

The policyholder advocate's supplementary report

A report by the office of the policyholder advocate in
connection with the reattribution of the inherited estates
of the CGNU Life and CULAC with-profits funds

3 September 2009

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This supplementary report was first published on 3 September 2009. This copy of the report is a revised version correcting various minor errors which was published on 7 September 2009.

Summary and conclusions

Introduction

The policyholder advocate's June 2009 report on the proposed reattribution of the with-profits funds of CGNU Life and CULAC explained that the policyholder advocate expected to produce a supplementary report which would be made available to the Court and on the policyholder advocate's website. The purpose of the supplementary report would be to update policyholders and the Court on various matters, including KPMG's review of Aviva's calculation of the value of the inherited estates at the Effective Date of the proposed reattribution; the analysis by LECG, using updated end 2008 data supplied by Aviva, of the reattribution offer; and the policyholder advocate's reassessment of her guidance to groups of policyholders.

Chapter 1: Size of the inherited estates

KPMG's review

1. KPMG notes that Aviva's RBS 31 May 2009 valuation of the combined CGNU Life and CULAC inherited estates was £1,055 million. However, the valuation of the inherited estates as at the Effective Date of 1 October 2009 (the Reattribution Estate), which will be used to determine Aviva's aggregate policyholders incentive payment (PIP), will roll forward the 31 May 2009 valuation and be based on the unweighted average of the inherited estate values as at 30 June, 31 July and 28 August 2009 (plus two months' interest). KPMG reports that the provisional values at 30 June and 31 July are £1,174 million and £1,257 million respectively. Aviva's final review of these figures is expected to be completed by 8 September. The provisional 28 August valuation is expected to be made available by Aviva during the High Court hearing, which is due to commence on 14 September 2009.

2. The value of the inherited estates has reduced significantly since the year-end 2008 valuation of £1,570 million. KPMG's analysis has revealed that a significant amount of the reduction was due to lower property values (down 15 per cent in the UK and 17 per cent in Europe) which reduced asset share values and thus considerably increased the cost of meeting policyholders' guaranteed benefits. Changes in equity values played a limited part

in the reduction of the inherited estates, as the inherited estates held few equity assets and Aviva had also hedged the impact of equity risk on the cost of meeting policyholders' guarantees. Movements in fixed interest yields and index-linked government securities also reduced the value of the inherited estates significantly since the end of 2008.

3. KPMG's assessed levels of prudence and other adjustments in Aviva's 31 May 2009 RBS inherited estates total £174 million, making the total valuation of the estates at 31 May 2009, for the purposes of the policyholder advocate's evaluation of Aviva's PIP offer, £1,229 million (Aviva's valuation of £1,055 million plus £174 million). This compares with KPMG's assessment of prudence and other adjustments in the 2008 year-end RBS valuation of £177 million which, added to the £1,570 million RBS valuation, gave a total estate value of £1,747 million as at end 2008, which the policyholder advocate used in her June 2009 report as the basis of her evaluation of Aviva's reattribution offer. KPMG considers that such prudence, whilst appropriate in the RBS valuation for FSA solvency purposes, is inappropriate for the purpose of estimating the value of potential special distributions from the inherited estates which underlies the policyholder advocate's assessment of Aviva's reattribution offer, including her guidance to policyholders as to whether the offer is in their interests.

4. In addition, KPMG advised that Aviva's 31 May 2009 RBS valuation of the inherited estates is inappropriately calculated in respect of Aviva's adjustment to the valuation to ensure that new with-profits business previously sold does not result in electing policyholders being worse off due to the sale of this new business. KPMG considers that, in order to ensure that policyholders who choose to elect are not worse off due to the sale of new business during 2008 and 2009, Aviva should make a positive adjustment to its value of the inherited estates at 31 May 2009 for the purposes of valuing the Reattribution Estate (which will determine Aviva's aggregate PIP payment) of approximately £20 million.

Policyholder advocate's comment

5. The policyholder advocate has been informed by the FSA that in its view, in arriving at the value of the inherited estate for the purpose of calculating the PIP, the FSA

agrees with KPMG that, in the absence of convincing arguments to the contrary, Aviva should make the adjustment with respect to the new business subsidy as set out above.

6. The policyholder advocate has taken account of the total KPMG adjustment of £174 million in her analysis of the offer.

7. Aviva has taken account of only £100 million in its analysis of the offer. The policyholder advocate is aware that Aviva believes the £174 million identified by KPMG is at the higher end of the range of prudence and other adjustments that may exist.

Nevertheless the policyholder advocate considers that Aviva should take account not only of the £20 million new business subsidy discussed above, but it should also take some account of the balance of £54 million which remains the difference between Aviva's adjustments (assuming Aviva take account of the £20 million) and KPMG's adjustment.

Chapter 2: Aviva's 2008 data update

Introduction

1. Both the policyholder advocate's June 2009 report (chapter 33) and her guidance booklet (page 6), which was sent by Aviva in its voting pack to all eligible policyholders, explained that the data which the policyholder advocate had used to inform her guidance to policyholders had been provided by Aviva based on policies in force on 21 November 2006. It was also explained that during the summer the policyholder advocate would be checking her guidance against year-end 2008 data produced by Aviva and, 'If this results in any significant change to her present guidance, Aviva intends to enable the relevant policyholders to decide whether or not to change their vote' (para 33.20 of the June report). A summary of conclusions, based on this updated year-end 2008 data, is presented below.

Policyholders' aggregate potential future special distributions

2. In the analysis undertaken using year-end 2006 data, in all cases Aviva's aggregate PIP offer exceeded LECG's estimate of the potential special distributions to eligible policyholders. Using the year-end 2008 data with an assumed estate value of £1,200 million as at 1 October 2009 under Aviva's new business assumptions, Aviva's aggregate PIP offer of £500 million still far exceeds estimated future special distributions to eligible policyholders of £55 million. This effect holds true (though to a less significant effect)

across all the other estate and new business assumptions and therefore the policyholder advocate's first criterion¹ continues to be satisfied.

Policyholders' share of the residual value of the reattributed inherited estates

3. Eligible policyholders are projected to receive all of their projected special distributions, plus 63 per cent of the residual value of the estates under Aviva's new business assumptions, for an assumed estate value of £1,200 million. This compares to a figure of 60 per cent using the 2006 data. Therefore the policyholder advocate's second criterion² continues to be satisfied in the year-end 2008 data.

Aviva's shareholders' internal rate of return (IRR)

4. LECG has also estimated shareholders' IRRs arising from the reattribution against the year-end 2008 data. LECG has calculated that the IRR for shareholders from the reattribution is 9.0 per cent with an assumed estate value of £1,200 million, using year-end 2008 data, compared with 10.3 per cent using year-end 2006 data. The main reason for the decrease in the IRR to shareholders is the decrease in Aviva's forecast of the expected net return on the fund. However, the shareholder IRR has decreased by less than the fund rate, implying a proportionate increase in the level of profit to shareholders from the reattribution. Aviva has stated it is not revising its original estimate of a shareholder return of 8.2 per cent from an estate of £1,200 million, based on year-end 2006 data. In addition, in a presentation to analysts in May 2009, Aviva quoted a shareholder IRR of 13.5 per cent from an estate of £1,250 million.

Allocation of the PIP

5. Under Aviva's new business assumptions with an assumed estate value of £1,200 million, over 96 per cent of policyholders are offered a PIP allocation greater than potential future special distributions. This proportion is effectively the same when using the year-end 2008 data compared with the year-end 2006 data, therefore no alterations to the conclusions of LECG's analysis are necessary.

¹ That, in aggregate, eligible policyholders receive a PIP that is at least equal to their estimated potential special distributions across a range of new business assumptions and estate values.

² That eligible policyholders receive at least 50 per cent of the residual value of the inherited estates under Aviva's new business assumptions.

Guidance to policyholders

6. The policyholder advocate's conclusion on the guidance to policyholders is therefore that:

- there are no significant changes to the guidance that was given to policyholder groups 1 (regular premium policies with a maturity or surrender date up to and including 2016), 2 (single premium policies with no fixed maturity) and 3 (regular premium policies with a maturity or surrender date between 2017 and 2021) and therefore we recommend that no new guidance be issued; and
- there are more significant changes to guidance for eligible policyholders in group 4 (regular premium policies with a maturity or surrender date beyond 2021). However, due to immaterial differences between distributions in later years and the high degree of volatility around break-even years depending on the assumptions made, we believe it is not necessary to reissue the guidance.

New business sensitivity analysis

7. LECG has analysed Aviva's PIP offer using four new business assumptions, three of which rely on Aviva's forecasts until the end of 2010, applying the following assumptions thereafter: (i) a 5 per cent increase per annum (Aviva's assumption); (ii) a 5 per cent decrease per annum; and (iii) a 15 per cent decrease per annum. Aviva has provided actual new business sales for the first half of 2009 and forecasts for the remainder of the year. These figures show that in the first half of 2009, Aviva withdrew its Inflation Protected Guarantee bond option ("IPG bond"), which accounts for a significant portion of the annual projected sales in 2009. Additionally, to meet Aviva's new business assumption for 2009, remaining sales of other bonds and pensions would have (and Aviva projects them) to be significantly higher than in the first half of the year. Aviva has not provided any rationale for why the sales of pensions and other bonds are forecast to significantly increase in the second half of 2009. Therefore, LECG's position is that Aviva should review its new business assumptions for 2009 and 2010 and adjust them based on actual

experience. Aviva has stated it is not revising those assumptions. LECG has therefore considered an additional new business sensitivity beginning with 50 per cent of Aviva's new business assumption in 2010 and applying Aviva's assumption of 5 per cent annual growth thereafter.

Higher investment returns sensitivity analysis

8. LECG also performed its analysis assuming investment returns that were approximately 0.5 per cent higher than assumed in Aviva's 2008 data in each year of the projection period. This analysis illustrated that the position of eligible policyholders is not materially affected.

Chapter 3: Safeguarding the value of potential special distributions to non-electing policyholders: re-assessing Aviva's Old WPSF 'safety net'

Introduction

1. Aviva, the FSA and the policyholder advocate are agreed that overall non-electing policyholders should not be disadvantaged by the reattribution. This is an important principle which the policyholder advocate has sought to maintain across a broad range of scenarios, and Aviva has agreed to top up the inherited estate of the Old WPSF with up to £100 million from the RIEESA to preserve the value of non-electors' potential future special distributions (referred to by Aviva as their VPDP) in the event of an estimated shortfall. The basis for calculating VPDP in context of assessing the position of non-electors or the adequacy of the safety net mechanism rests with Aviva and is not entirely resolved within the AFH report or the Scheme. Aviva has stated it will be providing a supplementary letter to the AFH report and a further witness statement in the High Court, detailing the revised methodology for determining the VPDP of non-electors in its calculation of the safety net payment.

2. For the policyholder advocate's June 2009 report, LECG reviewed Aviva's analysis of the position of non-electors and concluded that Aviva's 'safety net' was likely to preserve non-electors' potential future special distributions at a level similar to what they would have been without a reattribution assuming that 95 per cent of policyholders

accepted the offer of the PIP. Aviva has since re-addressed the adequacy of its proposed 'safety net', in the light of eligible policyholders' voting patterns, and LECG has also reviewed its analysis for the policyholder advocate.

LECG's analysis

3. Due to a lack of data, LECG is unable to accurately model an Old WPSF to estimate non-electors' VPDP post-retribution. Therefore, LECG and the policyholder advocate have reviewed Aviva's methodology for assessing the safety net and have requested changes to ensure the protection of non-electors is properly considered.

Based on feedback from the policyholder advocate's road shows and the logic behind the policyholder advocate's guidance, it became apparent that policyholders were likely to 'self-select', and vote according to their expectations about the future. This implies that policyholders who do not intend to surrender their policy for a number of years are more likely not to elect to take the PIP and therefore that the average persistency in the Old WPSF could be significantly higher than in the New WPSF. A review of Aviva's initial analysis revealed that it grouped fixed maturity policies according to outstanding term and grouped similar bonds into categories which were then treated homogeneously. This analysis did not take self-selection into account, as bond holders who leave the funds in the next five years were deemed to have the same VPDP per pound of asset share as bond holders who remain in the funds for 25 years.

4. Therefore, the implication for Aviva's initial analysis is that to the extent there is self-selection in policyholder voting, the VPDP of non-electors absent a retribution, particularly for open maturity bond holders, is likely to be understated and consequently the estimated safety net payment required will also be understated. As a result, LECG and the policyholder advocate suggested that Aviva use the voting patterns for fixed maturity policyholders as a proxy for the voting behaviour of open maturity policyholders.

5. Based on the policyholder advocate's concerns, Aviva has revised its method for calculating the VPDP of non-electing open maturity policyholders and applied its new method to the latest profile of votes received as at 21 August 2009; Aviva's projections

based on these figures suggest that 15 per cent of total policies may be considered non-electors and will be transferred to the Old WPSF. Aviva has conducted its analysis based on these projections and on the same 10 per cent annual decline in new business from 2011 onwards that was used when the safety net was assessed for the purposes of the policyholder advocate's June 2009 report.

6. Aviva's analysis suggests that with the policyholder advocate's and Aviva's preferred approach, an additional payment of £15 million is required as a result of taking into account self-selection in Old WPSF lapse rates, at a Reattribution Estate of £1.2 billion. Aviva has stated that given current voting patterns it does not believe that any shortfall in the Old WPSF calculated on base lapse assumptions for all policies (that is excluding the 'self-selection' bond issue) would amount to more than £80m. LECG's review of actual voting results indicates that there is a general increase in the proportion of non-electors as outstanding term increases, but without any large fluctuations that would indicate a bias towards an extreme voting scenario that may result in a greater shortfall than in Aviva's previous scenarios. Additionally, an element of randomness and 'no' voting for open maturity policies with Market Value Reduction ("MVRs"), as explained further in Chapter 3, serves to reduce any potential safety net issue.

7. LECG and the policyholder advocate are satisfied with the changes Aviva has made in calculating non-electing policyholders' VPDP and believe that the new basis reflects an appropriate approach to ensuring the position of non-electing policyholders is preserved and one on which the adequacy of the safety net can properly be assessed. The policyholder advocate is therefore still satisfied that the potential future special distributions of non-electing policyholders will be broadly maintained across a range of scenarios post-reattribution.

Chapter 4: The Scheme and non-electing policyholders – issues in the policyholder advocate's report

1. At the time of writing the June 2009 report there were a small number of Scheme or Scheme related provisions where Aviva had agreed in principle to the policyholder

advocate's position, but the details remained to be agreed. These have now been finalised to her satisfaction.

2. She had also identified a number of other Scheme provisions where she had requested amendments which had been rejected by Aviva. There have been no further developments in relation to any of these and so the position remains unsatisfactory.

Chapter 5: With-profits governance – issues in the policyholder advocate's report

1. The policyholder advocate is particularly concerned that the governance framework which applies after the effective date is adequate to protect the interests of those policyholders who have chosen not to elect for the PIP, hoping to do better in the long term through remaining invested in the Old WPSF and receiving special distributions from excess surpluses in the Old WPSF estate.

2. Noting the inherent conflict that the board of the company faces between the interests of shareholders and those of with-profits policyholders, and the incentive to under-distribute that is caused by FSA rules which allow estate monies to be used to pay expenses that would otherwise be borne by shareholders, the policyholder advocate has pressed for improvements in the governance structures proposed by Aviva.

3. In particular she is concerned that neither the With-Profits Committee (WPC) nor the With-Profits Actuary (WPA) are sufficiently accountable to policyholders. The essential problem is that the institutional structure of the WPC cannot be relied upon to protect policyholders' interests unless its activities are made subject to regular external scrutiny, which underscores the need for adequate transparency (similar concerns arise in the case of the WPA). The policyholder advocate believes that the most effective way to ensure that both WPC and WPA maintain an independent approach that prioritises policyholder interests is if they have to justify their decisions to policyholders directly.

4. In particular she has pressed Aviva to agree to an annual report to policyholders by the WPA (accompanied by one from the WPC) which, as well as commenting generally on the conduct of his role in the year in question would include (a) an analysis of the uses of

the Old WPSF inherited estate over the year, the justification for those uses, and an analysis of the size of the estate and its movement over the year; (b) information separately regarding the management of the Old WPSF, new business and the justification for investment decisions made; and (c) a commentary on the strength of the fund and of the likelihood of special distributions and of any special distributions made during the year.

5. Aviva has not agreed to this. They do not consider the policyholder advocate's suggestions to be necessary changes to be made at this stage, but will keep them under review whilst monitoring their own approach to policyholder communications. They express their intention to continue to operate in accordance with FSA rules regarding communications to policyholders.

6. In the policyholder advocate's view, this response does not take into account the fact that a scheme will exist or the special circumstance that non-electors have made their decision on the basis of expected special distributions, and where (as explained above) the company has incentives that militate against those special distributions being made. Non-electors need a counter balance to this incentive, and while it is true that the FSA has powers that could protect them, the policyholder advocate considers that a more effective counter-balance would be transparency obligations such as those discussed above.

Chapter 6: KPMG comments on the reports of the Actuarial Function Holder (AFH), the With-Profits Actuary (WPA) and the Independent Expert

The Independent Expert's supplementary report

1. The Independent Expert has provided his updated assessment of the effect of Aviva's proposals on policyholder security and benefit expectations based on unaudited information as at 30 June 2009.
2. The Independent Expert has not changed any of his conclusions in light of the change in strength between the funds.
3. KPMG has no reason to disagree with the Independent Expert's conclusions.

4. The Independent Expert has not changed his conclusions in respect of the governance around the charging of industry levies to asset shares and our comments in the policyholder advocate's June 2009 report stand.

5. Section 11 of the Independent Expert's supplementary report sets out responses to the main arguments put forward by policyholders.

The AFH's supplementary report

6. The AFH has provided a supplementary report which considers whether any of the conclusions set out in the AFH report need to be changed in light of developments that have taken place since that report was finalised.

7. The AFH considers the fact that the financial strength of CULAC was stronger than that of CGNU Life at 30 June 2009, and goes on to explain some of the reasons for this development.

8. KPMG has no reason to disagree with the AFH's conclusions.

9. Regarding the impact on holders of non-elected policies, the AFH states that in view of the concerns expressed by the policyholder advocate about the potential for non-electors experiencing lower lapses than electors which would invalidate their VPDP calculation, the Board have agreed that, when determining the VPDP Adjustment, an allowance will be made for the possibility that the lapse rates for Non-Elected Bond policies would have been lower than those for Elected Bond policies (and so VPDP would increase). The AFH states that Aviva and the policyholder advocate are currently discussing how this might best be achieved using information obtained from an analysis of the outcome of the election and that the results of those discussions are expected to be concluded and the agreed proposals put to the High Court prior to the Court Hearing on 14 September 2009. (These discussions have now concluded and KPMG understands that this will be addressed in a supplementary letter produced by the AFH.)

10. The AFH has considered the impact of other recent developments since the date of his report and has not changed the conclusions in his report. One development is that an

amount equal to the Old WPSF Proportion of the 2007 new business subsidy should be transferred from the RIEESA to the Old WPSF immediately after the Effective Date.

