Comments on Final Scheme Documentation

The Documentation is voluminous – the main proposal is 191 pages

There is also

Accounts to 30/06/01
Your Questions Answered
Chairman's Letter
Voting Pack

The scheme proposals seem identical to those already published. In the very limited time available I have concentrated upon identifying new information in respect of the Society's financial position, about which the Directors have been reluctant to elaborate.

As previously, financial figures are in Accounts format. The Accounts mix up the With Profit fund with the non-profit fund and sometimes the unit linked funds and ignore terminal bonuses. From this it is difficult (if not impossible) to discern a clear view of the with profit fund's underlying assets. No figures are given of the aggregate of with-profit policyholder values (including terminal bonuses). For this information we still have to relay upon statements made by the Directors and by the Appointed Actuary. In these documents they have been a little more forthcoming.

Salient factors

Investment losses in the first half of 2001 were

	£m
Realised Investment Gains	1,942
Unrealised Losses	(3,473)
Net	(1,531)

This equates to about -5.7% of assets at December 2000 (£26,862) and almost exactly what we estimated from Stock Market indices.

The return on the With Profit fund is given at –4.7%, which percentage includes investment income as well as net capital losses.

It is said that the loss to 30th Sept increased to -9.1%, but markets have improved from that date. The FTSE on 5th Dec was 5,333 and well on its way back to the level immediately before the 16th July bonus cut of 5,537.

As we expected, the 16% hit of 16th July was by no means entirely as a result of Stock Market Losses. Other main factors were

a) The need to recover the GAR cost £1,468 million, which was not recovered in 2000 as a result of an insufficiency of profits.
b) The need to bring aggregate reported policy values more into line with assets.

The figures can be quantified more accurately:

The Fund value at July 2001 after 16% hit was stated to be £22,800 million. This means that before the hit it was £27,143 and the hit was £4,343. (16% of £27,143 is £4,343 and £27,143 less £4,343 is £22,800). The hit is made up as to:

	£m	**%**
Stock Market Losses	1,531	5.64%
GAR Cost	1,468	5.41%
Re-balancing	1,344	4.95%
Total	4,343	16.00%

The Directors continue to decline to say whether the re-balancing of assets and policy values

a) recovered excessive past bonuses so as to bring aggregate reported policy values into line with assets OR
b) created a surplus of assets over aggregate reported policy values

However the Appointed Actuary has now explained that his advice is that policy values need to be kept within the range of +-5% of available asset values. The Chairman confirms that at the end of September they were in this range, i.e. policy values did not exceed assets by more than 5%. Given that asset values fell about 5% between June and Sept, one might assume that at the end of June assets and policy values were in balance or there was an up to 5% excess of assets over policy values. This at least gives an indication of the likely relationship between with-profit assets and policy values.

The Current fund size is given at £20.1 Billion and Claims in June to Sept stated to total £1.7 billion.

Make-up of With Profit Fund

This is now:

At October 01	%
Equities	34
Properties	14
Fixed Interest	52
	100

Prospects

Even if the compromise succeeds the Appointed Actuary sees little scope for immediate changes to the investment structure. There are too many prospective claims, i.e. people retiring or leaving and practically no premium income. Because Terminal bonuses have been slashed, a high proportion of the fund is represented by guaranteed benefits, which need very conservative investment. This may be an advantage in the immediate future, but if equity prices start marching upwards again, this fund will soon fall behind. Because of the need to track policy values against market changes the Financial Adjuster may be in frequent use.

Is this a good compromise?

I do not think that this is a particularly good compromise. There are too many rough edges. The reluctance of the Directors to be open about the Society's true financial state has discouraged trust. One could argue about the balance between GAR's and non-GAR's, but personally I think it gets this aspect about right.

GAR's, particularly those approaching retirement, will say that 16.3% is going to fall a long way short of the extra funds they need to replace the contractual annuity they are signing away.

Non-GAR's, particularly recent ones, will say that 2.5% is not going to counter the 16% hit they have just suffered.

GAR's must appreciate that the compromise gives them the freedom to use their uplifted policy value to buy an annuity (with or without profits and with or without bells and whistles) or a draw-down scheme from another Insurance Company.

Non-GARS must appreciate that in any compromise they themselves are going to pay 75% of their 'compensation', so the net amount is never going to be huge. Those that think they are going to get a better deal out of the Courts should read the Warren and Moss opinions and must expect to pay their own legal costs.

Those that think that a NO vote will produce a better deal from this Board or a replacement are deceiving themselves. Few current investors will wait for a new board to be elected and a new deal to emerge. Those that have waited once have done badly (-16%!) and few will want to wait again.

The FSA have clearly lined up two backstops

1) the imposition of a mis-selling review
2) if the pressure of litigation gets too much – appointment of an administrator

Those that think the FSA will impose a better deal for them should read the Glick opinion (not more than 5% if you have good evidence and nothing if you don't) and reflect on the time the pensions mis-selling review of the late eighties has taken to come to fruition. Those that think that an Insolvency Practitioner will provide a better deal should talk to those with some experience of the subject. An Insolvency Practitioner friend of mine was so fearful of the prospects of his co-professionals taking charge of Equitable that he was one of the first to bale out in December 2000!

The short answer to the question is No it is not a good compromise, but it is the best we are going to get and the alternatives are very much worse.

What are the Prospects for Equitable if the Compromise Succeeds?

The compromise at least permits

a) An orderly dismantling of the Society as policyholders, leave, retire or die.
b) A possible deal with another Insurer, particularly Halifax Equitable.

Orderly dismantling, whilst a great deal better than liquidation, is not particularly attractive, either to policyholders or to Halifax, who have spent £750 million for little return. As part of a closed fund with a minuscule smoothing kitty, members may expect modest returns and declining levels of service. Halifax may be able to skim some profit from its administration and investment agreement but cannot really consummate its advantage until:

1) The Equitable fiasco is buried and some degree of calm is restored
2) Equitable policyholders have the confidence to want to start investing again
3) There is a substantial Halifax insurance subsidiary open for business. At present Clerical Medical is quite large, Halifax Equitable is tiny and Equitable though still sizeable is closed.

Only then can Halifax start to earn some profits, see some growth and earn re-rating of its own shares from (boring low-rated mortgage provider) to (exciting high-rated insurance company).

The obvious course is to shunt together HE with ELAS or perhaps to merge them with Clerical Medical. The pre-requisite for this is a boost to ELAS assets and reserves. Halifax could provide this, paving the way for re-opening for new business. There would be no likelihood of any substantial windfall and we would have to learn to live with the shareholders. However being part of a live fund with reserves, premium income and investment freedom would still be quite attractive.