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Lessons from the Aviva reattribution and
FSA regulation of with-profits

Financial Services Consumer Panel

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This is a presentation given to the FSA consumer panel who are already aware of most of the issues.

I have added notes to help people who know a reasonable amount about the issues to better understand what the slides are saying.

For those who would like an introduction to the ideas I have attached a link to our website which has a lot of information. I also attach a separate file which takes a few pages from our guide to policyholders which help to explain the policy issues discussed here.

If I think items are reasonably self-explanatory I do not cover them in the notes.

What I'll cover

- A priori assumptions
- What is the inherited estate and what is it for?
- How did FSA + COBS affect the reattribution?
- Why was there a special pre-reattribution distribution?
- The outcome
- How the fund will run after the reattribution
- How an economic regulator would change COBS
- How an economic regulator would change governance

A priori how would one expect with-profits to operate?

- Policyholders protected by a 'duty of care'
 - same standards whether estate owned 90:10 or 0:100 by shareholders
- Fund ring-fenced so that 90:10 applies to the whole fund
 - including estate
- Expenses are either an appropriate cost and charged, or they are not
 - estate not to be used for expenses not permitted to be charged to asset shares
- New business written if best portfolio investment choice
 - estate capital charged for properly, not given away for free
- Capital in fund used in same way whoever 'owns' estate
 - assets backing guarantees invested in at least as risk-averse places as would be if shareholders owned 100% of estate

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Expect fund to be run in the interests of the fund and its current participants:

Investment choices should be the same as those the company would take if the money was its own, with some variation to take into account the different risk appetites of policyholders.

In other words new business should only be written if it fully pays for using all the capital it needs, including fund capital from the estate which is required to ensure that there is enough money to pay out the guarantees promised even in unusually bad times. The FSA does not require companies to cover the cost of using estate capital for this purpose when new business is priced, meaning that new business is costed at a loss to the fund, and hence current policyholders are not rewarded for the cost of new business using this capital.

Assets backing guarantees (coloured in dark blue on slide 6): Given that policyholders are probably more risk averse than shareholders, one would expect decisions to be taken with this in mind. One would not expect to see investments held in a significantly more risky way than they would be if shareholders owned the capital – but that is what actually happens, particularly with the part of the fund providing assets to back the guarantees in force.

This is a consequence of the FSA rules incentivising companies to hold estates together with significant discretion which companies can use to increase the levels of estate/assets to back guarantees that appear to be required when alternative risk choices require much smaller estates/assets to back guarantees.

Principles created by our QCs

1. The Insurer will establish and maintain a with-profits fund into which premiums will be paid
3. The purposes of a with-profits fund are to meet guaranteed benefits and, subject to this, to generate profits for distribution [to policyholders]
5. The with-profits fund will be managed for those purposes and not for other purposes
7. Any profits earned by the with-profits fund will be distributed [to policyholders] insofar as their retention is not justified for the purposes of the with-profits fund
9. The Insurer will exercise its powers and discretion reasonably and fairly

To which I would add:

6. The with-profits fund will be managed so there is no undue discrimination or preference

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This slide looks at the principles our QC's developed to fit with how one would expect with-profits funds to be managed.

Our QC's were not convinced that the law would back the economic argument that 'fair' also encompassed undue preference or discrimination and therefore could not object to 'intergenerational transfer' (a key topic explained further on). As a result I have added an explicit 6th principle. It does not seem to me that something can be considered 'fair' if the rules allow preference to new business policyholders and are anti-competitive

