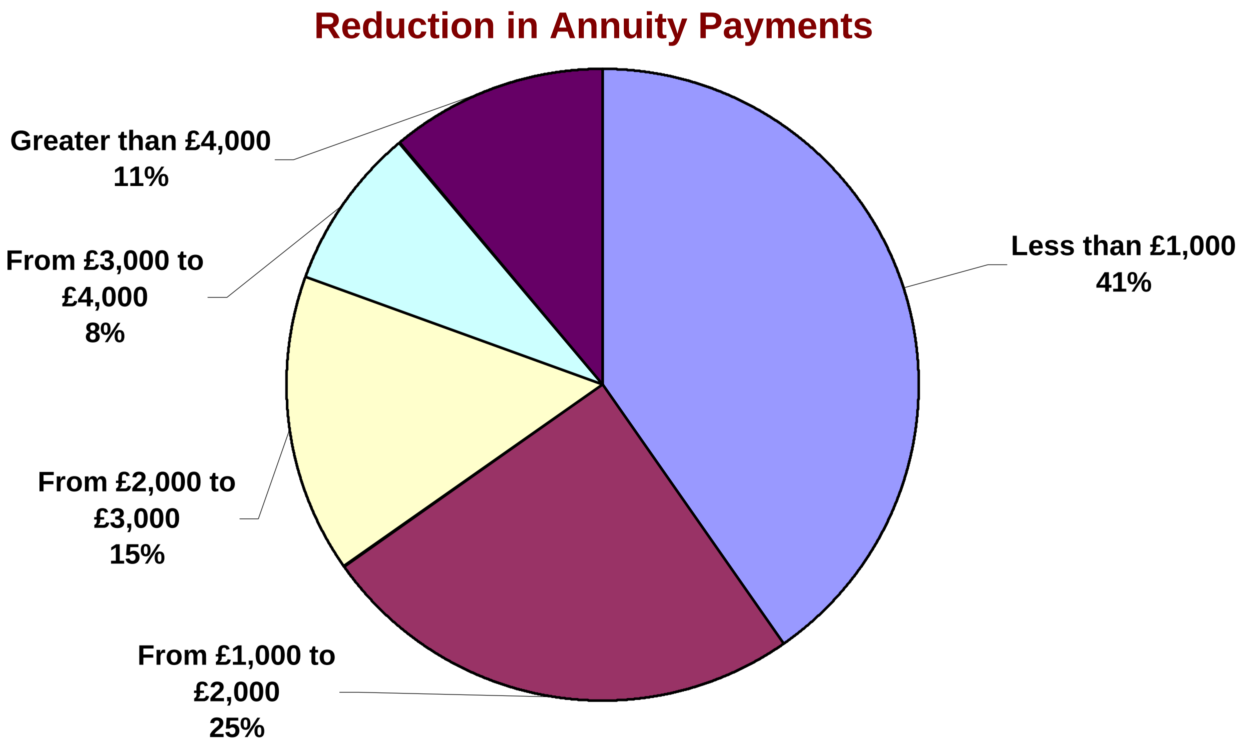
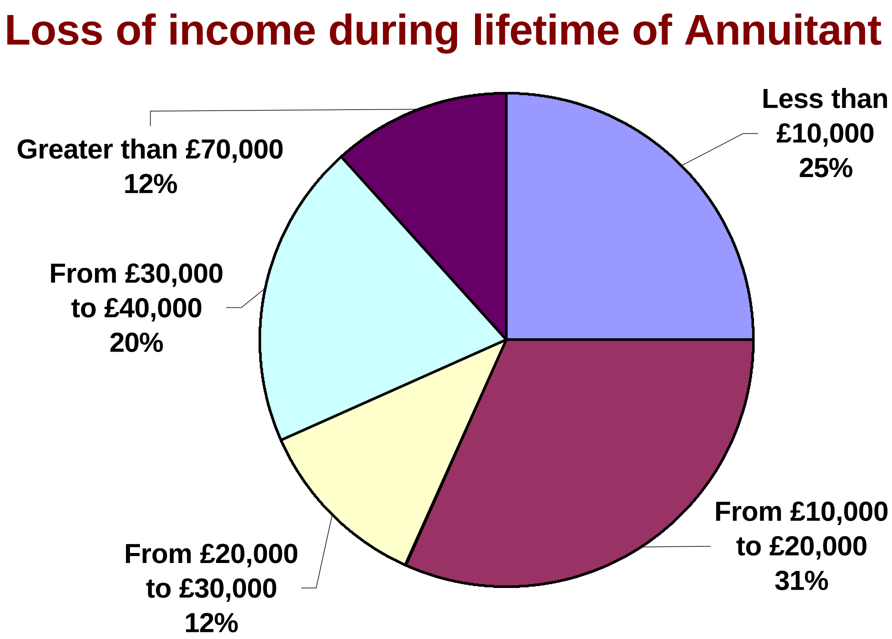