11. Although KPMG notes that the transfer to be made from the RIEESA to the Old WPSF in respect of the 2007 new business subsidy serves to reduce the strength of the RIEESA in the New WPSF we do not believe this to be material enough to lead to a change in the AFH's conclusions.

12. KPMG notes here that the AFH has not updated his views in respect of KPMG's areas of disagreement on the AFH report and so KPMG's comments stand. In particular KPMG's comments relate to the fact that the power to allocate some or all of future industry levies to asset shares has been introduced, and is solely for the Board to determine without the power of veto from the WPC on the charging of these levies to asset shares, and the fact that KPMG does not agree that the remaining assets of the Old WPSF should be invested in any form of strategic asset.

The WPA's supplementary report

13. The WPA has provided a supplementary report which considers whether any of the conclusions set out in the WPA report need to be changed in light of developments that have taken place that report was finalised.

14. The WPA considers the fact that the financial strength of CULAC was stronger than that of CGNU Life at 30 June 2009, and concludes that the conclusions in his report do not need to be changed.

15. KPMG agrees that the WPA's conclusions do not need to change.

16. The WPA has considered the impact of recent developments since the date of his report: KPMG agrees that of the recent developments commented on by the WPA, there is no reason for the WPA to change his conclusions.

17. KPMG notes however that a recent development not considered by the WPA in his conclusions is the fact that Aviva stopped selling with-profits business with inflation-linked guarantees in April 2009. We believe that the WPA should have considered whether

this may have an impact on the levels of expected future new business which in turn could impact the VPDP calculations. He has not done so.

18. In appendix 18B to the policyholder advocate's June 2009 report KPMG commented on a number of areas on which it disagreed. The WPA has not changed his views in these areas. In particular the same comments noted above in the comments on the AFH supplementary report regarding industry levies and strategic assets are relevant here.

Chapter 7: Communications with policyholders

1. Since the beginning of June 2009 the policyholder advocate has undertaken a major communications effort to help policyholders understand the issues that had been addressed in her negotiations with Aviva. The communications have been designed to allow policyholders the opportunity to examine the issues at an overview level or at increasing levels of detail depending on their concerns.

2. A policyholder-friendly guidance booklet was sent to eligible policyholders and made available on a new policyholder advocate website, which also contained her June 2009 report, questions and answers, a video question and answer session with the policyholder advocate, other supporting materials, a booking facility for roadshows and some details of the roadshow presentations. The roadshows took place in ten towns and cities. At each a presentation by the policyholder advocate was followed by questions and answers from attendees. Key issues raised at the roadshows are listed in chapter 7 and in chapter 8 there are responses from the policyholder advocate. Film of one of the roadshows together with selected questions and answers from a number of different roadshows were also posted on the website.

3. A call centre and a correspondence facility were available to help policyholders.

Chapter 8: Objections and complaints received from policyholders

The policyholder advocate has received a number of questions, objections and complaints from policyholders, variously in written correspondence including formal objections to the reattribution, at her call centre and during her roadshows. The policyholder advocate has identified certain key issues arising from this correspondence as well as from objections to

the reattribution which have been received by Aviva. The policyholder advocate's comments on those issues are set out in chapter 8.

Presentation of information

Certain sections of the supplementary report have been prepared by Aviva. These are indicated with a vertical bar in the left hand margin of the relevant section (that bar is yellow for those viewing a colour copy of this report or light grey for those viewing a black and white copy).

Certain information in this report and its associated annexes has been redacted (i.e. blanked out). This has been a requirement of Aviva, in order to prevent the public disclosure of information which Aviva believes is commercially sensitive. In some cases, information which is not regarded by Aviva to be commercially sensitive has been redacted in order to prevent the readers from deriving information which Aviva believes to be commercially sensitive. The policyholder advocate does not agree that this information is commercially sensitive and believes that the redactions are inappropriate and unnecessary.

The policyholder advocate has tried to ensure that the report is as accessible as possible but given the considerable complexity of the reattribution, some parts of the report are likely to be more readily understandable to readers who have some familiarity with the concepts involved.

A glossary of certain abbreviations used in this supplementary report can be found at Annex 3 of the policyholder advocate's June 2009 report. In addition, where technical terms are used in the report, they are generally explained in the context in which they are used.

Introduction

The policyholder advocate's report on the proposed reattribution of the with-profits funds of CGNU Life and CULAC was published in June 2009. That report pointed out that the policyholder advocate expected to produce a supplementary report before the High Court hearing which would be made available to the Court and on the policyholder advocate's website. It was explained in the policyholder advocate's report (paragraph 2.10) that the main reasons for producing this supplementary report would be to explain the outcome of KPMG's review of Aviva's calculation of the value of the inherited estates at the Effective Date of the proposed reattribution and of LECG's updating of its analysis of Aviva's reattribution offer using end 2008 data supplied by Aviva.

This supplementary report deals with both the above matters (in chapters 1 and 2 respectively). It also provides additional information on various other issues. Chapter 3 discusses a re-evaluation of the adequacy of Aviva's 'safety net', designed to protect the position of non-electing policyholders in relation to potential future special distributions from the inherited estate of the Old WPSF; chapter 4 provides an update on the issues of concern to the policyholder advocate, as set out in her June 2009 report, relating to Aviva's Scheme and the position of non-electing policyholders; chapter 5 similarly discusses issues in the policyholder advocate's June report, dealing with with-profits governance arrangements; chapter 6 comments on the supplementary reports of the Actuarial Function Holder (AFH), the With-Profits Actuary (WPA) and the Independent Expert (IE); chapter 7 updates communications with policyholders, including feedback from the roadshows conducted by the policyholder advocate in June-July 2009; chapter 8 concerns questions, objections and complaints received from policyholders. Annexes 1 to 5 provide additional information on the matters covered in this report.

In producing this supplementary report, the policyholder advocate worked closely with her advisers on all the issues that had to be addressed in order to provide an update to her June 2009 report. This supplementary report expresses her own views, where necessary after consultation with her advisers. Where views are expressed by advisers, the policyholder advocate is in agreement with them.

Chapter 1: Size of the inherited estates

Introduction

1.1 As described in chapter 23 of the policyholder advocate's June 2009 report, KPMG, as the policyholder advocate's actuarial advisers, consider that Aviva's valuation of the inherited estates of CGNU Life and CULAC, calculated in accordance with FSA requirements for the realistic balance sheet (RBS) is a prudent valuation of the funds' liabilities and that some adjustments are appropriate to establish an estate valuation which is more relevant as a basis for the policyholder advocate's assessment of Aviva's reattribution offer.

1.2 KPMG has updated to 31 May 2009 its analysis for this purpose of the size of the inherited estates as at end 2008, which was summarised in the policyholder advocate's June 2009 report. The policyholder advocate has used KPMG's revised valuation of the inherited estates at mid 2009 to re-assess Aviva's reattribution offer against Aviva's updated 2008 data, as described in chapter 2 below.

1.3 In addition, KPMG has reviewed the approach used by Aviva to calculate the Reattribution Estate. The size of the policyholder incentive payments that will be made to policyholders who elect to accept Aviva's reattribution offer will depend on the valuation of the combined CGNU Life and CULAC inherited estates close to the Effective Date of the reattribution (called the Reattribution Estate). Aviva has proposed that the Reattribution Estate be calculated by Aviva using an unweighted average valuation of the CGNU Life and CULAC inherited estates across three consecutive months prior to the Effective Date (as detailed in the Actuarial Function Holder's report, para 3.2). If the Effective Date is 1 October 2009, as proposed by Aviva, a realistic balance sheet valuation of the inherited estates will be performed as at 31 May 2009 and rolled forward to 30 June, 31 July and 28 August 2009. The unweighted average inherited estates' valuations as at 30 June, 31 July and 28 August will then be increased by two months' interest to allow for the period to the Effective Date.

1.4 Prior to the publication of the policyholder advocate's June 2009 report, KPMG considered the approach proposed by Aviva to the calculation of the Reattribution Estate.

KPMG concluded that it was comfortable with the approach, provided that no unjustified changes to the methodology or assumptions are made between the 2008 year and 31 May 2009, and provided that any changes are made which KPMG would expect (for example, due to changes in the economic environment).

1.5 At the time of writing the policyholder advocate's June 2009 report, detailed discussions were still in progress between Aviva, the FSA and KPMG on behalf of the policyholder advocate, as to the exact nature of the assurances around the setting of assumptions and methodologies used in Aviva's calculation of the 31 May 2009 realistic balance sheet valuation of the CGNU Life and CULAC inherited estates. It was therefore stated in the policyholder advocate's June 2009 report (para 3.5) that KPMG's review of the assumptions and methodologies used in Aviva's calculation of the Reattribution Estate, compared with those used for the end 2008 realistic balance sheet valuations would be published in the policyholder advocate's supplementary report.

1.6 A summary of KPMG's findings is set out below, following a summary of Aviva's evaluation. Further details of Aviva's evaluation and KPMG's review are given in annexe 1.

Aviva's evaluation

1.7 The valuation of the inherited estate on which payment of the Policyholder Incentive Payment (PIP) is made to eligible policyholders who elect to accept the offer will be calculated using an unweighted average valuation of the CGNU Life and CULAC inherited estates at 30th June 2009, 31st July 2009 and 28th August 2009 (the "Reattribution Estate").

1.8 In practice these valuations will be performed using the methodology Aviva employs for its interim valuation reports each year – which means that a realistic balance sheet calculation for CGNU Life and CULAC will be performed as at 31st May 2009 and then a balance sheet economic impact projection applied. The balance sheet economic impact projection methodology has been reviewed by Aviva's external auditors and agreed with both FSA and the policyholder advocate.

1.9 For PIP payments this methodology will be used to derive the Reattribution Estate. The Reattribution Estate figure will be increased by two months interest using the London Interbank Offered rate (LIBOR) applying on 31st July 2009 to allow for the period to the Effective Date (assumed to be 1st October 2009).

1.10 There are a number of factors which together have an impact on movements of the inherited estate, these include:

- Investment mix and returns on the assets backing asset shares;
- Investment mix and returns on the assets backing the inherited estate;
- The projected value of non-profit policy liabilities and the assumptions made in their calculation;
- The projected cost of guarantees, policy options and promises and the assumptions made in their calculation.

Investment mix

1.11 The investment strategy for the CGNU Life and CULAC funds is described in the PPFM. The investment strategy aims to provide the highest long-term returns balanced against acceptable levels of solvency risk.

1.12 The funds are invested in a range of assets. Investment returns are benchmarked against indices, such as the FTSE All Share Index (UK equities), the FTSE World Europe (ex UK) Index (European equities) and the IPD Life and Pension Funds Index (UK property).

1.13 The investment strategy for the inherited estate can differ from the rest of the fund. Usually, the vast majority of the investments are the same as asset shares, consistent with the preferred management approach and strategy of investing in growth assets.

1.14 The Risk Appetite Framework that applies to CGNU Life and CULAC does envisage that the investment strategy of the inherited estate would be used as a mechanism

to control the level of risk in the fund, and in particular that the mix of assets would be altered to reduce risk in adverse conditions.

1.15 Consistent with this, and in response to the continued market volatility, the asset mix for the inherited estate was changed in 2008 so that less is invested in equities. This has the effect of making the value of the inherited estate less volatile, but it does not stop the size of the inherited estate varying.

Inherited Estate Valuation at 31st May 2009

1.16 Since the 31st December 2008 Realistic Balance Sheet valuation:

- Assets of the CGNU Life and CULAC with-profit fund reduced in value by £1,464m;
- Liabilities estimated for the CGNU Life and CULAC with-profit fund reduced more slowly by £967m;
- As a consequence, the value of the CGNU Life and CULAC inherited estates reduced by £498m to £1,031m at 31st May 2009.

1.17 This movement is analysed in more detail below. Further information is also provided on post reporting adjustments that have now been applied which bring the value of the inherited estate to £1,055m³ at 31st May 2009. This higher valuation is that which Aviva proposes (subject to external review by Aviva's auditors) to use for the balance sheet economic impact projection.

1.18 The key drivers for the change in the inherited estate value over this period were:

- Investment performance;
- Changes in assumptions;
- Modelling improvements;

³ At the date of this report, this figure is still in the process of being reviewed by Aviva's external auditors and could therefore be subject to change.

- Cost of Guarantees on claims exceeding those assumed.

1.19 As can be seen from the table below, the adverse investment performance has had the most significant impact on the inherited estate valuation. The table provides a more detailed breakdown for the CGNU Life and CULAC with-profit funds.

(£millions)	CGNU	CULAC	Total
Open	765	764	1,529
Close	466	565	1,031
Change to analyse	-299	-199	-498
Investment performance	-320	-272	-592
Modelling/opening adjustments	20	25	45
Assumption changes	55	64	119
Miscellaneous	1	5	6
Other experience variances	-36	-3	-39
New Business	-20	-12	-32
Untraced	2	-6	-4
Total analysed	-299	-199	-498

1.20 A significant amount of the reduction in the size of the inherited estates over the period was due to lower property valuations (values down 15 per cent in the UK and 17 per cent in Europe), which reduced asset shares and consequently increased the cost of guarantees.

1.21 Changes in equity values over the period played a limited part in the reduction in the size of the inherited estates due to the limited equity exposure presently in the inherited estates and the dynamic hedging strategy previously implemented which reduced the equity risk for the cost of guarantees.

1.22 Movements in fixed interest yields also had a significant negative impact on the size of the inherited estates due to their exposure to long dated stocks. The loss in the first quarter 2009 was a partial reversal of the benefits achieved by this strategy in 2008. The exposure to long dated stocks has now been reduced.

1.23 Movements in index linked yields were also adverse due to the inherited estates being exposed to short dated stocks.

1.24 Assumption changes made over the period which have had a notable effect on the size of the CGNU Life and CULAC inherited estates are economic and lapse rate assumptions.

1.25 For economic assumptions, the implied market volatility assumed on equities has reduced significantly. This reduces the projected cost of guarantees.

1.26 Lapse assumption rates for ex-General Accident endowment business and unitised with-profits bonds have been changed to bring them closer to actual lapse experience.

Post reporting adjustments and modelling improvements

1.27 Some changes to the reported valuation were identified through the review process, but too late for inclusion in the mid 2009 Realistic Balance Sheet reporting. Under normal business circumstances these adjustments would be noted and taken into account in the next reporting cycle.

1.28 These changes reduce the reported 31st May 2009 CGNU Life and CULAC inherited estate valuation by £26m taking the figure to £1,005m.

1.29 A number of additional modelling improvements are planned for release in August 2009 (release 2) and early/mid 2010 (release 3). These are aimed at further improving the accuracy of the Stochastic Modelling. The effect of the 'release 2' developments will be taken into account when assessing the inherited estate valuations at 31st May 2009 for the purposes of the aggregate PIP calculation. These changes lead to an increase in the 31st May 2009 valuation of £50m taking the figure to £1,055m.

1.30 In line with the statements made in the Actuarial Function Holders report, the 31st May inherited estate valuation for CGNU Life and CULAC will be reviewed by the company's external auditors who will conduct a reasonable assurance review of the hard close valuation as at 31st May 2009. This review will be more rigorous than the normal

review performed for half year interim reporting purposes. In particular the review will conform to ISAE 3000.

1.31 The final valuation of the CGNU Life and CULAC inherited estates at 31st May 2009 will be published on Aviva's reattribution web-site before the High Court Hearing starting 14th September 2009.

Inherited Estate Valuation at 30th June 2009

1.32 The Realistic Balance Sheet at Interim 30th June 2009 has been obtained by carrying out a full valuation of the realistic assets and liabilities of the CGNU Life and CULAC With-Profits Funds at 31st May 2009. This "hard close" valuation, in most respects, represents a full valuation based on the in-force policy data, accounting data and asset values as at 31st May 2009.

1.33 Three balance sheet economic impact projections are then required as at 30th June 2009, 31st July 2009 and 28th August 2009 by

- Projecting the assets and asset shares using an estimate of the investment returns achieved between the 31st May 2009 and the relevant valuation date. The estimate is based on the returns achieved by reference to appropriate market indices allowing for tax;
- Recalculating guarantee costs and other liabilities allowing for the new asset share level and the economic conditions at the relevant valuation date;
- Determining the revised inherited estates; and
- Carrying out an analysis of change.

1.34 The key drivers of change are expected to be equity values, property values, interest rates, credit spreads and equity implied volatility. The effect of the changes in economic conditions will be derived by reference to the end of May data.

1.35 The economic roll-forward methodology was reviewed by Aviva's auditors and agreed with FSA prior to the conclusion of negotiations. The methodology has also been

reviewed by the policyholder advocate's advisers, who concluded that they agree with this methodology.

1.36 Aviva has concluded that the valuation of the CGNU Life and CULAC inherited estates used for the purposes of calculating the PIP payment to eligible policyholders who elect to accept the offer will be £1,174m⁴ at 30th June 2009 (subject to external review by Aviva's auditors).

1.37 The AFH report noted that this figure may be different to that published by Aviva Plc at the half year. The difference in valuation results from:

- Post reporting adjustments and modelling improvements; and
- Difference in the balance sheet economic impact projection.

1.38 The final valuation of the CGNU Life and CULAC inherited estates at 30th June 2009 will be published on Aviva's reattribution web-site before the High Court Hearing starting 14th September 2009.

Inherited Estate Valuation at 31st July 2009

1.39 Using the same methodology as outlined above, Aviva has concluded that the valuation of the CGNU Life and CULAC inherited estates used for the purposes of calculating the PIP payment to eligible policyholders who elect to accept the offer will be £1,257m⁵ at 31st July 2009 (subject to external review by Aviva's auditors).

1.40 The final valuation of the CGNU Life and CULAC inherited estates at 31st July 2009 will be published on Aviva's reattribution web-site before the High Court Hearing stating 14th September 2009.

⁴ At the date of this report, this figure is still in the process of being reviewed by Aviva's external auditors and could therefore be subject to change.

⁵ At the date of this report, this figure is still in the process of being reviewed by Aviva's external auditors and could therefore be subject to change.

Inherited Estate Valuation at 28th August 2009

1.41 At the time of preparing this report the 28th August 2009 inherited estate valuation of the CGNU Life and CULAC inherited estates is not available. Aviva's intention is to provide a provisional figure during the High Court Hearing starting on 14th September 2009.

1.42 The final valuation of the CGNU Life and CULAC inherited estates at 28th August 2009 will be published on Aviva's reattribution website by 30th September 2009.

Additional comments

1.43 From Aviva's perspective, in preparing their realistic balance sheets insurance companies have to make careful assumptions about what might happen in the future (many of the policies could be in existence for more than 25 years). Inevitably there will always be differences of opinion on whether the assumptions made are prudent or optimistic. The key 'check and balance' for Aviva is to take a collective look at all of the assumptions and ensure that they are reasonable as a whole.