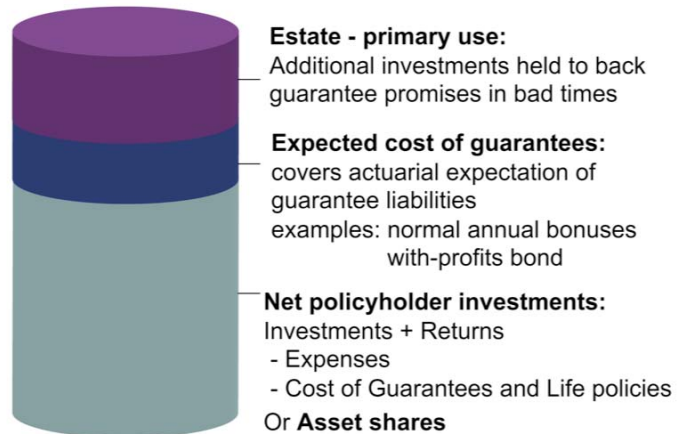
Reality of with-profits

- 'Law free zone': law not tested in reattribution
- FSA Regulation and COBS sets 'property rights'
- FSA does not protect customers through mimicking competition
 - in contrast to other consumer protection regulators (excl. safety)
- COBS permits estate erosion and intergenerational transfer
 - + extensive discretion ensures eligible P/Hs expect small share of estate
- FSA is effective negotiator through its 'fairness' judgement
 - PA obtains power indirectly from FSA

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Apart from being administratively difficult, any decision to try to bring a test case to clarify the law would have been appealed up to the highest court because of the financial consequences for all parties. By the time this was resolved many, possibly the majority, of the current policyholder group whom I represented would have left the funds. In this case, whatever the law, a bird in the hand is truly worth more than two in the bush. Any legal challenge could not realistically have come from the Policyholder Advocate.

What is the inherited estate and what is it for?



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Estate is magenta

Expected cost of guarantees dark navy blue



And asset shares aquamarine.

It has been pointed out that the colours are not easy to read for some people who are colour blind.

Estate is the safety net +

Estate is the excess of assets of fund over liabilities 

•Where liabilities are:

- policyholders' net investments 
- the expected cost of guarantees of in-force business 

•+ an allowance for future new with-profits business

–note: new business is expected to pay for:

- full cost of strain capital
- expected cost of guarantees
- but not for **additional security to cover bad times** (estate capital
 - which is what creates the new business subsidy (preference)
 - and results in intergenerational transfer

The surprise here is that the FSA also allows estate to be held back to cover the cost of guarantees for new business which are not ever charged for.

Many people think that it is strain capital which causes intergenerational transfer. It is not. The FSA requires companies to cover the cost of strain capital over the lifetime of the policy. Since the fund is fully compensated for this cost it does not cause any subsidy, or any intergenerational transfer. It is not charging new business for the use of estate capital which is both a subsidy to new business (preference) and the cause of intergenerational transfer.

The effect of the FSA COBS rules

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As the following slides show, the effect of the FSA COBS rules is overwhelming.

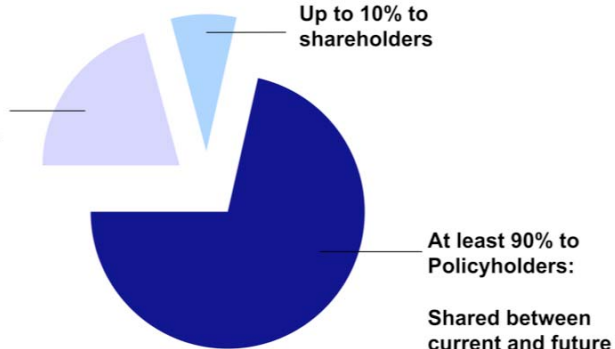
The impact is clearly material to current policyholders.

The following slides are based on the estate being at £1.2bn.