Chart 3: The loss of Income over the Remaining life of the Annuity.

What is not immediately obvious is that these reductions illustrated above apply for the rest of the annuitants' lives, as the new lower annuity is the base point from which growth, if any, might occur. This shows the amount of money that each annuitant has lost as a result of the reduction assuming the annuitant lives to age 80.

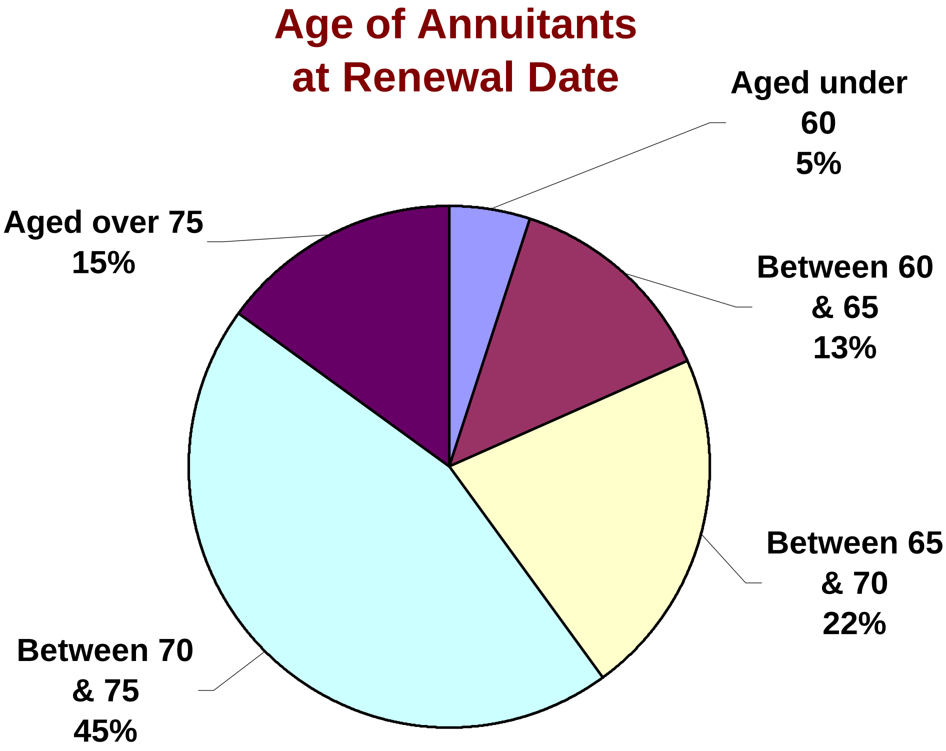


The key points of interest are as follows:

a) Approximately 44%of the annuitants will lose over £20,000 of income between now and the time of their death.

b) The weighted average loss of income is approximately £23,500.

Chart 4: The Age of Annuitants at the Renewal Date



The age of the annuitant defined as their age on June 30th, 2003.

As can be seen the majority of annuitants, some 82% are over the official age of retirement of 65, though as everyone is aware once you are over the age of 55, the probability of obtaining any meaningful well paid employment is extremely difficult.

Chart 5: The Actual Percentage reduction in Annuity payments

As can be easily seen only 30% of annuitants had a reduction of less than a 20%! The majority, approximately 52%, had reductions in excess of 24%, which is entirely and easily predictable from the method the ELAS used to compute the reduction.