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BRIEFING

# Equitable Life

Corporate governance issues

## Executive summary

The recent release of Lord Penrose's report on Equitable Life highlights the dangers to companies of ineffectual boards and demonstrates the need for board members to really understand the business for which they are responsible. The report identifies a number of areas in which the non-executive members of the board of Equitable Life effectively delegated their responsibilities to the executive management, leaving critical decisions to be made by company executives.

In August 2001 Ruth Kelly MP, Financial Secretary to the Treasury, asked Lord Penrose to enquire into the circumstances leading to the (then) current situation at Equitable Life. The recent release by the Treasury of Lord Penrose's report has highlighted the dangers to companies of ineffectual boards and demonstrated the need for board members to really understand the business for which they are responsible.

In its 818 pages, the report identifies a number of areas in which the non-executive members of the board of Equitable Life effectively delegated their responsibilities to the executive management, leaving critical decisions to be made by company executives.

## Who governed Equitable Life?

In formal terms, the board of directors governed Equitable Life. As a life insurance company, the board might generally have been expected to act on the recommendations and advice of the actuarial department. However, board members ought to have not only understood but also challenged the advice they were receiving and should have acted as the central decision-making body of the company.

This was not what happened at Equitable Life. Lord Penrose reported that: 'at all material times [Roy Ranson, the company's actuary] had de facto executive control of the relevant areas of the business' and board members had little understanding of the issues or involvement in the decision-making process regarding core elements of the company's business. Equitable Life's actuarial

department controlled the decisions relating to product design, valuation of liabilities and risk management, decisions that resulted in the cuts to policy values in 2001. However, it was the ability of a discrete part of Equitable Life to make these decisions without any real scrutiny or challenge by the board that Lord Penrose saw as being 'arguably the first and most significant failure' in relation to the company.

The company's risk management systems were not effective. The executive retained control of risk management. Major areas of judgement that were critical to the running of the company were not within the remit of the audit committee. In particular, the valuation of Equitable Life's liabilities, product development and the reserving implications of guarantees given to policyholders remained outside the scope of the audit committee, for the most part the preserve of the actuarial department.

## How did this situation come about?

How was it that the actuarial department at Equitable Life came to control so much of the decision-making process and that the board allowed this situation to continue?

Part of the answer must be the nature of Equitable Life's business. Both in regulatory terms and in practice, life insurance business is highly dependent on actuarial advice and analysis. This need not have meant the board was entirely reliant on actuaries, however. Lord Penrose noted that the board of a life office can be as competent

as any other to reach decisions on the basis of intelligible advice. In fact, the more common complaint about the relationship between the actuary of a life company and its board is that the actuary has insufficient input into board decisions, not that the actuary has too much control.

At Equitable Life, the problem appears to have been a combination of the corporate culture and the personalities involved. One former board member described the governance structure of the society up until the late 1980s as characterised by ‘gentlemen and players’ – the board comprised mainly City professionals with little knowledge of the workings of a life office, and management was located physically away from the board at the insurer’s office in Aylesbury and had ‘little cultural connection’ with board members.

In addition, Lord Penrose described Roy Ranson, the appointed actuary from 1982 until 1997, and its chief executive from 1991, as ‘autocratic’. (He also criticised Mr Ranson’s simultaneous holding of both these roles, saying that ‘on no account should it be permitted’.) Lord Penrose went on to say that Mr Ranson conflated his external duties in relation to certain matters to an exclusive ownership of those matters, regardless of the responsibilities of the directors.

The problems arising from the actuarial department were compounded by the board’s make-up. Lord Penrose found that for the most part board members did not understand how the application of actuarial concepts could affect the business, relying almost exclusively on the actuarial department to determine important issues. It was left to the actuaries not only to identify the problems and risks of the business but also to a large extent to decide upon the strategy for dealing with them. Lord Penrose concluded that the board had insufficient knowledge and skills to provide an effective challenge to the executive in critical areas. Questions from board members about certain aspects of the business did not result in proper explanations from the appointed actuary.

For example, the lack of a comprehensive audit committee function was attributed to ‘the intransigent resistance of the executive’ to attempts by board members to encroach on their exclusive areas of interest. In the words of Lord Penrose: ‘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’.

## Could this happen elsewhere?

Lord Penrose was careful to confine his comments to the peculiarities of the situation faced by Equitable Life. The problems with control of key areas of decision-making and risk management at Equitable Life may have been in part attributable to certain characteristics of the company. Its mutual status meant that it had no shareholders to answer to and there was limited scope for policyholder action. While there existed the general requirements contained in the Insurance Companies Act 1982 that a company be soundly and prudently managed, Equitable Life was not subject to the more rigorous standards of governance expected of a listed company.

Arguably, the presence of shareholders and the adherence to a code of good practice such as the 2003 Combined Code would have helped prevent the types of problems found at Equitable Life. However, even with the structures of good governance in place the success of a company depends on the competence of those in charge. Unless the board has the skills and information necessary to make informed decisions, there will always be scope for things to go wrong.

It is easy to judge the actions of those involved against contemporary standards of best practice, rather than within the context of the environment in which they were operating. The directors of Equitable Life would no doubt assert that they strived to do their best for policyholders. With hindsight it is clear that they lacked the skills or information to do so and could not provide an effective challenge to the dominance of certain individuals at the company. Whether former directors now have to pay for that is a matter for the courts to decide, with the case by Equitable Life against nine of its former directors due to be heard by the High Court in 2005.

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