Expected division of estate if there were no reattribution

FSA concessions to shareholders beyond their '10%'

e.g. shareholder tax, misselling compensation, strategic assets,



- FSA concessions which go to shareholders:
 - permanently erode the estate
 - reduce capital which would otherwise have gone at some point to policyholders
 - erosion of the estate is a material detriment to policyholders
- Concessions are anti-competitive: funds without estates can't charge estate for these items

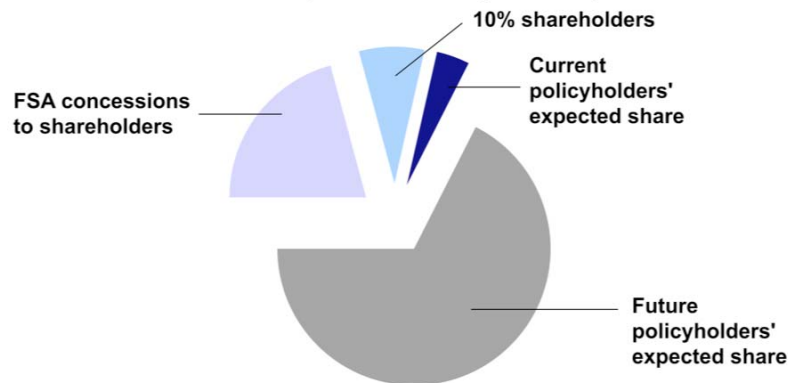
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Notes on FSA recent rules on estates not covered above:

- Over time companies must not add to estates, so asset share capital can't be used to add to an estate
- Broadly therefore an estate can't be 'grown' any more
- Over time the existing estate will be
 - either distributed through FSA concessions to shareholders which permanently erode the estate
 - Or distributed in special distributions
 - Insofar as the estate does not get paid out in FSA concessions to shareholders it will eventually go to policyholders
- Eventually the estate will not be able to provide the subsidy for new business that it currently does, and new business will have to pay the full cost of the estate capital it uses.
- Once new business is paying for the full cost that it imposes on the fund the effect of new business will be the same as if the fund were closed

Expected division of estate, no reattribution

– Aviva's base case: new with-profits business grows 5% pa from 2011



Most of estate goes to future policyholders who have no contract and hence no rights

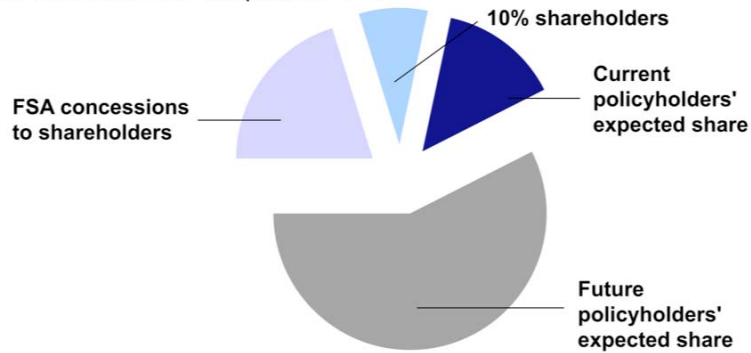
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Since discovering that under the FSA rules the majority of the estate was expected to go to future policyholders we have coloured their share as grey, reflecting their rather odd position of being 'ghosts at the feast'. Although these policyholders have no contract, and hence no rights (and no vote in a reattribution), they do have a very significant financial interest in the estate.

They are the ghosts with no legal rights but yet 'own' a substantial portion of the estate. In a reattribution this means that the rights being sold (to 90% of the estate) are not the same as the interests being sold (here around 5% of the estate). Given this difference, and since the FSA rules require the policyholder advocate to consider the reattribution offer against the benefits eligible policyholders are giving up, it is hardly surprising that the Policyholder Advocate had little to negotiate with unless the FSA lent support to her position.