1.44 Individual assessment of selective assumptions to test whether they are considered optimistic or pessimistic could produce differences of opinion. However if changes are made on such a piecemeal basis they are likely to unbalance the overall reasonableness of the assumptions as a whole, which could in turn have a negative impact on the long-term security of policyholder benefits.

1.45 The Office of the Policyholder Advocate used their valuation of the size of the inherited estate in their assessment of the offer, and in reaching their conclusions.

1.46 In addition, the Policyholder Advocate has suggested that a positive adjustment of £20m should be made to the 31st May 2009 valuation used for determining the Final Aggregate PIP. This adjustment represents the difference between the size of the new business subsidy assessed on a RBS basis rather than MCEV basis at point of sale.

1.47 FSA has recently written to Aviva regarding the treatment of the perceived prudence in the inherited estate. At the time of writing this report Aviva is still in

discussion with the FSA. The conclusion of these discussions will be reported to the High Court Hearing starting 14th September 2009.

KPMG's review

Purpose of this report

1.48 KPMG's aim in producing this report is to identify any areas of prudence and other adjustments in the 31 May 2009 CGNU Life and CULAC RBSs in order that the policyholder advocate can include any such adjustments in her updated analysis used for guidance to policyholders. Any adjustments identified will be assumed to be valid for all levels of "Estate Value" used in the policyholder advocate's analysis, and for the avoidance of doubt, the same level of adjustments is assumed to be valid for the rolled forward inherited estates at 30 June 2009, 31 July 2009 and 28 August 2009 which are the values used to determine the PIP.

1.49 Such prudence, while appropriate for FSA solvency purposes, may not be appropriate for the purpose of calculating the value of potential benefits from special distributions forgone because they favour shareholders by making the value of these potential benefits lower. Any areas of prudence and adjustments identified are to be used by LECG in its modelling to provide an update to the policyholder advocate of the value of potential future special distributions to policyholders and shareholders based upon end 2008 policy data and for a range of different amounts of the combined inherited estates of CGNU Life and CULAC.

1.50 As a part of this process, it was agreed with the policyholder advocate that KPMG would have discussions and share its findings with the FSA.

1.51 Throughout this report KPMG makes comparisons between Aviva's market consistent embedded value (MCEV) basis and its RBS basis. The rules around the basis used for MCEV are that the assumptions are to be the company's best estimate (i.e. excluding margins for prudence). Clearly, expectations of what may happen in the future are judgemental and there could be a range of assumptions which could be deemed to be a company's best estimate. However KPMG has taken the MCEV basis as Aviva's view of its best estimates basis and as such as a good starting point to determine whether any areas

of prudence exist in the RBS. KPMG notes that Aviva has only recently reported on an MCEV basis, however KPMG has used the term MCEV throughout the report as a term used for best estimate assumptions with risk-free rates equal to swap rates (which KPMG used during the negotiations).

1.52 Aviva, in its evaluations of the value of the offer to policyholders and to shareholders at 31 December 2008, allowed for a £100 million addition to the value of the published inherited estates at that date. It is KPMG's understanding that only a very small part of this £100 million was in respect of the difference between the MCEV basis and the RBS basis. KPMG believes that the full impact of differences between the two bases where appropriate should have been taken into account by Aviva in its offer.

1.53 For the avoidance of doubt, any areas of prudence identified by KPMG in the 31 May 2009 inherited estates of CGNU Life and CULAC over and above that reflected in the £100 million KPMG understands has been allowed for by Aviva at that date have not, as far as KPMG is aware, been allowed for by Aviva in determining the size of the aggregate policyholder incentive payment (PIP). They have, however, been taken into account by the policyholder advocate in her assessment of guidance to policyholders.

1.54 The policyholder advocate has shared the results of KPMG's analysis as at 31 May 2009 with the FSA so that these can be considered as part of the FSA's "fairness review".

1.55 In this report KPMG has sought to highlight those areas in the Aviva RBS valuation of CGNU Life and CULAC as at 31 May 2009 where conservatism in the figures reported to the FSA may understate what KPMG considers a fair or reasonable valuation of the inherited estates. Such conservatism can arise from the methods or approaches laid down by the FSA, or from the implementation of these methods by the industry generally or by any particular company. Aviva is by no means unusual in having some element of conservatism in its implementation. It is stressed here that the adjustments proposed in this report are put forward for the purposes of the reattribution transaction. None of the adjustments are intended to question the appropriateness of Aviva's published RBSs, and the areas of prudence KPMG has highlighted are not out of line with what KPMG would expect to see within the basis used for the RBS.

Summary of the inherited estates

1.56 The table below summarises the financial position of the two funds at 31 December 2008 and 31 May 2009 (before any post valuation adjustments):

Table 1.1: Summary of the inherited estates at 31 December 2008, and 31 May 2009

(£millions)	31 December 2008			31 May 2009		
	CGNU	CULAC	Total	CGNU	CULAC	Total
Regulatory value of the admissible assets of the fund	14,798	15,175	29,973	13,647	14,394	28,041
- non-profit mathematical reserves	-965	-2,002	-2,968	-948	-1,833	-2,781
+ present value of future profits on non-profit business	396	436	832	398	353	751
Total realistic assets	14,229	13,609	27,837	13,097	12,914	26,011
With profits benefit reserve (WPBR)	10,120	9,595	19,715	10,070	9,476	19,546
+ Planned enhancements	570	565	1,135	238	246	484
- Planned deductions	-8	-6	-14	-8	-6	-13
+ Guarantee charges	-60	-49	-109	-55	-45	-100
+ Contractual guarantees	1,146	1,060	2,206	1,207	1,209	2,416
guaranteed minimum pension (GMP)	17	21	38	10	13	23
+ non-Contractual guarantees (Mortgage Endowment Promise)	221	219	440	178	211	388
+ Financial options (GAOs)	20	210	230	15	141	156
+ Smoothing costs	-27	-16	-43	-71	-63	-134
- Shareholder transfers & tax	147	158	305	107	121	228
+ Other long-term insurance liabilities	-149	-111	-260	-182	-135	-317
+ Realistic current liabilities	1,466	1,199	2,665	1,122	1,181	2,303
Total realistic liabilities	13,464	12,845	26,309	12,631	12,349	24,980
Excess realistic assets (i.e. the estate)	765	764	1,529	466	565	1,031

Source: 2008 FSA returns Forms 18 & 19 and Aviva's interim Realistic Reporting report. Figures are subject to rounding.

The post valuation adjustments as at 31 May 2009 total +£24 million, giving combined value of £1,055 million at that date.

1.57 The 31 May 2009 combined inherited estates are below £1.2 billion, the value below which in its “It’s your choice” booklet Aviva states “is the lowest value at which we would be likely to still be able to proceed”. However, the provisional values at 30 June 2009 and 31 July 2009 are £1,174 million and £1,257 million respectively; and the average of these two figures exceeds £1.2 billion. Given the constraints on time, Aviva was not able to finalise its review of the provisional results prior to the completion of this report. Its final review of these figures is expected to be completed by 8 September. Therefore the results above may be different from those which are actually used in the calculation of the estate value for the purpose of determining the PIP offer. The provisional 28 August 2009 value is expected to be available during the High Court hearing.

1.58 The inherited estates have reduced significantly over the period. The analysis has revealed that a significant amount of the reduction was due to lower property values (down 15 per cent in UK and 17 per cent in Europe) which reduced asset shares and thus significantly increased the cost of guarantees. Clearly this is a situation which could reverse in the future. Changes in equity values over the period played a limited part in the reduction in the inherited estates due to the fact that there was limited equity exposure in the inherited estates and the approach of dynamically hedging the impact of equity risk on guarantee costs. Movements in fixed interest yields also had a significant negative impact on the inherited estates due to the estate having continuing over exposure to long dated stocks. The loss in the first quarter was a partial reversal of the substantial profits achieved by this strategy in 2008. Aviva has since removed the over exposure to long dated stocks. Movements in index-linked gilts were also adverse due to the estate having over exposure to short dated stock. Other factors impacting the reduction in the inherited estates are discussed in more detail in section B of Annexe 1.

The adjusted value of the inherited estate

1.59 The table⁶ below summarises the published value of the inherited estate and the adjustments KPMG proposed for use by the policyholder advocate in her analysis at 31 May 2009 (based upon end 2008 data). The adjustments included by the policyholder advocate in her analysis at 31 December 2008 (based upon end 2006 data) are also shown for comparative purposes.

Table 1.2: Adjustments to the combined inherited estate at 31 May 2009 and 31 December 2008

Item (£millions)	31 December 2008	31 May 2009
Value of the inherited estate	1,529	1031
Stochastic Modelling developments post 31 May 2009	0	50*
Post valuation adjustments	41	(26)*
Total value of inherited estate	1,570	1,055
Add back 2007 new business subsidy	■	■
Adjust mortgage endowment mis-selling reserve.	10	5
Add back contingency prudence	33	29
Adjust "other compensation" liabilities to MCEV		8
Adjust non-profit annuity value of in-force (VIF)	■	■
Adjust other non-profit VIF	0	15
Convert liabilities to swaps	-30	29
Adjust persistency assumptions to MCEV on insurance bonds	■	■
Adjust persistency assumptions on endowments	8	0
Prudence in projected equity backing ratio (EBR)		5
Adjust persistency assumptions to MCEV on CULAC conventional pensions with GAOs.		10

⁶ Aviva has required that certain figures in the table be blanked out on the basis that the figures for the 2007 new business subsidy are commercially sensitive. If only the 2007 new business subsidy figures were blanked, it would still be possible to derive them from the table. Accordingly, other figures in the table have also been blanked out even though Aviva does not claim that they are of themselves commercially sensitive. The policyholder advocate believes the 2007 new business subsidy figures are not commercially sensitive and that they should be disclosed.

Item (£millions)	31 December 2008	31 May 2009
Adjust GAO take-up and mortality to MCEV		10
Total adjustments	177	174
Revised inherited estate	1,747	1,229

Source: KPMG Analysis

* The £50 million shown as at 31 May 2009 for ‘stochastic modelling developments post 31 May 2009’ represents the effect of enhancements to the stochastic models which were made by Aviva after the models had been used to generate the 31 May figures. This figure has been provided to KPMG by Aviva. KPMG understands that the enhanced model will be used to prepare the RBS as at 30 September 2009.

* The -£26 million shown as at 31 May 2009 refers to the ‘overs and unders’ adjustment which would ordinarily have been included in the final RBS results as at 31 May 2009 given more time. Normally such items which are picked up after formalising results would be included in the next formal valuation. Since the 31 May 2009 valuation will be used as the basis for determining the June, July and August estimates for the purpose of the incentive payments to be made, KPMG believes it correct to allow for these known items in the 31 May 2009 results.

1.60 Four of the adjustments for prudence shown in table 1.2 above made at 31 May 2009 were not made at 31 December 2008. The prudence within these areas was known about at 31 December 2008, but adjustments were not made at 31 December 2008.

- Prudence in projected equity backing ratio (EBR) - a small area of additional prudence has been highlighted by the revised methodology and KPMG has now taken a high level adjustment into account.
- Adjust persistency assumptions to MCEV on CULAC conventional pensions with GAOs – KPMG has considered the available experience analyses and believe that a slightly higher lapse assumption could be justified for the MCEV basis (which will reduce the allowance made for the cost expected to arise on the exercise of GAOs).
- Adjust GAO take-up and mortality to MCEV – the impact was small at the year end and time constraints meant KPMG was not provided with estimates. For the 31

May results KPMG has been provided with details of the impact and have therefore included this in the adjustments made.

- Adjust “other compensation” liabilities to MCEV – more detailed analysis highlighted this as an area of prudence.

1.61 If future experience follows the assumptions underlying the MCEV then the proportion of each of the adjustments shown in Table 1.2 which are held in respect of policies which are allocated to the New WPSF on the Effective Date will revert to shareholders over time.

1.62 The adjustments above in table 2.2 are summarised and explained in Annexe 1B.

2007 New Business Subsidy ([REDACTED] million adjustment to the estate)

1.63 This figure has been updated since 31 December 2008 by Aviva to allow for the rate of investment return credited to asset shares over the five month period.

Other long term insurance liabilities (+£5 million, +£29 million, +8 million adjustments to the estate)

1.64 At the year end KPMG made adjustments to the inherited estate for the following items:

- Mortgage endowment mis-selling reserve +£10 million
- Converting mortgage endowment promise to swaps £0 million
- Converting UWP VIF to swaps £0 million
- Contingency prudence +£33 million

1.65 For the May 2009 RBS KPMG has taken the same approach as at the year end to the adjustments to be made:

⁷ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

1.66 Aviva has informed KPMG that the mortgage endowment mis-selling reserve has decreased due to a release of reserves offsetting actual claims as well as a weakening of the reserves reflecting the actual experience being more favourable than assumed. In light of this KPMG has reduced the adjustment made from £10 million to £5 million.

1.67 The impact of moving the mortgage endowment promise and UWP VIF onto swap rates (i.e. the MCEV basis) was immaterial for both the 31 May 2009 and 31 December 2008 valuations.

1.68 The contingency reserve has been reduced from £33 million to £29 million and KPMG's May 2009 adjustment of +£29 million therefore reflects the reduction in the reserve.

1.69 In addition to the above adjustments, Aviva provided KPMG with further information with regard to the value placed on the "other compensation costs" for MCEV purposes. The difference between the RBS and MCEV figures is £8m and KPMG has made an additional adjustment for this at 31 May 2009.

Value of the non-profit business (■■■■ million,⁸ +£15 million adjustment to the estate)

1.70 The key assumptions used in valuing the annuity business are annuitant mortality and credit spreads (or liquidity premiums) applied. The mortality basis was considered at the year end and KPMG made no adjustment for this assumption as it was based on the MCEV assumptions and was in line with the industry.

1.71 To allow for any prudence in the RBS liquidity premiums, KPMG asked Aviva to provide KPMG with the results of the calculation of the value of the non-profit business using future investment return assumptions for annuities based on swaps plus 150 basis points (the MCEV basis used for shareholder owned annuity business) and for other non-profit business based on swaps (the MCEV basis), consistent with the approach KPMG took at the year end. The non-economic assumptions adopted to value non-profit business for RBS purposes are the same as for MCEV.

⁸ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

1.72 The results provided by Aviva were as follows:

- ■ million⁹ for non-profit annuity VIF
- £15 million for other non-profit VIF.

These amounts are included in Table 1.2.

Convert all relevant liabilities to swaps (+£29 million adjustment to the estate)

1.73 The one area of potential prudence which KPMG highlighted at the year end in the market consistent methodology was the use of a risk free rate of gilts plus 10 basis points as opposed to the use of swaps.

1.74 At 31 December 2008 the difference was -£30 million which was negative due to the distortion in the swap and gilt yields. KPMG reduced the estate at 31 December for this -£30 million.

1.75 KPMG asked Aviva to provide it with the impact of valuing the liabilities using swaps as opposed to gilts plus 10 basis points at 31 May 2009 and the impact of this was to increase the inherited estates by a total of £29 million. This was almost totally due to the impact on liabilities for inflation protection guarantees. KPMG has made the adjustment to the 31 May 2009 inherited estates.

Persistency – Insurance Bonds (■ million¹⁰ adjustment to the estate)

1.76 There are some durations where the RBS lapse assumptions are more prudent than the MCEV assumptions (ie lapse assumptions are lower which means that more policies are projected to stay in force and benefit from minimum guarantees in adverse scenarios). In addition the assumptions have been changed at in-force durations 7 and 8 for UWP policies for which MVR-free dates apply in the future. The total impact of using assumptions

⁹ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

¹⁰ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

different from MCEV is around £■■■ million¹¹ and of this the impact of the change in assumptions made by Aviva at 31 May 2009 is £16 million.

1.77 At the year end KPMG added back £■■■ million¹² for persistency prudence in relation to the differences in the RBS and MCEV. This was based on an estimate provided by Aviva which actually turned out to be an over-estimate. The estimate of the difference provided by Aviva at 31 May 2009 is £■■■ million.¹³

1.78 KPMG's adjustment at 31 May 2009 is reduced from £■■■ million¹⁴ to £■■■ million¹⁵ which reflects the known differences in the MCEV and RBS bases. KPMG has not made an adjustment for the additional £16 million for the updated assumptions since these reflect actual changes in persistency experience as opposed to additional levels of prudence.

Projected EBR (+£5 million adjustment to the estate)

1.79 The changes to the modelling of the projected EBR include a small amount of prudence in relation to the approximations inherent in the projection of the support provided by the inherited estate. In addition, KPMG has mentioned in its previous report that there is a small amount of prudence in the modelling due to the fact that the EBR is not allowed to reduce below 40 per cent. where, in reality, in very extreme cases it could. KPMG asked Aviva what the impact of removing this 40 per cent floor would be. The result would be an increase in the inherited estate of £11 million at 31 May 2009. This is clearly an extreme scenario and so the actual allowance for prudence is somewhere between 0 and £11 million. Given the fact that there are two potential areas of prudence

¹¹ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

¹² Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

¹³ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

¹⁴ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

¹⁵ Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.

(albeit small), KPMG has made an adjustment at 31 May 2009 of £5 million to allow for these.

Adjust persistency assumptions to MCEV on conventional pensions with GAOs (+£10 million adjustment to the estate).

1.80 The persistency assumption for the contracts with GAOs was changed at the 31 December 2008 year end from 5 per cent to 1.5 per cent, but KPMG made no adjustment to the inherited estate at 31 December 2008 for this on the understanding that the MCEV assumption at the 2009 half year would be adjusted to be consistent with the RBS assumption.

1.81 The MCEV assumption at 30 June 2009 was not adjusted and KPMG is informed that the MCEV results are relatively insensitive to this assumption, so it is unclear whether the change will be made. KPMG notes however that post Wagner the MCEV results will become sensitive to this assumption because of the more direct exposure the AVLAP shareholder will have to the experience of the with-profits policies of the New WPSF.

1.82 KPMG has seen a high level summary of the available experience analysis which does suggest that some reduction in rates from 5 per cent may be appropriate. However, in the absence of having confirmation that the MCEV basis will be changed, KPMG has made a small adjustment to the inherited estates under the assumption that the MCEV could be justified as being higher than the 1.5 per cent used in the RBS. The high level adjustment KPMG has made is +£10 million.

Take- up rates and mortality on business with GAOs (+£10 million adjustment to the estate)

1.83 For the business with GAOs, the MCEV mortality basis is weaker than for the RBS basis (i.e. more deaths are expected under MCEV which means fewer policyholders are assumed to benefit from the exercise of the GAO). The impact of using MCEV assumptions as opposed to the RBS assumptions is to increase the inherited estate by approximately £3 million.

1.84 Similarly, the GAO take-up rates used for the RBS are more prudent (i.e. are higher) than the corresponding MCEV assumptions. The impact of using MCEV

assumptions as opposed to the RBS assumptions is estimated to increase the inherited estate by less than £10 million.

1.85 We identified there were some margins at the year end but were informed that these were likely to be immaterial. Although the above figures are relatively immaterial, KPMG has nevertheless added a further £10 million in light of the prudence is the mortality and take-up rate prudence at 31 May 2009.

Table 1.3: Inherited estates estimated as at 30 June 2009, 31 July 2009

Unaudited Inherited Estate as at	CGNU	CULAC	Total	(£millions) Post Valuation Adjs	Total
31 May 2009	466	565	1,031	24	1,055
30 June 2009	512	662	1,174	0	1,174
31 July 2009	568	689	1,257	0	1,257

1.86 The figures for 30 June 2009 and 31 July 2009 inherited estates in the table above, subject to any final review, along with the 28 August figure will form the basis on which the Estate Value is calculated.

Calculation of the Estate Value used to determine the PIP

1.87 It is an FSA requirement that any new with-profits business sold from the beginning of 2007 should be sold without an expectation that it would require a permanent subsidy from the inherited estates. For the 2007 new business subsidy, both Aviva and the policyholder advocate took the new business subsidy into account in their analyses of the offer. The method on which to eliminate the new business subsidies was not prescribed by the FSA but the objective was that existing policyholders should not expect to be worse off due to the writing of this business. Shareholder transfers are reduced to the extent that the value of new with-profits business determined at point of sale would otherwise be negative. For this purpose the value of new business is calculated by Aviva on an MCEV basis. (We refer to any such restriction in shareholder transfers as “new business subsidy” in this

report, but in practice the restriction is intended to ensure that new with-profits business is not expected to require a permanent subsidy from the inherited estates.)

1.88 The elimination of any potential subsidy on an MCEV basis rather than the more prudent RBS basis at point of sale will mean that the inherited estate (which is determined on the RBS basis) will suffer an up front reduction due to the new business sold, but this reduction in the inherited estate will be recouped over time if the future experience of the new with-profits business follows the MCEV basis, and so in the longer term policyholders are not expected to be worse off in terms of the impact on the inherited estate.

1.89 Accordingly, the value of the inherited estates at 31 May 2009 will be understated by the difference between the point of sale value of new with-profits business written in 2008, and in the first five months of 2009, calculated using the MCEV basis and that value calculated on an RBS basis. If future experience for such new business follows the MCEV basis then that difference will accrue to the inherited estate of the Old WPSF and the RIEESA according to the 'Old WPSF Proportion' and the 'New WPSF Proportion' respectively, since these are the proportions that such business will be allocated to the Old WPSF and the New WPSF on the Effective Date. KPMG therefore has no concerns regarding this treatment.

1.90 However, the resulting understatement of the value of the inherited estates at 31 May 2009 will reduce the uniform uplift which would otherwise be applied to minimum incentive payments, and importantly the release of the majority of these margins over time have not, as far as KPMG is aware, been taken into account in Aviva's assessment of the offer.

1.91 The actual impact on the combined inherited estates at the point of sale of the 2008 new business on a RBS basis is £16 million, and the impact on the combined inherited estates writing new business in 2009 is estimated to be less than £5 million.

1.92 KPMG believes that, for consistency, Aviva should make a positive adjustment to the value of the inherited estates at 31 May 2009 used for the purposes of calculating the Reattribution Estate Value (on which the incentive payments made to holders of Elected Policies will depend). This adjustment should reflect the notional additional reduction in

shareholder transfers required in order to eliminate the subsidy on the RBS basis at point of sale. This adjustment would be approximately £20 million.

1.93 More generally, as far as KPMG is aware, Aviva assumed the RBS basis applied in all areas of its negotiations, including its valuation of the inherited estates for the purposes of estimating the potential special distributions forgone by policyholders and the potential shareholder value arising from the reattribution. In other words, Aviva took very little account of the margins between the MCEV basis and the RBS basis in its negotiations for determining the PIPs. KPMG believes such an approach acts to understate the potential benefits forgone by policyholders, and the potential shareholder value arising from the reattribution, as calculated by Aviva.

Comment by the policyholder advocate

1.94 The policyholder advocate has been informed by the FSA that, in arriving at the value of the inherited estate for the purpose of calculating the PIP the FSA agrees with KPMG that, in the absence of convincing arguments to the contrary, Aviva should make the adjustment with respect to the new business subsidy as set out above.

1.95 The policyholder advocate has taken account of the total KPMG adjustment of £174 million in her analysis of the offer.

1.96 Aviva has taken account of only £100 million in its analysis of the offer. The policyholder advocate is aware that Aviva believes the £174 million identified by KPMG is at the higher end of the range of prudence and other adjustments that may exist. Nevertheless the policyholder advocate considers that Aviva should take account not only of the £20 million new business subsidy discussed above, but it should also take some account of the balance of £54 million which remains the difference between Aviva's adjustments (assuming Aviva take account of the £20 million) and KPMG's adjustment.

Chapter 2: Aviva's 2008 data update: evaluation of Aviva's aggregate PIP offer and the policyholder advocate's guidance to policyholders

Introduction

2.1 In the policyholder advocate's June 2009 report (para 3.16), it was explained that the policyholder advocate engaged LECG to undertake financial modelling in order to inform her evaluation of Aviva's aggregate PIP offer and to assist in the provision of guidance to eligible policyholders as to whether Aviva's offer is in their interests.

2.2 In order to assist LECG to undertake analysis of Aviva's reattribution proposals, Aviva provided LECG with data from its Wagner model over a 25 year future period. The Aviva projections were carried out as at 31 December 2006. The data was provided by Aviva in 2007 on the policies in force as at 21 November 2006. Since production of the data there has been a significant change in economic conditions, whilst certain policyholders have left the CGNU Life and CULAC with-profits funds. The policyholder advocate said in her June 2009 report that Aviva would be providing LECG with updated data as at end 2008 and LECG would then carry out additional analysis during the summer. The policyholder advocate also explained that, if the LECG analysis results in any significant change to her guidance to policyholders, Aviva intended to enable the relevant policyholders to decide whether or not to change their votes (para 3.19). Aviva provided LECG with the updated 2008 data during June and July 2009 and LECG completed its analysis of the data in August 2009.

2.3 Summaries of Aviva's analysis following the 2008 data update and that of LECG, together with the policyholder advocate's conclusions are set out below. Further details are provided in annexe 2.

Aviva's analysis

2.4 Prior to making the reattribution offer to eligible policyholders in the CGNU Life and CULAC with-profits funds, Aviva and the Policyholder Advocate assessed the reattribution offer, both at an aggregate level and for individual policyholders, primarily using policy data at 31st December 2006 and projections (using assumptions for the next 25 years) performed from that date. Whilst adjustments were made to allow for some

changes since that date (most notably the change in the size of the inherited estates), the underlying policy projections were all made from this base date.

2.5 Recognising that changes in economic circumstances coupled with the effects of actual experience since end-2006, and changes in the projection assumptions could impact the results of the analyses performed and the conclusions reached from consideration of these results, the election mailing pack materials made it clear that additional analysis would be performed during the election period in order to satisfy all stakeholders that guidance remained unchanged.

2.6 Before making its offer to eligible policyholders, Aviva carried out an initial assessment of the likely effect of the changes on their, and the policyholder advocate's recommendations. This concluded that there was unlikely to be a significant impact and it was therefore agreed that the reattribution offer should still be made whilst more detailed analysis was carried out to confirm these conclusions.

Key assumption and experience changes

2.7 Only a few changes were made to the model and these were only applied where they were necessary to reflect changes in the management of the fund that could not be accommodated in the code, for example:

Investment Strategy

- The asset shares Equity Backing Ratio (EBR) assumption used in the model reflected the actual asset mix at December 2008 (56 per cent), and thereafter followed the EBR algorithm previously used in the modelling.
- In response to market conditions, the EBR for the inherited estate was reduced during 2008. The Estate EBR assumption used in the model therefore reflected the actual asset mix at December 2008 and thereafter was typically modelled to increase over time.
- The assumptions used for investment of assets backing guarantees followed the hedging programme Aviva had in place at December 2008.

New Business

2.8 The key change in new business assumptions allowed for modelling of all new with-profit bond business to include a money-back guarantee option from the beginning of 2009.

2.9 It should be noted that the volumes of new business projected to be sold by Aviva remained unchanged.

2.10 Other than in the following areas, no significant assumption changes were made in the period end 2006 to end 2008:

Realistic Balance Sheet

- The Size of the Inherited Estate annexes explains the change over the period 2006-2008 in detail.

Economic Scenarios

- The economic scenarios used were outputs from the Aviva Real World Economic Scenario Generator calibrated to conditions at 31st December 2008 (rather than 31st December 2006).

Lapse Assumptions

2.11 The changes in lapse assumptions from the December 2006 EEV assumptions fall into three categories:

- Changes made as part of the conversion from EEV to MCEV;
- Changes made between 2006 and 2008 year ends;
- Change made for RBS Reporting at December 2008 but not yet reflected in MCEV basis.

2.12 The assumptions used in the production of the end 2008 data corresponded with year end 2008 MCEV assumptions in all but one area, where lower lapse rates were assumed.

Expense Assumptions

2.13 The assumptions used in the production of the end 2008 data corresponded with year end 2008 MCEV assumptions which are in line with the Management Services Agreement which came into effect on 1st January 2009.

Aviva analysis and conclusions

2.14 Aviva's assessment of the PIP offer, both at an aggregate level and for individual policyholders, has been updated using end 2008 data.

Value of Potential Distributions (VPDP)

2.15 The VPDP has been recalculated using December 2008 data and compared with the information presented in Table 3 of section 7.6.11 of the AFH report as follows:

Value of Potential Distributions to Policyholders (VPDP)			
<i>Estate Value (£m)</i>	<i>Aggregate PIP (£m)</i>	<i>AFH Report VPDP (£m)</i>	<i>YE08 data VPDP (£m)</i>
1600	720	223	190
1529	681	n/a	170
1400	610	161	137
1200	500	103	95

PIP Breakeven Period

2.16 In paragraph 7.6.12 of his full report the Actuarial Function Holder (AFH) states “for virtually all eligible policies, the value of potential distributions in the next 10 years was not expected to exceed the PIP offered. Further, for at least 95 per cent of eligible policies, the value of potential distributions in the next 25 years was not expected to exceed the PIP offered.”

2.17 In order to assess whether this continued to be a materially accurate statement Aviva considered the PIP Breakeven analysis throughout the range of reasonable inherited estate values at the Effective Date.

2.18 The result of this analysis is that Aviva is satisfied that the statements of 99 per cent (or virtually all) policyholders would need to wait more than 10 years for distributions to exceed the PIP and at least 95 per cent more than 25 years is still materially accurate

Old WPSF Safety Net

2.19 Aviva also undertook some analysis of the votes recorded in the Wagner Data Store as at 21st August 2009 in order to check that the agreed £100 million cap on the safety net continued to be reasonable. To do this the ‘extreme’ scenario previously tested were assessed to see if they were still viable given the election experience to date.

2.20 Aviva observed that the safety net scenarios were all quite different from the voting patterns seen to date and that even the least extreme of the safety net scenarios (Scenario 1) is considerably more skewed than election experience to this point.

2.21 Aviva consider that it is possible for the Old WPSF to reach a Scenario 1 or 2 election outcome, but that this would require an extreme difference in the remainder of the election from the voting to date. The remaining safety net take up scenarios cannot happen from this point.

2.22 The analysis showed that in the vast majority of situations the aggregate VPDP for non-electors as a group continues to be adequately protected. In addition the analysis showed that benefit security of non-electors is also protected across all of the tested scenarios. Aviva therefore concludes this offer continues to be fair to non-electors.

LECG’s analysis

2.23 The purpose of LECG’s analysis is to update its analysis based on 2006 data, the conclusions of which were set out in the policyholder advocate’s June 2009 report for new data based on the 2008 year end position. This new data has been prepared using the same approach as the 2006 data but the data has been modified to reflect actual experience between 2006 and 2008 (especially in terms of investment returns over that period and lapse rates) and changes in assumptions that Aviva has made in respect of the future 25 year projection period from the end of 2008. The year-end 2008 data also allows for actual new business written in the period since 2006.

2.24 There are three key elements of the data affecting the policyholder advocate's analysis of the reattribution offer that have changed significantly since 2006:

- asset shares of eligible policies – the downturn in the global economy and financial markets has meant that over the past two years asset values around the world have fallen significantly. These falls have reduced the current value of the policies that are eligible for the reattribution;
- Aviva's actual lapse experience – between 2006 and 2008, Aviva has experienced significantly different lapses in the funds compared to what it projected in the year-end 2006 data. Lapse rates were, in general, lower than expected over the two year period. Aviva has used this recent experience of lapses to project future expected lapses. In comparison with the year-end 2006 data, Aviva has increased lapse rates on open maturity policies and reduced lapse rates on regular premium policies with fixed maturities. If policies are expected to remain in the funds for different amounts of time compared to the 2006 data, then those policies will have different expectations of potential future special distributions which might impact the results of the analysis carried out; and
- expected future investment returns – for the purposes of projections based upon the year-end 2006 data, the pre-tax return on the fund was forecast to be 6.6 per cent per annum. For the purposes of projections based upon the year-end 2008 data, Aviva has projected a pre-tax return that has fallen to 5.5 per cent per annum, a fall of 1.1 per cent per annum. Professor Brealey has provided the policyholder advocate with his opinion on the likely changes in long-run investment returns between the end of 2006 and the end of 2008 and has concluded that he would not expect a fall in long-run returns greater than around 0.5 per cent per annum (attached to Annexe 2B). This is significantly lower than the fall of 1.1 per cent per annum in Aviva's year-end 2008 base data. Therefore, the policyholder advocate has performed a sensitivity analysis using year-end 2008 data provided by Aviva with investment returns that are 0.5 per cent per annum higher than in the base case assumptions.

2.25 LECG has reviewed Aviva's year-end 2008 data to assess whether the latest data supports the conclusions reached in the policyholder advocate's June 2009 report relating to:

- the estimation of the aggregate potential special distributions to eligible policyholders;
- the estimation of the split of the residual inherited estates between eligible policyholders and shareholders in the reattribution;
- the estimation of Aviva shareholders' internal rate of return from the reattribution;
- the analysis of the allocation of the PIP and a comparison with the allocation of possible future special distributions for individual eligible policies; and
- the development of guidance to groups of policyholders as to whether Aviva's offer is in their interests.

2.26 In particular, LECG has analysed whether Aviva's aggregate offer still meets the policyholder advocate's two primary criteria: firstly on all estate values, eligible policyholders are expected to receive an aggregate PIP that is greater than possible future aggregate special distributions under Aviva's new business assumptions and, secondly, that eligible policyholders are expected to receive more than 50 per cent of the residual value of the inherited estates under Aviva's new business assumptions at all estate values.

2.27 LECG has also assessed the position of non-electors to ensure that the interests of non-electing policyholders are protected across a broad range of potential outcomes for future special distributions and potential voting patterns by eligible policyholders. The conclusions relating to non-electors are discussed in Chapter 3 and Annexe 3B to this report.

2.28 In its assessment of Aviva's aggregate PIP offer in this chapter, LECG has summarised the analysis with an assumed estate value of £1,200 million as at 1 October 2009 and under Aviva's new business assumptions only. However, in order to compare the year-end 2008 data results with those set out in the policyholder advocate's June 2009

report, and in her guidance booklet which was sent to policyholders, the revised guidance to policyholders is provided for assumed estate values as at 1 October of £1,200 million and £1,570 million and under both Aviva's new with-profits business assumptions (5 per cent per annum growth from 2011) and the policyholder advocate's alternative assumptions (-5 and -15 per cent per annum declines from 2011).

2.29 The results of all LECG's analysis with both assumed estate values of £1,200 million and £1,570 million and under all three new business assumptions described above are provided in Annexe 2B.

2.30 LECG has also assessed the aggregate offer based on an additional new business assumption using updated new with-profits business data provided to us by Aviva. This latest data shows the effect that the removal of the Inflation Protected Guarantee bond option ("IPG bond") in the first half of 2009 might have on any forward looking assumptions in relation to new business growth. The IPG bond accounted for a significant proportion of Aviva's new business sales since its introduction at the beginning of 2006. Aviva's latest forecast for new business sales in 2009 (based on actual sales up to 30 June 2009 and projections until 31 December 2009) shows that the IPG bond accounts for around 60 per cent of annual sales, even though it was only available for less than four months of the year. Table 2.1 below shows Aviva's actual and forecast new business sales for 2009.

Table 2.1 Aviva's 2009 new business sales, APE, £ million

	January to June 2009 actual sales	July to December 2009 projected sales	2009 sales
Pensions	6.5	14.9	21.4
IPG bond	58.9	0	58.9
Other bond	10.2	14.2	24.4
Total	75.6	29.1	104.7
Aviva's new business assumptions			116

Source: Aviva and LECG analysis

APE = annual premium equivalent

2.31 The table above shows that, if the period from July to December 2009 is indicative of the level of new with-profits business that Aviva is able to sell without the IPG bond, then 2009 annual sales would be around £58.2 million, compared to Aviva's new business assumption for the reattribution analysis of £116 million, a fall of 50 per cent. To meet Aviva's new business assumption for 2009, remaining sales of other bonds and pensions would have (and Aviva projects them) to be significantly higher than in the first half of the year.

2.32 Aviva has not provided any rationale for why the sales of pensions and other bonds are forecast to significantly increase in the second half of 2009. Therefore, LECG's position is that Aviva should review its new business assumptions for 2009 and 2010 and adjust them based on actual experience. Aviva has stated it is not revising those assumptions.

2.33 The policyholder advocate understands that, as part of its planning cycle for the coming year, Aviva's marketing team is currently looking at options for a product to replace the IPG bond that may reduce the impact of its withdrawal. To take the withdrawal of the IPG bond into account in the analysis of the reattribution, the policyholder advocate has considered an additional new business sensitivity, in which 2007 to 2009 follow Aviva's actual new business sales and forecasts, but from 2010 onwards the assumed level of new business is 50 per cent of Aviva's assumption (i.e. new business sales grow at 5 per cent per annum, but from a lower base).

2.34 The table above also shows that Aviva expects the sales on Pensions and 'Other Bond' products to grow significantly in the last 6 months of 2009. At the time of writing Aviva has not provided an explanation to support this forecast and in the absence of such an explanation we believe this forecast to be optimistic. The risk being that Aviva will not write this level of new business or will write new business with minimal associated guarantees, meaning that Aviva's analysis will understate the potential future special distributions for eligible policyholders.

2.35 In updating the guidance to eligible policyholders, LECG has also assessed the offer using the assumption that special distributions are expected to increase by 25 per cent

above those under Aviva's new business assumptions as a proxy for higher investment returns in line with the analysis in the policyholder advocate's June 2009 report and policyholder guidance booklet. Finally, LECG has asked Aviva to provide data that assumes investment returns are 0.5 per cent higher (to support Professor Brealey's opinion) than currently forecast in Aviva's base data to assess whether this results in any significant changes to conclusions. The results of LECG's analysis under these additional assumptions are provided in Annexe 2B.

2.36 Aviva has also performed analysis using the year-end 2008 data. Aviva has stated that its updated analysis has lengthened the break-even period for policyholders as compared to using year-end 2006 data and therefore increased the proportion for whom the offer represents "good value" or "excellent value". With the year-end 2008 data and an assumed estate of £1,200 million, Aviva's analysis says that the offer represents "excellent value"¹⁶ for over 99 per cent of policies.