Expected division of estate, no reattribution

– lower new business: -5% pa from 2011



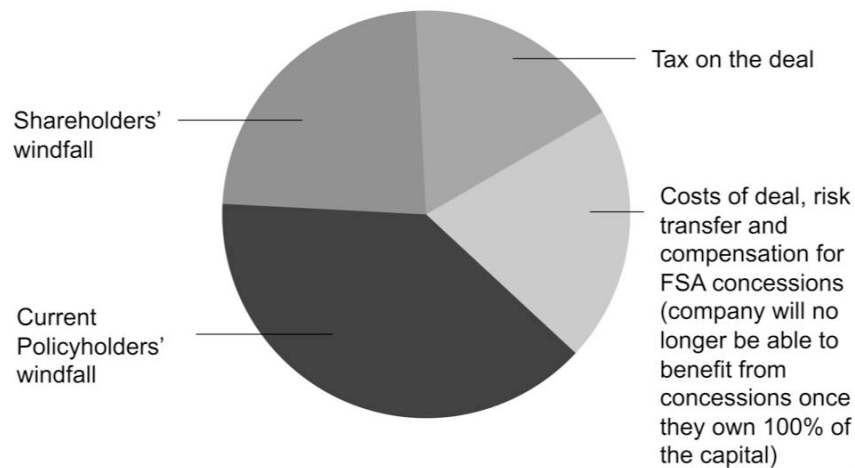
Lower new business means more goes to current policyholders and less goes to shareholders in FSA concessions, but more than 10%

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This is the same as the previous slide but with different assumptions about new business. This slide is based on new business falling by 5% a year as opposed to Aviva's base case which assumes that new business grows by 5% a year. It shows graphically that the more new business written, the less current policyholders' 'share' of the estate.

Even in this case future policyholders are expected to receive more than half the estate, and current policyholders a relatively small %age.

How future policyholders' share of estate is divided in a reattribution



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This slide shows how the money which would have gone to future policyholders (the ghosts) was actually used in the reattribution (base case).

A reattribution stops money going to future policyholders, so it is freed up and can be used to cover the tax and costs of the deal, as well as providing a windfall for shareholders and current policyholders.

The costs of the deal include compensation for shareholders for the FSA concessions to shareholders which shareholders will no longer be able to take advantage of once they own 100% of the estate.

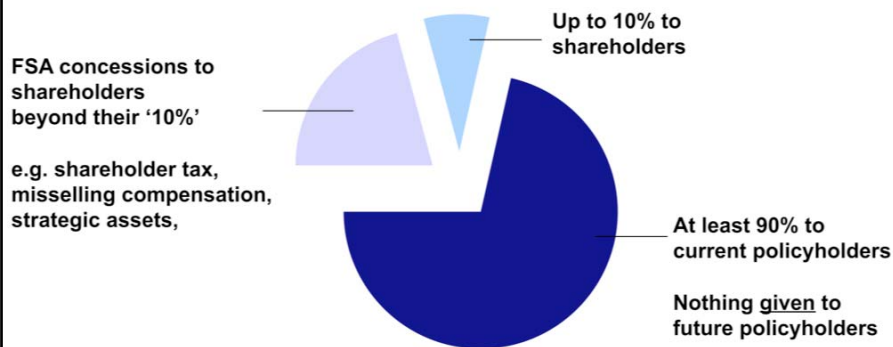
FSA Rules: Why much of inherited estate goes to future policyholders

- New with-profits policies with their guarantee promises
 - need capital to cover bad times
- FSA permits estate capital to be used without compensation
 - delays special distributions as capital is tied up and is therefore not 'excess'
 - any special distributions shared with new policies
 - results in current policyholders getting less
- Estate transferred from one generation of policyholders to next
 - each generation gains when their policy is set up
 - each generation may or may not get a special distribution
 - whatever remains is passed onto the next generation

FSA Rules: Effect of COBS permitting intergenerational transfer

- Not charging for the use of estate capital is anti-competitive
 - companies without estates have to charge this cost in order to be profitable
 - post reattribution companies will charge for use of reattributed estate capital
- Charging for use of estate capital would make investment in new business:
 - profitable for existing fund
 - special distributions for eligible policyholders nearly identical to closing the fund
 - stop most of the estate being vested in future policyholders
 - who have no contract and hence no rights
 - in a reattribution would match rights being sold to interests given up
- FSA said in a reattribution the expected value of the estate going to future policyholders
 - must be shared with eligible policyholders
 - did not give any indication of what it would view as 'fair'