2.37 In its previous analysis of the reattribution offer, based on 2006 data, Aviva said that its expected shareholder internal rate of return ("IRR") from the reattribution was between 8.2 per cent and 10.6 per cent for assumed estate sizes of £1,200 million and £2,500 million, respectively. In a presentation to analysts in May 2009, Aviva presented a shareholder IRR of 13.5 per cent, based on a reattribution estate as at 1 October 2009 of £1,250 million and assuming a take-up rate of policyholders voting to accept the reattribution of 80 per cent.

2.38 In June 2009, Aviva provided a reconciliation between the 8.2 per cent to 10.6 per cent IRR range and the 13.5 per cent IRR to the FSA, which has subsequently been provided to the policyholder advocate. Aviva explain that there are three main reasons for the differences in the two IRRs:

¹⁶ By which Aviva means that policyholders would have to wait at least 25 years until the estimated value of future special distributions is likely to exceed the offer.

- *“The stated IRRs differ, reflecting the different bases used in the IRR calculations”;*
- the 13.5 per cent IRR *“captured all of the financial benefits of the wider Wagner programme”;* and
- the 13.5 per cent IRR also included *“an update of the assumptions to reflect emerging end 2008 data and results”.*

2.39 Aviva’s IRR analysis is discussed in more detail in Annexe 2B to this report.

2.40 Aviva’s PIP offer is based on the size of the combined CGNU and CULAC inherited estates close to the date that the reattribution and fund transfer is effected, currently assumed to be 1 October 2009. The ‘key reference point’ for this valuation will be the Realistic Balance Sheet (“RBS”) values prepared for the FSA.

2.41 In KPMG’s view, the RBS figures often include elements of prudence which require adjustment before they can be used for the policyholder advocate’s assessment of Aviva’s offer. KPMG has therefore advised a number of adjustments to the RBS values which raise the value of the combined inherited estates, for the purposes of assessing the offer, by £174 million as at 31 May 2009 (see Chapter 1). However, this adjustment of £174 million included one very late change to the data provided by Aviva to KPMG to enable KPMG to finalise their adjustments. Previous to this, an adjustment of £232 million as at 31 May 2009 had been estimated by KPMG.¹⁷ In the time available LECG has not been able to re-perform all analysis based on the new adjustment of £174 million.

Therefore, in this chapter, analysis of Aviva’s aggregate PIP offer using the adjustment of £174 million applied to an assumed estate of £1,200 million as at 1 October 2009 and Aviva’s new business assumptions of 5 per cent per annum growth from 2011 onwards (“Aviva’s base case”) is provided. However, for the purposes of providing guidance to policyholders, the analysis is shown across estate values of £1,200 million to £1,570 million and Aviva’s and the policyholder advocate’s new business assumptions using the earlier adjustment of £232 million, though reference is made to how the guidance under

¹⁷ The value of KPMG’s latest adjustment to the inherited estates rolled forward to the effective date of the reattribution on 1 October 2009 was estimated by LECG to be £176 million. The value of the previous adjustment as at 1 October 2009 was estimated to be £234 million.

Aviva's base case might change if the later adjustment of £174 million was applied. Full analysis across all estate values and new business assumptions using an upwards adjustment of £232 million (and comparison of Aviva's base case with an adjustment of £174 million) to the assumed estate value is included in Annexe 2B.

Policyholders' aggregate potential future special distributions

2.42 To evaluate Aviva's aggregate PIP offer, it is necessary to consider what the positions of eligible policyholders and shareholders might have been absent a reattribution. As the terms of the reattribution scheme are designed to preserve the regular and guaranteed benefits of policyholders, this involves estimating the potential value of special distributions, absent a reattribution, which eligible policyholders will give up if they accept Aviva's reattribution offer.

2.43 Aviva's new business assumptions have been tested on a 1 October 2009 assumed estate value of £1,200 million.¹⁸ The resulting projections of aggregate special distributions to all policyholders and shareholders are shown in Table 2.2 below. For comparison, the figures published in the policyholder advocate's June 2009 report, which were based on year-end 2006 data, are shown in brackets.

¹⁸ In the policyholder advocate's June 2009 report, additional assumed estate sizes of £1,570 million, £1,800 million, £2,100 million and £2,500 million were considered. Given the actual value of the estates during the summer of 2009, these values are now considered very unlikely and therefore are not considered.

Table 2.2 Present value of potential future special distributions of excess surplus absent a reattribution, assumed estate value of £1,200 million at 1 October 2009,* £ million, figures in brackets indicate comparables using year-end 2006 data

Assumption	Eligible policyholders	Future policyholders	Shareholders	Eligible policyholders' share of distributions to all policyholders
Aviva's new business assumptions: 5% per annum increase	55 (83)	1,119 (1,087)	130 (130)	5% (7%)

Source: LECG analysis.

* £1,200 million is the unadjusted value of the estate; LECG's calculations are made after taking into account KPMG adjustments.

2.44 In comparison with the results using year-end 2006 data there has been a reduction in the potential amount of special distributions to eligible policyholders. This reduction in the potential future special distributions to eligible policyholders has been caused by three main factors:

- the fall in the value of eligible policyholders' asset shares since 2006: the poor performance of the financial markets during 2007 and 2008 has reduced the value of existing business asset shares. However, new business projections have remained the same in nominal terms. Existing business therefore makes up a smaller proportion of total asset shares in force in the future, and so is projected to receive a smaller share of any future special distributions;
- investment returns: all else being equal, the lower fund rate forecast by Aviva serves to defer distributions. Eligible policyholders make up a smaller proportion of the fund in future years, so delay serves to increase the dilution of special distributions through sharing with future policyholders; and

- lapse assumptions: overall lapse assumptions have decreased and so more eligible policyholders in these groups are projected to stay in the fund for longer thus diluting the potential special distributions to any individual policyholder.

2.45 These factors are partially offset by lower capital requirements, thus serving to bring distributions forward and increase them.

2.46 In the analysis undertaken using year-end 2006 data, in all cases Aviva's aggregate PIP offer exceeded LECG's estimate of the potential special distributions to eligible policyholders. Using the year-end 2008 data with an assumed estate value of £1,200 million as at 1 October 2009 under Aviva's new business assumptions, Aviva's aggregate PIP offer of £500 million still far exceeds estimated future special distributions to eligible policyholders of £55 million.

Policyholders' share of the residual value of the reattributed inherited estates

2.47 A specific issue that arises in a reattribution is that, because of the FSA rule that allows inherited estate capital to be used to support new with-profits business, the inherited estate that would otherwise go to future policyholders may instead be transferred to shareholders. The FSA has said that in a reattribution, compensation to eligible policyholders for giving up their rights to future special distributions from the inherited estate should include payment for any estate that, without a reattribution, would have been distributed to future policyholders. The policyholder advocate and her advisers have therefore estimated the 'residual value' of future policyholders' share of the inherited estates, which represents the portion of the inherited estates that may have been distributed to future policyholders, less relevant costs and risks associated with the reattribution.

2.48 Appendix 37 to the policyholder advocate's June 2009 report described the policyholder advocate's approach to valuing the residual inherited estates in the context of the proposed reattribution, which includes making allowance for costs and risks that are currently charged to the inherited estates under current FSA rules that, following the reattribution, will instead be borne by shareholders. The calculation of the residual inherited estates and the division between eligible policyholders and shareholders using

Aviva's updated 2008 data and under Aviva's new business assumptions is shown in the table below.

Table 2.3 Residual value of the inherited estates, Aviva's new business assumptions

1 October 2009 estate value	£1,200m
KPMG adjustments*	£176m
Adjusted estate value	£1,376m
Costs, risks and tax	£480m
Value after reattribution costs, taxes & allowances	£896m
Shareholders' future distributions from whole estate	£130m
Eligible policyholders' expected future special distributions	£55m
Residual estate value after all distributions, costs & allowances	£710m
Eligible policyholders	
Share of policyholders' expected future special distributions	100% £55m
Share of the residual estate value	63% £445m
Total to eligible policyholders (Aggregate PIP)	£500m
Shareholders	
Share of shareholders' expected future special distributions	100% £130m
Share of the residual estate value	37% £266m
Total to shareholders	£396m

Source: LECG analysis and KPMG adjustments.

* KPMG adjustments of £174 million as at 31 May 2009 rolled forward to 1 October 2009 are £176 million.

2.49 As the table shows, eligible policyholders are projected to receive all of their projected special distributions, plus 63 per cent of the residual value of the estates under Aviva's new business assumptions, for an assumed estate value of £1,200 million. This compares to a figure of 60 per cent using the 2006 data.¹⁹

¹⁹ The policyholder advocate's second criterion, that eligible policyholders receive at least 50 per cent of the residual value of the inherited estates under Aviva's new business assumptions, has therefore been satisfied in the analysis using both year-end 2006 data and year-end 2008 data.

Aviva's shareholders' IRR

2.50 LECG has also estimated shareholders' IRRs arising from the reattribution against the year-end 2008 data. LECG has calculated that the IRR for shareholders from the reattribution is 9.0 per cent with an assumed estate value of £1,200 million, after taking into account adjustments to the value of the estate of £174 million as at 31 May 2009, as advised by KPMG. Results of LECG's analysis of IRRs for a full range of estate values and new business assumptions are shown in Annexe 2B.

2.51 Professor Brealey has advised in his note attached to Appendix 37 of the policyholder advocate's June 2009 report, that any return above the rate of return on the fund should be considered as "profit" from the reattribution. Therefore, with a fund rate after tax of 5.2 per cent, this implies profit from the reattribution of 3.8 per cent, based on a shareholder IRR of 9.0 per cent as calculated by LECG. The fact that the estimated shareholder IRR has decreased by less than the fund rate implies an increase in the proportional profit to shareholders from the reattribution. Based on the 13.5 per cent IRR provided to analysts by Aviva in May 2009, profit from the reattribution is 8.3 per cent when compared with the fund rate.

2.52 In the policyholder advocate's June 2009 report based on end 2006 data, LECG's assessment of the IRR to shareholders was 10.3 per cent with an estate value of £1,200 million. The main reason for the decrease in the IRR to shareholders is the decrease in Aviva's forecast of the expected net return on the fund.

2.53 The FSA has said that it will consider the appropriateness and fairness of the return to shareholders.

Allocation of the PIP

2.54 In the policyholder advocate's June 2009 report, LECG carried out analysis comparing the PIP allocation for individual eligible policies to the value of their potential future special distributions across a range of estate values and new business assumptions. The same analysis has been carried out using year-end 2008 data for the assumed estate value of £1,200 million, under Aviva's new business assumptions. The results of this analysis are shown in Table 4 below with figures for year-end 2006 data in brackets.

Table 2.4 Aggregate results of allocation analysis, figures for year-end 2006 comparables are shown in brackets

1 October 2009 assumed estate value	Aviva's assumptions of 5 per cent annual increases in new business from 2011	
	Special distributions > PIP allocation	PIP allocation > special distributions
£1,200m	3.4% (3.4%)	96.6% (96.6%)

Source: LECG analysis

2.55 The table above illustrates that under Aviva's new business assumptions with an assumed estate value of £1,200 million, over 96 per cent of policyholders are offered a PIP allocation greater than potential future special distributions. The proportion of policyholders with a PIP offer greater than potential future special distributions is the same when using the year-end 2008 data as compared with the year-end 2006 data.

2.56 Factors identified earlier in this chapter, such as the fall in the value of eligible policyholders' asset shares, lower investment returns and changes in lapse assumptions, should lead to a small decrease in proportions of policyholders with PIP allocations greater than potential future special distributions. Under Aviva's new business assumptions, for an assumed estate value of £1,200 million, this decrease is so small it is not actually apparent in the table above. Therefore, the changes to the proportion of policyholders with a PIP offer greater than potential future special distributions are immaterial and no alterations to conclusions from LECG's analysis are necessary.

Guidance to policyholders

2.57 One of the key objectives of carrying out the new analysis based on year-end 2008 data is to assess whether the policyholder advocate's guidance, provided to eligible policyholders in the "Making your choice" booklet, needs to be re-issued to particular groups of policyholders. Accordingly the same analysis was carried out as had been done previously with the year-end 2006 data.

2.58 LECG has grouped policies by type and outstanding term in order to provide an indication as to when, if at all, potential future special distributions will exceed the PIP offer. Policies are not grouped by size because larger policies will simply, pro-rata, receive larger future special distributions from the inherited estates. The same groupings that are

included in the policyholder advocate’s guidance booklet that was sent to eligible policyholders and the policyholder advocate’s June 2009 report have been analysed here.

Table 2.5 Policyholder groups

Policyholder group	Premium type	Maturity or expected surrender date
1	Regular	Up to and including 2016
2	Single	No fixed maturity date
3	Regular	Between 2017 and 2021
4	Regular	Beyond 2021

Source: Groups assigned by LECG

2.59 LECG emphasises that the figures provided in the guidance to policyholders are indicative only, providing an illustration of when potential future special distributions are likely to equal Aviva’s PIP offer on different assumptions. Factors influencing potential future special distributions such as investment returns and the level of new business are highly uncertain.

2.60 In the tables for the guidance in this chapter, years when cumulative special distributions are estimated to equal Aviva’s PIP offer are shown for both assumed estate values of £1,200 million and £1,570 million. However, only break-even years for an assumed estate value of £1,200 million are described, as the size of the estate is likely to be closer to this value at the effective date of the reattribution. Break-even years for both estate values are described in detail in Annexe 2B.

Regular premium policies maturing or surrendered before 2017

2.61 Based on LECG’s analysis using year-end 2008 data, all policyholders with regular premium policies maturing or being surrendered before 2017 should accept Aviva’s offer.

2.62 The table below illustrates the guidance for policyholders in this group. Figures in brackets are comparables using year-end 2006 data which appeared in the June 2009 report.

Table 2.6 Years in which potential future special distributions may exceed PIP offers on average, regular premium policies maturing before 31 December 2016, figures in brackets are comparables using year-end 2006 data

1 October 2009 assumed estate value	Aggregate PIP offer	Aviva's new business assumptions: 5% per annum increase from 2011	Policyholder advocate's alternative new business assumptions:			
			5% per annum decline from 2011	15% per annum decline from 2011	2009 new business experience	Aviva's new business assumptions with 25% higher special distributions
£1,200m	£500m	Never (Never)	Never (Never)	Never (Never)	Never	Never (Never)
£1,570m	£704m	Never (Never)	Never (Never)	Never (Never)	Never	Never (Never)

Source: LECG analysis

2.63 The results are therefore the same as was found for this group of policyholders using the year-end 2006 data. Using the lower KPMG adjustments of £174 million as at 31 May 2009 and with an assumed estate value of £1,200 million under Aviva's new business assumptions, Aviva's PIP offer continues to exceed the estimated potential future special distributions for an average eligible policyholder in policyholder group 1. LECG believes that across all the scenarios considered here, the use of the lower level of KPMG adjustments would not lead to any significant change in the years when future special distributions are expected to exceed the PIP offer (quoted in Table 2.6 above).

Single premium policies with no maturity date

2.64 Policyholders with single premium policies that have no maturity date face a more finely balanced decision. The length of time that policyholders in this group intend to remain invested in the funds determines whether potential future special distributions are likely to exceed the PIP offer. The table below illustrates the guidance for policyholders in this group.

Table 2.7 Years in which potential future special distributions may exceed PIP offers on average, single premium policies, figures in brackets are comparables using year-end 2006 data

1 October 2009 assumed estate value	Aggregate PIP offer	Aviva's new business assumptions: 5% per annum increase from 2011	Policyholder advocate's alternative new business assumptions:			
			5% per annum decline from 2011	15% per annum decline from 2011	2009 new business experience	Aviva's new business assumptions with 25% higher special distributions
£1,200m	£500m	2025 (2024)	2020 (2019)	2019 (2018)	2019	2024 (2023)
£1,570m	£704m	2022 (2020)	2018 (2017)	2017 (2017)	2017	2021 (2019)

Source: LECG analysis

2.65 In comparison to the guidance with year-end 2006 data, the years when potential future special distributions are expected to first exceed the PIP offer have not changed significantly, moving out by up to one year. The earliest year when future special distributions are expected to exceed the PIP offer with an assumed estate value of £1,200 million has moved from 2018 in the year-end 2006 data compared to 2019 in the year-end 2008 data, assuming a 15 per cent per annum decline in new business.

2.66 Under the lower KPMG adjustments of £174 million as at 31 May 2009 and with an assumed estate value of £1,200 million under Aviva's new business assumptions, the break-even year when potential future special distributions are expected to first exceed the PIP offer has not changed significantly, moving out by one year, to 2026. LECG believes that across all the scenarios considered here, the use of the lower level of KPMG adjustments would not lead to any significant change in the years when future special distributions are expected to exceed the PIP offer (quoted in Table 2.7 above).

Regular premium policies maturing or surrendered between 2017 and 2021

2.67 Policyholders with regular premium policies which will mature or be surrendered between 2017 and 2021 are more likely to receive special distributions with a cumulative present value greater than the PIP offer compared to policyholders with regular premium policies maturing before 2017. The table below illustrates the guidance for policyholders in this group.

Table 2.8 Years in which potential future special distributions may exceed PIP offers on average, regular premium policies maturing between 1 January 2017 and 31 December 2021, figures in brackets are comparables using year-end 2006 data

1 October 2009 assumed estate value	Aggregate PIP offer	Aviva's new business assumptions: 5% per annum increase from 2011	Policyholder advocate's alternative new business assumptions:			
			5% per annum decline from 2011	15% per annum decline from 2011	2009 new business experience	Aviva's new business assumptions with 25% higher special distributions
£1,200m	£500m	Never (Never)	Never (Never)	2019 (2019)	Never	Never (Never)
£1,570m	£704m	Never (Never)	2019 (2018)	2018 (2017)	2018	Never (Never)

Source: LECG analysis

2.68 Comparing the year-end 2006 data with the year-end 2008 data, the earliest year when cumulative special distributions are at least equal to the PIP offer, there have been no changes to the policyholder advocate's guidance to policyholders in group 3 assuming an estate value of £1,200 million.

2.69 Using the lower KPMG adjustments of £174 million as at 31 May 2009 and with an assumed estate value of £1,200 million under Aviva's new business assumptions, the break-even year when potential future special distributions are expected to first exceed the PIP offer has not changed. LECG believes that across all the scenarios considered here, the use of the lower level of KPMG adjustments would not lead to any significant change

in the years when future special distributions are expected to exceed the PIP offer (quoted in Table 2.8 above).

Regular premium policies remaining in the funds beyond 2021

2.70 Consistent with the guidance provided in the policyholder advocate's guidance booklet, policyholders with regular premium policies which will mature or be surrendered after 2021 are the group with the most difficult decision to make. The longer period to maturity means that policyholders who are willing to remain in the funds will have a higher probability of receiving special distributions and therefore a higher probability that these potential future special distributions might exceed the PIP offered. The table below illustrates the guidance for policyholders in this group.

Table 2.9 Years in which potential future special distributions may exceed PIP offers on average, regular premium policies maturing after 1 January 2021, figures in brackets are comparables using year-end 2006 data

1 October 2009 assumed estate value	Aggregate PIP offer	Aviva's new business assumptions: 5% per annum increase from 2011	Policyholder advocate's alternative new business assumptions:			
			5% per annum decline from 2011	15% per annum decline from 2011	2009 new business experience	Aviva's new business assumptions with 25% higher special distributions
£1,200m	£500m	Never (2028)	2021 (2019)	2019 (2018)	2020	2028 (2025)
£1,570m	£704m	2026 (2021)	2019 (2018)	2018 (2017)	2019	2023 (2020)

Source: LECG analysis

2.71 As the table above shows, on average, policyholders in this group are likely to receive future special distributions which exceed the PIP offer under all except one of the assumptions considered. Using year-end 2008 data, under Aviva's new business assumptions and with an assumed estate value of £1,200 million, future special distributions are not expected to exceed the PIP offer, whereas previously, using year-end

2006 data average eligible policyholders who are in-force within this group were expected to break-even in 2028.

2.72 The earliest year in which future special distributions are expected to exceed the PIP offer with an assumed estate value of £1,200 million is 2019 under the assumption that new business declines by 15 per cent per annum.

2.73 Using the lower KPMG adjustments of £174 million as at 31 May 2009 and with an assumed estate value of £1,200 million under Aviva's new business assumptions, the break-even year when potential future special distributions are expected to first exceed the PIP offer has not changed. LECG believes that across all the scenarios considered here, the use of the lower level of KPMG adjustments would not lead to any significant change across all the scenarios considered here in the years when future special distributions are expected to exceed the PIP offer (quoted in Table 2.9 above).

2.74 Under the assumption that special distributions are 25 per cent higher, future special distributions are expected to first exceed the PIP offer in 2028 with an assumed estate value of £1,200 million.

2.75 Under the assumption based on 2009 actual new business experience with an assumed estate value of £1,200 million, the year when the present value of cumulative special distributions is estimated to exceed the PIP offer is 2020, similar to the assumption of a 5 per cent per annum decrease in new business.

2.76 Comparing these results with the guidance from the year-end 2006 data, under Aviva's new business assumptions the years when future special distributions are expected to exceed the PIP offer have changed from 2028 to 'never' with an assumed estate value of £1,200 million. Under Aviva's new business assumption with 25 per cent higher special distributions, the year where future special distributions are expected to exceed the PIP offer has moved three years further out.

2.77 This change in the break-even period is not considered to be material however. Potential future special distributions towards the end of the period are estimated to be small and are expected to become smaller year-on-year, meaning that small changes in

assumptions can cause significant changes in the length of the break-even periods. For example, LECG estimates that special distributions to an average policyholder in group 4 would increase only by £17 between 2030 and 2031; £12 between 2031 and 2032; and £6 between 2032 and 2033.

2.78 The years when the present value of cumulative special distributions is expected to exceed the PIP offer have changed less significantly under other new business assumptions, by up to 2 years, between the year-end 2006 data and the year-end 2008 data.

2.79 LECG has also carried out analysis on an alternative assumption with 0.5 per cent higher investment returns as compared with the fund return assumed in Aviva's end 2008 data. In the higher investment returns sensitivity the guidance for policyholder groups 1, 2 and 3, with regular premium policies maturing before 2022 and single premium policies with no maturity date, does not change significantly. The years when cumulative special distributions are expected to first exceed the PIP offer have changed by a maximum of one year for these groups of policyholders.

2.80 The higher investment returns in this sensitivity analysis affect the guidance for policyholder group 4 most significantly. In Table 2.9 above, LECG has shown that, using year-end 2008 data, potential future special distributions to in-force policyholders in this group would never exceed the PIP, under Aviva's new business assumptions for an assumed estate value of £1,200 million, whereas, using year-end 2006 data, the break-even point was 2028. Under the higher investment returns sensitivity, policyholders in group 4 are estimated to break-even in 2030. Therefore, it is clear that small changes to assumptions around investment returns can have a significant impact on estimated break-even points for policyholders who expect to mature or surrender beyond 2021.

2.81 The policyholder advocate's conclusion on the guidance to policyholders is therefore:

- regular premium policies maturing or being surrendered before 2017 are unlikely to receive future special distributions that exceed the PIP offer. The guidance for this group of policyholders has not changed from the analysis using year-end 2006 data.

Consequently, guidance does not need to be re-issued to this group of policyholders;

- for single premium policies with no set maturity date, whether or not future special distributions might exceed the PIP offer depends on when policyholders are likely to leave the funds. The guidance for this group of policyholders has not changed significantly from the analysis using year-end 2006 data. As a result, guidance does not need to be re-issued to this group of policyholders;
- regular premium policies maturing or being surrendered between 2017 and 2021 might receive future special distributions that exceed the PIP offer in some scenarios, however it is expected to take until at least 2019, assuming an estate value of £1,200 million and 15 per cent per annum declines in new business. For this group of policyholders the guidance has only changed by one year under two sets of assumptions compared with the analysis using year-end 2006 data. Consequently, guidance does not need to be re-issued to this group of policyholders; and
- consistent with the policyholder advocate's guidance booklet, regular premium policies maturing or being surrendered after 2021 are likely to receive future special distributions that exceed the PIP offer (with break-even points moving out by up to 5 years) in all but one set of assumptions, the exception being under Aviva's new business assumptions with an assumed estate value of £1,200 million. Whereas previously the guidance issued by the policyholder advocate suggested that estimated special distributions would break-even by 2028, the new data suggests estimated special distributions will never equal or exceed the PIP offer to an average policyholder in this group. However, as explained above, the incremental estimated distributions for average policies in this group beyond 2021 are relatively immaterial. Additionally, small changes in assumptions can have a significant impact on break-even years for this group of policyholders. Therefore, due to immaterial differences between distributions in later years and the high degree of volatility around break-even years depending on the assumptions made, it has been concluded that it is not necessary to reissue the guidance.

Summary of conclusions

2.82 The conclusions reached by LECG from its analysis of Aviva's year-end 2008 data are as follows. As with the analysis of the 2006 data, all conclusions assume that the FSA's current rules concerning uses of inherited estates remain in place.

- Aviva's aggregate offer still meets the policyholder advocate's two primary criteria:
 1. Assuming an estate value of £1,200 million on 1 October 2009, eligible policyholders are expected to receive an aggregate PIP of £500 million, which is far greater than possible future aggregate special distributions under Aviva's new business assumptions of £55 million, and
 2. eligible policyholders are expected to receive more than 50 per cent (63 per cent) of the residual value of the inherited estates under Aviva's new business assumptions for an assumed estate value of £1,200 million as at 1 October 2009;
- LECG's estimated shareholder IRR from the reattribution, at an estate value of £1,200 million, is 9.0 per cent; that the shareholder IRR has decreased by less than the fund rate implies a proportionate increase in the level of profit to shareholders from the reattribution. The fairness of the return to shareholders is for the FSA to consider.
- at least 96 per cent of policies would be better off accepting the PIP under Aviva's new business assumptions and assuming an estate value of £1,200 million on 1 October 2009.

2.83 In comparison with the analysis using the year-end 2006 data, the year-end 2008 data analysis shows that:

- eligible policyholders' potential future aggregate special distributions are projected to be £55 million instead of £83 million, under Aviva's new business assumptions for an assumed estate value of £1,200 million;
- eligible policyholders' share of the residual value of the inherited estates is slightly higher (63 per cent in the year-end 2008 data compared with 60 per cent in the year-end 2006 data);

- LECG's estimated shareholder IRR is more than 1 per cent lower as a result of Aviva's lower projected investment returns (9 per cent instead of 10.3 per cent); however, as noted previously, the shareholder IRR has decreased by less than the fund rate, implying a proportionate increase in the level of profit to shareholders from the reattribution. Correspondingly when the higher investment returns are used, the estimated shareholder IRR recovers in line with the higher investment returns;
- the estimated proportion of eligible policies with a PIP offer that is higher than potential future special distributions is effectively unchanged (over 96 per cent);
- there are no significant changes to the guidance that was given to policyholder groups 1 (regular premium policies with a maturity or surrender date up to and including 2016), 2 (single premium policies with no fixed maturity) and 3 (regular premium policies with a maturity or surrender date between 2017 and 2021) and therefore it is not necessary to reissue the guidance; and
- there are more significant changes to guidance for eligible policyholders in group 4 (regular premium policies with a maturity or surrender date beyond 2021). However, due to immaterial differences between distributions in later years and the high degree of volatility around break-even years depending on the assumptions made, in LECG's view it is not necessary to reissue the guidance.

As described previously, LECG believes that Aviva should review its new business assumptions for 2009 and 2010 and revise them following the withdrawal of the IPG bond, which accounted for a significant portion of the annual projected sales in 2009; to meet Aviva's new business assumption for 2009, remaining sales of other bonds and pensions would have (and Aviva projects them) to be significantly higher than in the first half of the year. Aviva has not provided any rationale for why the sales of pensions and other bonds are forecast to significantly increase in the second half of 2009. Aviva has stated it is not revising its assumptions for 2009 and 2010. The additional new business sensitivity beginning with 50 per cent of Aviva's new business assumption in 2010 and applying

Aviva's assumption of 5 per cent annual growth thereafter was considered in response to this issue.

2.84 LECG also performed its analysis assuming investment returns that were approximately 0.5 per cent higher than assumed in Aviva's 2008 data in each year of the projection period. This analysis illustrated that the position of eligible policyholders is not materially affected.

Chapter 3: Safeguarding the value of potential future special distributions to non-electing policyholders: re-assessing Aviva's Old WPSF 'safety net'

Introduction

3.1 Aviva, the FSA and the policyholder advocate are agreed that non-electing policyholders should not be disadvantaged by the reattribution.

3.2 Aviva's method of allocating the firm's aggregate PIP offer between eligible policyholders is not completely aligned with the potential future special distributions from the inherited estates that they will forgo if they elect to accept Aviva's reattribution offer. This means that non-electors' potential future special distributions from the inherited estate of the Old WPSF may be lower than they would have been without a reattribution. Aviva therefore agreed to top up the inherited estate of the Old WPSF with up to £100 million from the RIEESA to preserve the value of non-electors' potential future special distributions (referred to by Aviva as their VPDP – see chapter 29 of the policyholder advocate's June report).

3.3 LECG considered whether the £100 million top-up would be adequate, reviewing Aviva's analysis of 110 possible scenarios which use different assumptions about the number and nature of non-electing policyholders and the amount of new with-profits business that Aviva might have written in the absence of a reattribution.

3.4 LECG's conclusion was that, over a reasonable range of assumptions about the future and an assumption that 95 per cent accepted the Aviva offer then Aviva's 'safety net' was likely to preserve non-electors' benefits at a level similar to what they would have been without a reattribution. In her June 2009 report, the policyholder advocate was therefore content that the 'safety net' mechanism proposed by Aviva to protect non-electing policyholders' interests in future distributions from the Old WPSF would be effective (as discussed in chapter 32 of the June report).

3.5 The basis for calculating VPDP in context of assessing the position of non-electors or the adequacy of the safety net mechanism rests with Aviva and is not entirely resolved in the AFH report or the Scheme. Aviva has stated it will be providing a supplementary

letter to the AFH report and a further witness statement in the High Court, detailing the revised methodology for determining the VPDP of non-electors in its calculation of the safety net payment. Following feedback from the policyholder advocate's road shows and a review of Aviva's methodology for evaluating the effectiveness of the safety net, it became apparent that policyholders were likely to 'self-select' based on their expectations for the future; this implies that policyholders who do not intend to surrender their policy for a number of years are more likely not to elect to take the PIP and therefore that the average persistency in the Old WPSF could be significantly higher than in the New WPSF, and is particularly relevant for bond holders with no fixed maturity date. Aviva has since re-addressed the adequacy of its proposed 'safety net', and LECG has also reviewed its analysis. These re-assessments are summarised below and discussed in more detail in annexe 3A and 3B of this report.

Aviva's view

3.6 Aviva's stated intention throughout the reattribution process has been to treat customers fairly, in developing the proposals Aviva's aim has been to ensure that the VPDP for non-electing policyholders as a group is broadly preserved by the reattribution when tested under a wide range of take-up scenarios.

3.7 VPDP is viewed as giving an estimate of the amount which groups of customers might potentially receive as future special bonuses. It is calculated using assumptions that Aviva considers to be reasonable assessments of what might happen over the next 25 years, although inevitably unforeseen circumstance (both beneficial and detrimental) in the future could, with the benefit of hindsight, make these assumptions look unrealistic.

3.8 As VPDP is an average of values determined across a wide range of possible scenarios it is not a suitable basis for individual customer decisions or for individual PIP allocation. Its value is in providing management with a useful tool to help them – as part of a range of considerations – to ensure that their proposals and recommendations are fair.

3.9 The policyholder advocate has recently expressed concern regarding the calculation of the VPDP Adjustments (as described in Paragraph 5.3.13 of the AFH report). The policyholder advocate has shared some analysis with Aviva which concludes that the

calculation of the VPDP Adjustment should allow for the possibility that the lapse rates in respect of Non-Elected Bond policies may be lower after the reattribution to those of Elected Bond Policies.

3.10 In assessing the implications of the policyholder advocate's conclusions, Aviva has considered whether lapse rates of Old WPSF policies are likely to depend on the prospects for future inherited estate distributions.

3.11 It seems more likely that lapse rates will depend on other factors, such as future investment performance (and in particular whether MVRs are being applied) and the future cash needs of the policyholders concerned.

3.12 Although Aviva does recognise that the lapse rates for electors may increase to some extent as a result of the reattribution (as they would no longer lose their potential incentive payment) there is no evidence to suggest that the lapse rates for non-electors will change as a result of the reattribution.

3.13 Having said this, it is conceivable that policyholders who intended to surrender their policies in the short term would choose to elect, whereas those policyholders who intend to hold their policies for the longer term would choose not to elect. In these circumstances it is possible that, if the reattribution did not go ahead, the lapse rates for those who have chosen to elect would have been higher than those who have chosen not to elect.

3.14 Although the overall lapse rates experienced before the reattribution are known, it is not possible to predict with any degree of certainty what the difference in lapse rates of policies in the Old and New With-Profit Sub Funds might be in the future.

3.15 Based on analysis of the votes received to 21st August 2009, it seems likely that a significant proportion of the non-electors will consist of policyholders who have received a voting pack but who have not returned a valid election form. In these circumstances it is difficult to conclude categorically that the non-electors will generally consist of policyholders who intend to maintain their policies over the longer term and who are therefore likely to exhibit a lower than average lapse rate.

3.16 Recognising that it is impossible for anyone to accurately predict the future, and that the open-maturity policies by their nature are investments that are held or surrendered based on the policyholders immediate need for the proceeds, it is feasible, although not certain, that the persistency levels for non-electing policyholders could be higher than that implied by the recent aggregate lapse experience of CGNU Life and CULAC policies.

3.17 Having agreed that different lapse experience (both negative and positive) is a possibility for non electors (and electors) post election. The question then is how much should be allowed for in the assessment of non electors' VPDP pre and post reattribution. The fact that some policyholders say they are going to retain their policies for longer doesn't necessarily mean that all non electors will and therefore, from Aviva's perspective, it is going to be the average of these assumptions that matter.

3.18 On this basis, further analysis of the voting experience to 21st August 2009 has been undertaken and the Aviva Board agreed to an alteration to the negotiated terms of the reattribution offer. At the time of writing the supplementary AFH report the detail of the adjustment had not been finalised. A further letter will therefore be produced and published to document the revised proposals and will be presented in an additional witness statement to the High Court Hearing starting on 14th September 2009.

Aviva's proposed solution

3.19 There is very little information available to guide an appropriate assessment of the lapse rates for non-electors after the reattribution. One source is the analysis of the AXA FSA returns:

Surrender rates			
	Old With Profits Fund	New With Profits Fund	Ratio
2004	5.0%	5.9%	86%
2005	7.8%	9.6%	81%
2006	15.1%	15.8%	95%
2007	17.3%	20.4%	85%

3.20 The applicability of this information is clearly limited by the relative lack of information available to policyholder under this exercise, but in the absence of any other information this would suggest that 80 to 95 per cent would be reasonable.

3.21 The policyholder advocate suggested that the voting patterns for fixed maturity policies may be a useful indicator of the relative lapse experience of non-electing policies without fixed maturity dates.

3.22 It is acknowledged that the voting patterns are one of the few available sources of data, although Aviva has concerns regarding making inferences from one set of products to be applied to a different set of products.

3.23 In particular, a number of factors influence both the lapse and election decisions. The thoughts and behaviours of one group of policyholders are not necessarily the same as those of another group of policyholders, so any method applied mechanistically can only be regarded as approximate. In Aviva's opinion this means that, at most, the voting patterns on products with maturity dates could only be used as a crude guide.

3.24 Nevertheless Aviva considered the approach suggested by the policyholder advocate to consider the results it would give.

3.25 Aviva concluded that the implied profiles could be quite unstable from year to year. In addition, in the first few years before distributions were projected it would only be the average rates, rather than the year-on-year rates, which would be relevant.

3.26 Aviva therefore suggested smoothing out the profile as follows:

- 60% for the first six years
- increase at 5% per annum until reaches 90% in year 12
- remain at 90% until year 14
- decrease at 5% per annum thereafter, reaching 35% in year 25

3.27 This approach will produce a differential in lapse rates in excess of that implied by the AXA experience. Aviva has therefore concluded that this approach errs on the prudent side and favours non-electors.

LECG's analysis

3.28 LECG is able to utilise its models to estimate non-electors' VPDP absent a reattribution for a wide range of voting scenarios; however, due to a lack of data, LECG is

unable to accurately model an Old WPSF to estimate non-electors' VPDP post-retribution. Therefore, the policyholder advocate is reliant on Aviva to provide analysis on the position of non-electors; LECG and the policyholder advocate are able to review this analysis for reasonableness and have worked with Aviva to update its methodology to take their concerns into account. Further details are provided in Annexe 3B.

3.29 The feedback from the policyholder advocate's road shows and the likelihood that policyholders were likely to 'self-select' based on the policyholder advocate's guidance (and vote according to their expectations) has confirmed that there is a strong likelihood that the persistency of policyholders in the Old WPSF will be greater than had been previously assumed. Policyholders who do not intend to surrender their policy for a number of years are more likely not to elect to take the PIP and therefore that the average persistency in the Old WPSF could be significantly higher than in the New WPSF. Actual voting results thus far indicate that policies with longer terms to run are more likely to vote 'no', supporting the theory of self-selection. Accordingly, Aviva's original approach to estimating non-electors' VPDP both absent a retribution and post-retribution needs to be revisited.

3.30 A review of Aviva's initial analysis revealed that it grouped similar bonds into categories which were then treated homogeneously. This analysis did not take self-selection into account, as bond holders who leave the funds in the next five years were deemed to have the same VPDP per pound of asset share as bond holders who remain in the funds for 25 years.