Division of estate either in closed fund or if estate capital charged



- All of the policyholder share of the estate would go to current policyholders over the years
- Either if the fund were closed
- Or new policyholders charged for estate capital used to back guarantees in bad times

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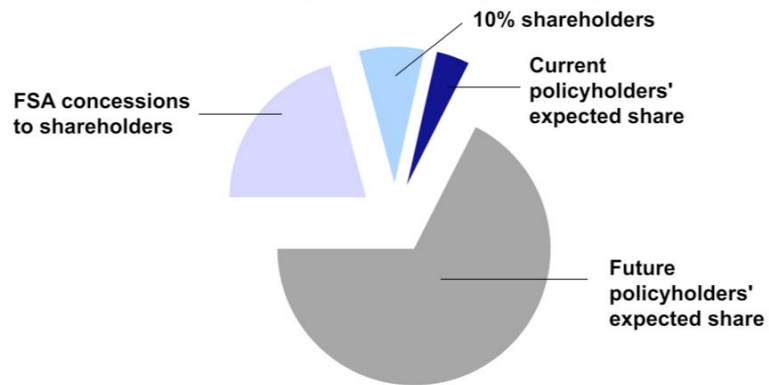
If new business is properly charged for the use of estate capital in backing their guarantees to cover bad times then there will be no intergenerational transfer, and all the estate will go to the current generation. The pattern of distributions would be very similar to that of a closed fund.

This makes sense. There should be no difference to policyholders whether the fund is open or closed.

However unless the COBS rules were amended, the FSA rules would still permit the company to use the estate to cover costs that if there were no estate shareholders would have to pay. There would still be erosion of estate value which would not go to policyholders but would be transferred to shareholders beyond their 'up to 10%'s'

Expected division of estate, no reattribution

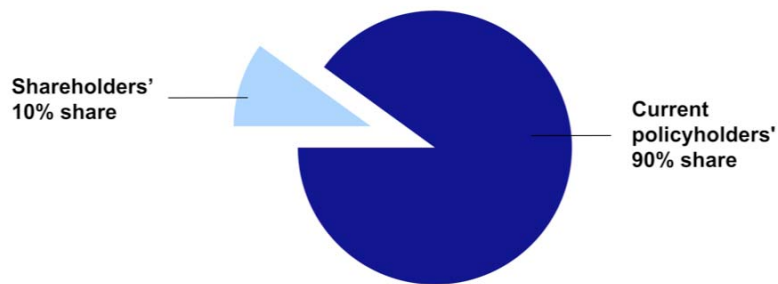
– Aviva's base case: new with-profits business grows 5% pa from 2011



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This is a repeat of any earlier slide showing just how much the rules which permit intergenerational transfer affect the value that current policyholders can expect to receive through special distributions from the estate.

What current policyholders would receive with economic regulation



This slide shows a pure 90:10 outcome where the FSA COBS no longer permitted concessions to shareholders which erodes the value of the estate for policyholders.

This is the outcome which economic regulation would ensure:

- Forward looking
- New business not subsidised
- No FSA concessions to shareholders allowing shareholders to take more than 'up to 10%' out of the estate
- Pro-competitive rules compatible with competitive outcomes

Although an economic regulatory approach would ensure that the company had no incentive to hold an excessive estate, or to hold an excessively risky approach to investments backing guarantees, this would only be the case if the rules and principles were being followed in practice.

it would still require regulatory oversight and enforcement to ensure that new business was being properly priced and erosion of the estate was not happening.

Changing the rules is not enough. Governance and transparency has to improve as well.

With-profits - why was there a special distribution in 2008?