3.31 The implication for Aviva's initial analysis is that to the extent there is self-selection in policyholder voting, the VPDP of non-electors absent a retribution, particularly for open maturity bond holders, is highly likely to be understated and consequently the estimated safety net payment required will also be understated. As a result, LECG and the policyholder advocate suggested that Aviva use the voting patterns for fixed maturity policyholders as a proxy for the voting behaviour of open maturity policyholders. That is, to assume that the same proportion of open maturity policies lapsing in a given year vote 'no' or don't vote as fixed maturity policies that mature in that year. Using this approach, ensuring that the overall lapse profile for the entire population of

policies remains the same, one can infer different lapse rates for the Old WPSF and the NWPSF in order to take self-selection into account when calculating the VPDP of non-electors, both absent a reattribution and post-reattribution.

3.32 LECG and the policyholder advocate therefore requested that Aviva update its methodology to allow for self-selection by policyholders as described above. As a result, Aviva analysed the non-electors and has produced a profile of adjustments to the standard lapse rates as follows:

- 60% for the first 6 years;
- increase at 5% per annum until reaches 90% in year 12;
- remain at 90% until year 14; and
- decrease at 5% per annum thereafter, reaching 35% in year 25.

3.33 LECG and the policyholder advocate broadly agree with Aviva's proposal and basis for smoothing the adjustments to non-electing bond policyholder lapse rates. Additionally, LECG has reviewed and substantiated the underlying voting and policyholder response data that Aviva has used to calculate these adjustments.

3.34 The revised approach to disaggregating eligible bond policyholders into electors and non-electors using the lapse rate adjustments above results in non-electing bond policyholders receiving a higher percentage of distributions and VPDP absent a reattribution compared to Aviva's previous approach. In the post reattribution position, the change in non-electors' lapse experience changes the projected distributions from the fund as well as the proportion of the asset share which relates to non-electors. Therefore, in order to calculate the post reattribution VPDP, Aviva projects the Old WPSF, in this instance being a fund with the same distribution of business as the New WPSF but where the lapse rates on non-electing bonds are lower than those on electing bonds in the New WPSF.

3.35 Aviva has presented analysis of the adequacy of the safety net based on its new basis for calculating VPDP for non-electing bond policyholders, assuming the same 10 per

cent annual decline in new business from 2011 onwards that was used when the safety net was assessed for the purposes of the policyholder advocate’s June 2009 report.

Additionally, Aviva has used the latest voting and response data and has assumed a 15 per cent non-election rate amongst policies that are still in force at the Effective Date.

3.36 The table below provides a summary of Aviva’s analysis, assuming an estate of £1,200 million, showing VPDP pre and post reattribution and safety net implications using the changed lapse rate assumptions. The safety net payment shown reflects any additional payment necessary over and above Aviva’s base analysis on all non-electing policies. Therefore, it purely reflects the impact of assuming different lapse rates for non-electing bond policyholders.

Table 3.1: Safety net payment based on Aviva’s new lapse rate assumptions for eligible bond policyholders with an assumed estate value of £1,200 million

	Pre-reattribution		Post-reattribution			
Lapse rate as % of base	Total VPDP	Bonds VPDP	Total VPDP	Bonds VPDP	Ratio post/pre VPDP	Additional safety net payment
Smoothed profile	55	31	49	28	89%	15

3.37 Aviva’s analysis suggests with the policyholder advocate’s and Aviva’s preferred approach (‘smoothed profile’) there is likely to be the need for an additional ‘safety net’ payment of £15 million. Aviva has stated that given current voting patterns it does not believe that any shortfall in the Old WPSF calculated on base lapse assumptions for all policies (that is excluding the ‘self-selection’ bond issue) would amount to more than £80m. LECG’s review of actual voting results indicates that there is a general increase in the proportion of non-electors as outstanding term increases, but without any large fluctuations that would indicate a bias towards an extreme voting scenario that may result in a greater shortfall than in Aviva’s previous scenarios. Additionally, the voting patterns within open maturity policies shows that there is a degree of randomness to responses where policyholders that hold policies with Market Value Reductions (“MVRs”) are voting

‘no’ when if they were voting on the basis of comparing the PIP to estimate VPDP then they should vote ‘yes’. This randomness in voting serves to reduce any potential safety net issue. This indicates that the £100 million safety net cap should be adequate based on the current voting pattern.

3.38 The policyholder advocate is therefore satisfied with the changes Aviva has made in calculating non-electing policyholders VPDP and believes that the new basis reflects an appropriate approach to ensuring the position of non-electing policyholders is preserved and one on which the adequacy of the safety net can properly be assessed. The policyholder advocate is therefore still satisfied that the potential future special distributions of non-electing policyholders will be broadly maintained across a range of scenarios post-retribution.

3.39 It should be noted that estimates of future special distributions are necessarily uncertain, as they are based on assumptions regarding the future behaviour of a number of unknown variables; the analysis used in the policyholder advocate’s assessment has been constructed based on assumptions that the policyholder advocate and/or Aviva consider reasonable, designed to assess the preservation of the potential special distributions of non-electors across a wide range of scenarios.

Chapter 4: The Scheme and non-electing policyholders – issues in the policyholder advocate’s report

4.1 In Chapters 4 and 20 of the policyholder advocate’s June 2009 report there were a small number of items which had not been finalised at the time of publishing the report, and a rather larger number of areas where the policyholder advocate felt that there should be more protection for policyholders than Aviva was proposing.

Items outstanding at original report date

4.2 *Reassurance that PIP formulae produce the correct aggregate* Aviva has always recognised that the policyholder advocate would need appropriate reassurance that the detailed formulae for the calculation of the PIP that are contained in Schedule 3 of the Scheme would, when applied to the actual book of eligible policies, produce the aggregate PIP number that had been agreed in negotiations. The form of comfort has been the subject of further discussion. The policyholder advocate has received a letter on behalf of the board of Aviva that describes in detail the internal and external auditing work that has been done to confirm that the formulae produce the correct outcome and confirms that the Aviva board is now satisfied that this is indeed the case. Aviva has also undertaken that if for any reason it should transpire that the formulae generate a total number that is more than 1 per cent less than the agreed aggregate, Aviva will agree with FSA an appropriate means by which to compensate electing policyholders for the shortfall.

4.3 *2007 new business subsidy top-up for Old WPSF* Because the FSA would, if the reattribution does not take place, require the inherited estates to be made good for the amount of the new business subsidy spent in 2007, Aviva has agreed that it is appropriate to pay an amount from the RIEESA into the Old WPSF to reflect this. The amount of this payment was under discussion at the time of writing the original report, but has now been agreed to be the Old WPSF Proportion of the aggregate 2007 subsidy. This payment will be made on the basis that, for purposes of testing whether there needs to be a VPDP adjustment, the amount of this subsidy top-up will be included in calculating both pre-reattribution VPDP – this will assume 100 per cent of the 2007 new business subsidy has been refunded, not just the ‘Old WPSF Proportion’ of the subsidy – and post-reattribution VPDP. The policyholder advocate is content with this outcome.

Other areas where the policyholder advocate thinks further protection merited

4.4 There have been no further developments on the matters which were highlighted in chapters 4 and 20 in the policyholder advocate's June 2009 report. The policyholder advocate continues to believe that the changes to the Scheme that she has requested remain valid additional protections for policyholders.

4.5 For ease of reference, the following is a re-print of the paragraphs of the original report that explain the changes requested by the policyholder advocate with the particular changes highlighted (the first time they are mentioned) in bold print.

“4.73 Another feature of the VPDP adjustment is that this (one-off) transfer might itself result in the Old WPSF becoming sufficiently strong that the obligation to make a compulsory special distribution is triggered earlier than would have been the case if the reattribution and the VPDP adjustment had not occurred. The policyholder advocate agrees with Aviva's view that this would not be appropriate, and she therefore has no objection to provisions in the Scheme that allocate the amount of any excess that would otherwise be distributable to a separate account known as the Old WPSF Bonus Amount (OBA). This amount is to be distributed to non-electing policyholders [and the holders of certain transferring ineligible policies] in the future, on a basis determined by Aviva in consultation with the With-Profits Committee. **However, the terms of the Scheme also apply this OBA approach (i.e. to ring-fence assets that might otherwise be available for distribution) even if there has been no VPDP adjustment, and the policyholder advocate sees no justification for this** (although accepts that the likelihood is low of the OBA provisions being triggered if there is no VPDP adjustment).”

“4.76 Currently, the FSA rules permit tax on distributions to shareholders from these with profits funds to be borne by the inherited estate. It is possible that the FSA could change this rule in the future so that shareholders would have to bear this cost (although it should be noted the FSA has confirmed that it does not foresee making any change to its rules in the near term). **The policyholder advocate is concerned that under the Scheme the Old WPSF policyholders could not be**

sure that they would benefit from such a change. She has discussed this with the FSA who have confirmed that:

- they do not in any way intend for an exception to be made to the general principle of non detriment to non electors;
- the Scheme does not in any way override future rule changes and if the rules were to change in the future they would expect Aviva to comply with them unless they had applied for and been granted a waiver; and
- to achieve a waiver, Aviva would need to satisfy FSA that (amongst other things) non-electing policyholders would be treated fairly if they were deprived of the benefit of the rule change, something that would on the face of things be very difficult for Aviva to demonstrate.

The policyholder advocate believes that policyholders should take considerable comfort from these confirmations, but continues to believe that the Scheme should be amended to put the position beyond doubt”.

“4.77 Three further provisions in the Scheme require particular comment:

- First there is a rather complex provision which allows the directors to adopt changes in management policy which benefit shareholders (excluding any policy the adoption of which the AVLAP Board consider necessary in order to treat customers fairly) where the benefit would not have arisen had the Scheme not been implemented provided that the prior approval of the With-Profits Committee is obtained. **The policyholder advocate considers that the approval of the With-Profits Committee should always be required for a policy that is specifically to the benefit of shareholders given the obvious conflicts of interest which arise in such a situation.**
- Second, there is a general provision that allows the continuation of pre-existing practices that would otherwise be a breach of the Scheme. Certain acceptable examples of this have been provided (for example pre-existing

reinsurance arrangements between the funds, and the current management services agreements), and **the policyholder advocate considers that if Aviva cannot recall any others, only the examples so far finalised should be permitted as exceptions.**

- Third, the Scheme expressly provides for the possibility of industry levies being charged to policyholders' asset shares, if the board considers it appropriate to do so, and subject to the overriding requirement to treat policyholders fairly. In contrast to the position for other new charges to asset shares, WPC approval is not required. Aviva's position is that the payment of industry levies could raise a financial security issue for the company, and therefore does not think it is appropriate for the WPC to have a veto. It also notes that the WPC will have a whistle-blowing right if it considers the charges or allocation of charges are unfair. **The policyholder advocate's view is that this, along with any other charges to asset shares, should be subject to WPC approval.**

“20.49 There are certain aspects of the Scheme which the policyholder advocate is not convinced provide appropriate protection for the non-electors. Her concerns about some aspects of the governance arrangements are described in chapter 18. In addition:

- There are Scheme rules allowing reinsurance arrangements between AVLAP funds. **All such arrangements require WPC approval in the case of the New WPSF, but outward reinsurance by the Old WPSF does not**, although, as Aviva points out, inward reinsurance does. **It may be the case that WPC approval is not currently required, but this is nevertheless an odd exception.**
- **The policyholder advocate has pressed unsuccessfully for a requirement that all investments by the New or the Old WPSF in loans or securities of any Aviva group company, and all transfers of assets or liabilities between the WPSFs and other Aviva companies and funds be**

subject to a requirement that the terms of any such investment or transfer be arms' length, and be approved by the WPC. She notes that this is not a protection that currently exists, but thinks the safeguards should be stronger for this type of transaction.....”

Strategic investments

4.6 The policyholder advocate expressed the view in the June 2009 report that the inherited estate should not be used to make strategic investments notwithstanding that this is permitted under FSA rules. Since these investments are made primarily for shareholder benefit, it is appropriate that shareholders bear the risk, and inappropriate that the OWPSF bears any risk. The policyholder advocate asked Aviva, notwithstanding current FSA rules, not to allocate strategic investments to the OWPSF. However, Aviva did not agree to this and has reserved the right to allocate a pro rata share of strategic investments to the OWPSF.

Aviva's view

4.7 Aviva notes that the policyholder advocate continues to believe that the aspects of the Scheme on which she wrote to FSA on 13th March 2009 should be changed. Aviva continues to disagree with these views for the reasons previously expressed in appendices to the policyholder advocate's June 2009 report such as 16A "Aviva's Scheme" and 32A "Position of Non-Electing Policyholders".

4.8 Aviva is satisfied that the policyholder advocate's views on these points do not alter the conclusions reached by the Actuarial Function Holder, With-Profits Actuary, Independent Expert or FSA on the fairness of the proposals.

Chapter 5: With-profits governance – issues in the policyholder advocate’s report

5.1 In chapter 18 of her June 2009 report, the policyholder advocate identified three key governance issues:

- the accountability of the With Profits Committee (WPC);
- WPC reports to policyholders; and
- disclosure of changes in the inherited estate.

She also questioned whether the role of the With Profits Actuary (WPA) provided sufficient governance protection for policyholders.

The policyholder advocate considers that proper governance of the Old WPSF is of fundamental importance in particular for non-electors, and has had further discussions with Aviva on this subject since the date of her earlier report. These have not resulted in the improvements she considers appropriate.

The importance of good governance

5.2 There is an inherent conflict between the interests of policyholders and shareholders in the operation of a with-profits business. But conflicts arise in particular where FSA rules permit the company to access estate capital for the company’s own purposes. If the company can use estate funds to pay expenses that it would otherwise have to pay itself, it will be naturally reluctant to reduce those estates through discretionary special distributions.

5.3 This conflict of interest is exacerbated by the fact that the directors of a with-profits company are in general required to pursue the interests of the company (and thus in practice its shareholders) and (other than having a regulatory obligation to treat customers fairly), have no general obligation or fiduciary obligation to pursue the interests of their policyholders.

5.4 The policyholder advocate considers, drawing on her experience as a regulator, that a crucial protection against the misuse of discretionary powers is that the person exercising such powers is subject to regular external scrutiny. That is why she has pressed for more regular and detailed reporting to policyholders by both the WPC and the WPA, and for a much clearer accountability to policyholders to be accepted by both of these governance entities.

5.5 There is a particular need for transparency and good governance in the case of non-electors. Such persons may have decided, on the basis of all the information available to them, including the policyholder advocate's guidance and the materials provided by Aviva, that it will be in their financial interest to remain with a fund holding an inherited estate. That decision will have depended on a comparison between the level of the PIP and the projected distributions described in these materials. If it turns out that the level of distributions is in practice significantly lower than those projected, non-electing policyholders will have made a bad decision and may feel understandably aggrieved.

5.6 The policyholder advocate's concern does not arise from that fact in itself, in that it is self-evident that future financial projections are inherently uncertain. But while such persons are inevitably exposed to the risks of a bad bargain arising from unexpected market conditions, it does not follow that they should be exposed to an additional risk that the company may not in practice exercise its wide discretion in the manner indicated in the materials to which the policyholder had access at the time of his or her decision.

5.7 The emergence of estate surplus for distribution to policyholders can be affected by many external events, but also by decisions that are directly under the control of the company. Obvious examples are the quantity of new business that is sold (and the terms of any guarantees contained in this new business) and changes in the investment policy adopted for investing estate assets or the reserves held for guarantees. Decisions of this nature raise obvious conflicts of interest between shareholders and policyholders, and between different classes and generations of policyholder.

5.8 This necessitates a governance framework which recognises and protects the interests of all interested parties. Instead, there are a number of respects in which the

governance arrangements currently in place fall far short of the standards necessary to ensure adequate protection for the interests of all relevant parties within the with-profits business.

Reports to policyholders

5.9 The current COBS rules require the company to produce an annual report to policyholders which addresses compliance with the PPFM; all significant relevant issues (including the way in which discretion has been exercised) and any competing or conflicting rights, interests or expectations of policyholders and shareholders.

5.10 The COBS rules do not cover what the report to policyholders should include if there were to be a scheme such as the one before the court. The policyholder advocate considers that non-electing policyholders should be regularly informed about the development of the Old WPSF estate, as to the likelihood and timing of future special distributions from that estate, and as to the reasoning behind any material decisions that may have had the effect of reducing the likelihood and size of future special distributions. Clearly, since the COBS rules do not cover what happens when there is a scheme, the scheme or associated documents would need to be amended to ensure that policyholders are adequately informed as described above. There is no such provision in the scheme.

5.11 As referred to in Chapters 6 and 18 of her June 2009 report, the policyholder advocate is concerned that neither the WPC nor the WPA is sufficiently accountable to policyholders. The essential problem is that the institutional structure of the WPC cannot be relied upon to protect policyholders' interests unless its activities are made subject to regular external scrutiny, which underscores the need for adequate transparency (similar concerns arise in the case of the WPA). The existing structure is such that the WPC is not directly accountable to policyholders. As stated above, this is a particular concern in relation to the Old WPSF.

5.12 She therefore believes that the WPC should be under a positive duty to report annually to with-profits policyholders in order to improve its accountability. She envisages that such a report would explain how the WPC has analysed policyholder interests and how they have been taken into account in the WPC's deliberations.

5.13 She also believes that the WPA should produce an annual report to policyholders, on which the WPC should comment. She envisages that the WPA's report would detail how the WPA has carried out his work, how he has evaluated policyholders' interests and how these have been taken into account in the management of the funds over the year. The report should explain how the differing interests of different policyholder groups have been handled. The report should include an analysis of the uses of the inherited estate over the year, the justification for those uses, and an analysis of the size of the estate and its movement over the year. This would also satisfy the need, which she identified at paragraph 18.43 of her June 2009 report, for disclosure of changes in the inherited estate over the year to be made available to policyholders. The report should provide information separately regarding the management of the Old WPSF, new business and the justification for investment decisions made. There should also be a commentary on the strength of the fund and of the likelihood of special distributions and of any special distributions made during the year. The suggested form of such a report is set out in Annexe 5 to this report.

5.14 The WPC should then comment (among other things) on certain specific aspects of the WPA's report, namely the justification for new business sold during the year, forward-looking plans, the strength of the Old WPSF and the likelihood of special distributions. Commercially sensitive information would, of course, need to be treated with due care by the WPC.

5.15 There are also certain specific respects in which the policyholder advocate considers that the role of the WPC is too limited, as referred to in Chapter 18 of the policyholder advocate's June 2009 report.

Conclusions on governance

5.16 The policyholder advocate's guidance to policyholders was based on what policyholders were expected to be giving up. These calculations could be under- or over-estimates, but they were predicated on good governance which would ensure that the natural conflicts of interest inherent in the running of with-profits funds did not impact on expected special distributions. If governance is not improved beyond what is currently in the scheme and associated documents there is an increased risk that the company will use

its discretion in ways that reduce special distributions below what non-electors might have expected from the guidance they received.