- FSA insisted reattribution done on likely asset strategy post a reattribution
 - company likely to be significantly more risk-averse once own 100% of estate
 - assets backing guarantees expected to be de-risked
- FSA intervention resulted in one-off change to investment strategy early 2008
 - mimicking how company likely to invest capital backing guarantees post reattribution
- Capital backing guarantees moved to less risky places
 - e.g. Gov. Bonds, dynamic hedge against equity losses
- Resulting in less capital needed in estate to cover guarantees in case of bad times
 - exposed significant excess surplus capital in the estate in Jan/Feb 2008
- Resulted in February 2008 special distribution
 - worth £2.1bn to P/Hs in added bonuses - paid in three tranches: 2008/9/10
 - nearly half of policyholders' share of estate

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The special distribution happened because the FSA agreed with the policyholder advocate that the fairness assessment of the reattribution offer should be made on the basis that the assets backing guarantees were de-risked (treated as if that money was already owned by shareholders). This is the band shown in earlier slides as dark navy blue.

If this had not been done, the company could have changed its approach to investment immediately after the deal was completed, and with the same risk appetite released a large amount of capital from the estate. Instead this happened before the deal was done so this excess capital could go out 90:10 to policyholders.

Given that policyholders are more risk averse than shareholders this should be the minimum standard without a reattribution.

In other words the FSA should not permit companies to increase the riskiness of these assets beyond that shareholders would accept, and as a result create the need for a much bigger estate.

During 2007 Aviva decided to de-risk the assets backing the cost of guarantees. The special distribution announced in Feb. 2008 released around half the estate showing just how powerful the choice of investment strategy is in determining the size of estate. This should not be a choice left to company discretion while the FSA rules create incentives to hold large estates.

The Outcome

- Overall policyholders have received:
- An offer of over 40% of the inherited estate from the reattribution
- Plus £2.1 billion from the special distribution in 2008/9/10
- Or a total of 70% of the inherited estate overall
- Without reattribution policyholders expected to get 5–10% of the estate (base case)
- Both shareholders and current policyholders have received windfalls under the current rules
- 85% of policyholders accepted the offer
- AXA 2000 - policyholders received 30% overall (20% from reattribution)

Aviva post reattribution - Shareholders own the reattributed estate

- Aviva will act as if the COBS rules were rewritten by an economic regulator
 - capital is 100% owned by the company

- S/Hs get no benefit beyond '10%'s' from COBS rules allowing them to use estate
 - have no incentive to 'misbehave' going forward
 - NB: company has been compensated for value of losing benefit of FSA concessions

- Will write new business if it makes commercial sense for shareholders
 - charge new business for the cost of using capital in the estate

- Choice of riskiness of assets backing guarantees set by Company
 - less risky choices than when policyholders effectively paid for 90% of risk

- Aviva will behave as if COBS rules were rewritten to be pro-competitive,
 - others with 90:10 estates will still be able to take advantage of the existing COBS
 - and they will continue to use COBS to their advantage to erode and transfer estates

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Aviva will act just as an economic regulator would want after a reattribution when they own the reattributed estate capital 100% (subject to good governance).

The same standards should be applied when the estate is within a 90:10 fund.

How an economic regulator would change the rules

- Review COBS to ensure that compatible with competitive behaviour
 - no estate erosion
 - no preference or discrimination

Specifically:

- Change 'no material detriment' everywhere to 'material benefit to in-force policyholders'
- Do not permit the estate capital to be used differently from the rest of the fund
 - either it is an appropriate expense for the fund or it is not
- Do not permit new business to be subsidised.
- ensure permitted only if to the material benefit of the fund and in-force policyholders

How an economic regulator would change the rules: **Governance**

- Review Governance in light of management conflicts of interest and COBS incentives
- COBS written pro-competitively requires pro-active monitoring and enforcement
- Where COBS is not written pro-competitively
 - incentives will be clearly misaligned
 - requiring more intrusive pro-active monitoring and enforcement

Specifically:

- Transparency - ensure external scrutiny from policyholders and other 3rd parties :
 - annual reports of substance from board, WPA and WPC to policyholders
 - 'Red hand' uses of estate and implications of company discretion in CFPPFM
 - report to include management of funds, uses of estate and exercise of discretion
 - e.g. levels of new business including effect on current policyholders' expectations