5.17 The policyholder advocate considers that increased transparency will lead to better governance. Accordingly, the WPC and the WPA should in the policyholder advocate's view be required to report annually to policyholders on the way in which they have exercised their powers.

5.18 Aviva has said it is not prepared to improve governance in the way that the policyholder advocate has proposed. This response does not take into account the fact that a scheme will exist or the special circumstance that non-electors have made their decision on the basis of expected special distributions, and where (as explained above) the company has incentives that militate against those special distributions being made. Non-electors need a counter balance to this incentive, and while it is true that the FSA has powers that could protect them, the policyholder advocate considers that a more effective counter-balance would be transparency obligations such as those discussed above.

Aviva's view

Governance

5.19 Aviva notes that the policyholder advocate continues to believe that aspects of the with-profit governance arrangements should be changed. Aviva continues to disagree with these views for the reasons previously expressed in annexe 30A "With-Profits Governance" to the policyholder advocate's June 2009 report.

5.20 Aviva is satisfied that the policyholder advocate's views on these points do not alter the conclusions reached by the Actuarial Function Holder, With-Profits Actuary, Independent Expert or FSA on the fairness of the proposals.

Annual Report to With-Profit Policyholders

5.21 The FSA specifies the type of annual reporting that needs to be made to with-profits policyholders in their handbook under COBS 20.4.7R and COBS 20.4.8G. In addition, SUP 43.16AR(4) sets out the requirement on the With Profit Actuary (WPA) to make a written report to with profits policyholders to accompany the annual report.

5.22 Under these rules a report must be made available to with-profits policyholders within six months of the end of the financial year. This report addresses compliance with the PPFM; all significant relevant issues (including the way in which discretion has been exercised) and any competing or conflicting rights, interests or expectations of policyholders and shareholders.

5.23 Copies of the “Board report to policyholders for 2008” and “With-Profits Actuary report to policyholders for 2008” for the CGNU Life and CULAC with-profit funds are available on Aviva’s web-site.²⁰

5.24 In addition, Aviva provides with-profits customers with an annexe to the CFPPFM entitled “Update on how we manage the with-profit fund”.

Compliance with the Scheme

5.25 Aviva will report annually to the FSA on compliance with the terms of the Fund Transfer and Reattribution Scheme.

With-Profits Committee

5.26 The WPC views communications with customers as the remit of marketing and the Board in normal circumstances. They consider that, only in exception, it would be appropriate for WPC to communicate directly.

5.27 The WPC view is that in most instances it is better and more fitting of the formal governance structures within the company to influence the Board/marketing in its messages to customers. In this regard the WPC is already quite active and recent examples such as the reviews of the customer friendly with profit guides illustrate where WPC advice and guidance resulted in material changes being made to improve documents.

5.28 The WPC has existing rights under its terms of reference to communicate directly with customers should it wish to do so, and does consider this option regularly. WPC continues to monitor its own approach on direct communication with policyholders.

²⁰ <http://www.aviva.co.uk/savings-and-investments/ppfm.html>

FSA Review

5.29 FSA is reviewing its rules on policyholder communications, and we understand that the policyholder advocate can input to these considerations.

Aviva Conclusions

5.30 Aviva welcomes the policyholder advocate's thoughts in this area, recognising that they appear to be geared towards reporting on the uses of the inherited estate, which are permitted uses, with a view to how these are affecting the likelihood of future special distributions to the with-profits policyholders in the CGNU and CULAC With-Profits Fund. This, from Aviva's perspective, arises from the policyholder advocate's view of the primary purpose of the with-profits funds being to distribute profits to policyholders which does not reflect the current legal position, the FSA's view or the accepted industry practice. These are covered in detail in the annexe 25A&B "Legal Issues Arising in Respect of Rights and Interests in and Uses of the Inherited estate" to the policyholder advocate's June 2009 report.

5.31 The policyholder advocate notes that policyholders in the Old WPSF may have not elected because of their interest in a possible future special distribution, Aviva has stressed this is unlikely for many years at least, and has said that to accept the reattribution offer would be in the interests of the vast majority of eligible policyholders (99 per cent).

5.32 In the interests of treating its policyholders fairly, Aviva has considered the policyholder advocate's proposals and has provided them to the WPA and WPC for their views. They do not consider them to be necessary changes to be made at this stage, but will keep them under review whilst monitoring their own approach to policyholder communications.

5.33 In summary, Aviva will continue to operate in accordance with the FSA rules regarding communications to policyholders. The suggestions made within the KPMG paper, Annexe 5A go beyond these rules.

Chapter 6: Comments on the supplementary reports of the Actuarial Function Holder, the With-Profits Actuary and the Independent Expert

Introduction

6.1 In the policyholder advocate's June 2009 report, KPMG, as the policyholder advocate's actuarial adviser, comments on these actuarial reports. KPMG has now made additional comments below on the supplementary reports which have been produced by the AFH, the WPA and the IE.

The Independent Expert's supplementary report

Introduction

6.2 The Independent Expert has provided his updated assessment of the effect of Aviva's proposals on policyholder security and benefit expectations based on unaudited information as at 30 June 2009.

Purpose of this report

6.3 KPMG has reviewed the supplementary report of the Independent Expert and has commented on the views expressed by the Independent Expert on the allocation of any benefits amongst the relevant with-profits policyholders.

Summary of the Independent Expert's updated assessment

6.4 In this section KPMG comments on the updated conclusions set out in the Independent Expert's report, and those set out below in bold are direct extracts from the Independent Expert's report.

6.5 **Section 2.2 "Based upon unaudited financial information as at 30 June 2009, in my opinion current policyholders of CGNU Life, CULAC, NUL(RBS), ALIL, AVLAP and AVA will not experience a significant reduction in the level of security for their guaranteed benefits as a result of the schemes."**

6.6 The Independent Expert has commented that CGNU Life now appears to be materially weaker than CULAC and AVLAP as at 30 June 2009 (see section 3.3 of the Independent Expert's supplementary report). In coming to his conclusion, the Independent Expert takes into account the fact that CGNU Life and CULAC have historically been

managed to ensure that the strength of the two funds are similar, and that steps could be taken to reduce the current imbalance.

6.7 KPMG notes that CULAC has in the past been weaker than CGNU Life.

6.8 An extract from section 3 of the Independent Expert's report is set out below:

Table 3.1: Statutory solvency position at 30 June 2009

£m	CGNU Life	CULAC	NUL(RBS)	AVLAP
Long term business admissible assets	13,600.0	14,419.5	12.2	55,291.4
Shareholder funds	139.1	121.9	49.3	730.2
Total assets (A)	13,739.1	14,541.4	61.5	56,021.5
Total long term liabilities (B)	12,715.6	13,143.0	12.2	52,056.1
Excess available assets (C=A-B)	1,023.4	1,398.4	49.3	3,965.4
Subordinated debt (D)				0.0
Implicit item for future profits (E)				59.6
Capital Resources of regulated related undertakings (F)		26.2		890.5
Capital Resources (G=C+D+E+F)	1,023.4	1,424.6	49.3	4,915.6
Minimum Capital Requirement (MCR) (H)	735.1	523.4	26.2	2,272.7
With-Profits Insurance Capital Component (I)	0.0	196.0	0.0	507.2
Capital Resources Requirement (CRR) (J=H+I)	735.1	719.4	26.2	2,780.0
Excess assets (=G-J)	288.4	705.2	23.1	2,135.6
Ratio of Capital Resources (net of WPICC) to MCR (=G-I)/H)	139%	235%	188%	194%

6.9 Based upon those figures, Aviva has calculated that the Capital Resources and Capital Resources Requirement of AVLAP at 30 June 2009 would have altered as shown below had the Proposed Schemes taken effect at that date.

Table 3.2: Pro forma statutory solvency position of AVLAP at 30 June 2009

£m	Pre-Scheme	Post-Scheme*
Long term business admissible assets	55,291.4	83,334.6
Shareholder funds	730.2	985.5
Total assets (A)	56,021.5	84,320.1
Total long term liabilities (B)	52,056.1	77,940.8
Excess available assets (C=A-B)	3,965.4	6,379.3
Subordinated debt (D)	0.0	0.0
Implicit item for future profits (E)	59.6	59.6
Capital Resources of regulated related undertakings (F)	890.5	893.0
Capital Resources (G=C+D+E+F)	4,915.6	7,331.9
Minimum Capital Requirement (MCR) (H)	2,272.7	3,253.3
With-Profits Insurance Capital Component (WPICC) (I)	507.2	957.4
Capital Resources Requirement (J=H+I)	2,780.0	4,210.7
Excess assets (=G-J)	2,135.6	3,121.2
Ratio of Capital Resources (net of WPICC) to MCR =(G-I)/H)	194%	196%

* Allowance has been made for £26 million of Additional Benefits costs to be met from surplus in the non-profit sub-funds of AVLAP.

6.10 Table 3.1 from the Independent Expert's supplementary report shows the extent to which CGNU Life is weaker than CULAC and AVLAP as at 30 June 2009. Therefore a concern would be if the strength of the CULAC fund were to be materially weakened post-scheme.

6.11 Comparing CULAC's ratio of "capital resources" to "minimum capital requirement" before and after the implementation of the Scheme would give 235 per cent compared to 196 per cent. Clearly the level post-Scheme is lower, but the Independent Expert has also taken into account the fact that, if the Proposed Schemes did not proceed, it appears likely that the proportion of new with-profits business allocated to CULAC would be increased. Other things being equal, this would gradually reduce the difference in financial strength between the two sub-funds.

6.12 In addition, the Independent Expert has taken into account the fact that the 2007 new business subsidy, adjusted to allow for the investment returns credited to asset shares

since 2007, must be repaid if the reattribution does not go ahead. If the reattribution does go ahead, an amount in respect of the Old WPSF share of the subsidy will be transferred from the RIEESA to the Old WPSF. Clearly due to this, the strength of the funds of CGNU Life and CULAC would be higher if the reattribution did not go ahead by the amount of 2007 new business subsidy. The Independent Expert does not consider this to have a significant impact on the security of the funds.

6.13 KPMG has no reason to disagree with the Independent Expert's conclusion set out in bold above.

6.14 **Section 2.3 “I confirm that I see no reason to change the conclusions regarding reasonable benefit expectations which are stated in my full report. In particular, in my opinion:**

No group of policyholders transferring to AVLAP or group of existing policyholders of ALIL will experience a material reduction in reasonable benefit expectations as a result of the schemes. This does not take into account the scope for future special distributions from the inherited estates of CGNU Life and/or CULAC (see paragraphs 1.2.25 and 1.3.20 of my full report). I consider that there are no aspects of the Main Scheme which would be likely to result in material unfairness to any group of policyholders.

No existing policyholders of AVLAP or AVA will experience a material reduction in reasonable benefit expectations as a result of the schemes.

The schemes specify governance arrangements which are capable of protecting the interests of transferring policyholders and of the existing policyholders of ALIL, AVLAP and AVA.”

6.15 Based on the information provided to KPMG, we concur that there is nothing that should lead the Independent Expert to change his conclusions in this area.

6.16 **Section 2.4 “I am satisfied that for each of CGNU Life, CULAC, NUL(RBS), ALIL, AVLAP and AVA the schemes are equitable to all classes and generations of**

policyholders. The schemes have a number of safeguards which I consider should be sufficient to ensure that the schemes operate as presented to the Courts.”

6.17 In coming to his conclusion above, the Independent Expert has taken all relevant recent events into account, including the fact that Aviva had incorrectly calculated the minimum incentive payment on certain Self employed Deferred Annuity policies (see section 5.1 of the Independent Expert’s supplementary report).

6.18 The Independent Expert has also taken account of the relative change in the strength of CGNU Life and CULAC as noted above. However the Independent Expert has not specifically commented in his report on what impact, CGNU Life being materially weaker than CULAC, has on the potential for special distributions. Clearly there is scope to view this as resulting in the potential special distributions available to policyholders of a CULAC policy now being more than those for policyholders of a CGNU Life policy. However we agree with the Independent Expert’s comments around the fact that historically the two funds were managed such that any short term differences in strength were rebalanced.

6.19 KPMG has no reason to disagree with the Independent Expert’s conclusions set out above.

Charging of future industry levies to asset shares

6.20 In appendix 19 of the policyholder advocate’s June 2009 report, KPMG commented on the following:

“The Scheme does not require the With-Profits Committee to approve any charges to asset shares in respect of some or all of future industry levies. We believe it would be appropriate for such approval to be required. In this respect, the Independent Expert places reliance upon the Board taking action in line with the With-Profits Committee’s recommendations, and reliance on the With-Profits Committee whistle-blowing to the FSA if they feel the need to do so. In effect the Independent Expert is taking the view that such reliance can be placed on the Board and With-Profits Committee. We do not share the Independent Expert’s view in this area, and would prefer approval for some or all of the future industry levies

being charged to asset shares to be subject to the approval of the With-Profits Committee.”

6.21 We note here that the Independent Expert has not updated his conclusions in this respect and our comments stand.

The AFH’s supplementary report

Introduction

6.22 The AFH has provided a supplementary report which considers whether any of the conclusions set out in the AFH report need to be changed in light of developments that have taken place since that report was finalised. Note that there have been changes to the names of the companies involved but the supplementary reports by the AFH and the WPA use the old names for ease of comparison with the previous reports.

Purpose of this report

6.23 KPMG has reviewed the supplementary report of the AFH and have commented on the impact of the AFH’s conclusions in light of recent developments. KPMG has not considered conclusions with respect to the Alternative Scheme.

Summary of the AFH’s updated conclusions

6.24 In this section KPMG comments on the key updated conclusions set out in the AFH report, and those set out below in bold are direct extracts from the AFH report.

Section 2.2.1 “In section 3 of this supplementary report I consider whether my conclusions relating to the impact of the Scheme and the Alternative Scheme on benefit security, set out in Section 6 and Section 10 of my report respectively, continue to apply. In particular I consider the impact on benefit security of merging the CGNU Life and CULAC With-Profits Funds and the effect of the Scheme on the benefit security for existing policyholders of NULAP and the Transferring Policyholders.

I conclude that:

On the basis of the financial position at 30 June 2009 all of the conclusions set out in Paragraphs 2.5.4 and 2.5.8 of my report continue to apply.”

6.25 The AFH considers the fact that the financial strength of CULAC was stronger than that of CGNU Life at 30 June 2009, and goes on to explain some of the reasons for this development. The AFH makes the argument that the CGNU Life and CULAC funds have effectively been run as one fund since 1998, with a balance of financial strength being maintained through the reinsurance of a proportion of the new with-profits business written by CGNU Life to CULAC. He also makes the point that there have been times in the past when the CGNU Life fund was stronger than the CULAC fund.

6.26 KPMG has no reason to disagree with the AFH’s conclusions.

6.27 **Section 2.2.2 “In section 4 of this supplementary report I consider whether my conclusions relating to whether or not the PIP offered to eligible policyholders should be considered attractive to them and whether the approach selected for the allocation of the transferred Inherited Estates is fair for the policyholders who have chosen not to elect to participate in the reattribution set out in Section 7 of my report continue to apply.**

I conclude that:

All of the conclusions regarding Policyholder Interests in the Inherited Estate and the Election set out in Paragraph 2.5.5 of my report continue to apply.”

6.28 Aviva has used different assumptions from the policyholder advocate to value the VPDP to policyholders. However KPMG has no reason to disagree with the AFH’s conclusions set out above given that Aviva has used these different assumptions.

6.29 KPMG would also note here the conclusions made by the AFH as to the impact on holders of non-elected policies. The AFH states that in view of the concerns expressed by the policyholder advocate about the potential for non-electors experiencing lower lapses than electors which would invalidate their VPDP calculation, the Board have agreed that, when determining the VPDP Adjustment, an allowance will be made for the possibility that

the lapse rates for Non-Elected Bond policies would have been lower than those for Elected Bond policies (and so VPDP would increase). The AFH states that Aviva and the policyholder advocate are currently discussing how this might best be achieved using information obtained from an analysis of the outcome of the election and that the results of those discussions are expected to be concluded and the agreed proposals put to the High Court prior to the Court Hearing on 14 September 2009. (These discussions have now concluded and KPMG understands that this will be addressed in a supplementary letter produced by the AFH.)

6.30 Section 2.2.3 “In section 5 of this supplementary report I consider whether my conclusions regarding the impact of the financing arrangements for the Policyholder Incentive Payments (PIPs) set out in Section 9 of my report continues to apply.

I conclude that:

On the basis of the financial position at 30 June 2009 the conclusion set out in Paragraph 2.5.7 of my report continues to apply.”

6.31 The proposed financing of the PIP has not changed and KPMG has no reason to disagree with the AFH’s conclusions in this area.

6.32 Section 2.2.4 “In section 6 of this supplementary report I consider the impact of any other developments since the date of my report which are relevant to the Scheme or the Alternative Scheme.

I conclude that:

- **the conclusions regarding policyholder interests in the Inherited Estate and the Election set out in Paragraph 2.5.5 of my report and my conclusions regarding the impact of the Scheme and the Alternative Scheme on benefit security set out in Paragraphs 2.5.4 and 2.5.8 of my report are not affected by the treatment of the 2007 new business subsidy.**

- **I see no reasons to change any of the conclusions in my report as a result of any of the objections raised up to the date of this supplementary report.”**

6.33 The AFH has considered the impact of other recent developments since the date of his report. The main development is that an amount equal to the Old WPSF Proportion of the 2007 New Business Subsidy should be transferred from the RIEESA to the Old WPSF immediately after the Effective Date. Such a transfer will be without conditions and, in particular, it will not represent a contingent loan under the capital support arrangements. The pre-Effective Date VPDP will be determined making an allowance for a notional refund of the 2007 new business subsidy and the post-Effective Date VPDP will be determined making an allowance for the actual refund of the 2007 new business subsidy. For the avoidance of doubt, this means that the treatment of the 2007 new business subsidy will not give rise to an increased likelihood that the £100 million cap on the VPDP Adjustment will apply in practice. The Effective Date BSF Test and the OBA calculations will be carried out after the transfer.

6.34 Although KPMG notes that the transfer to be made from the RIEESA to the Old WPSF in respect of the 2007 new business subsidy serves to reduce the strength of the RIEESA in the New WPSF we do not believe this to be material enough to lead to a change in the AFH’s conclusions.

Other Issues

6.35 In appendix 17B to the policyholder advocate’s June 2009 report KPMG commented as follows:

- “we note that the power to allocate some or all of future industry levies to asset shares has been introduced, and is solely for the Board to determine. There is no power of veto from the WPC on the charging of these levies to asset shares. Although KPMG has been told that the PPFM for the old with profit sub fund (Old WPSF) and the new with profit sub fund (New WPSF) and the Independent Expert’s report will discuss how the WPC needs to be made aware of, and consulted on, such levies being charged to asset shares,

and that the Board will properly consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies, we would have expected this important area of governance to be set out in the Scheme or the AFH report. Importantly, it would in our view be more appropriate for this power to be subject to the WPC approval process;

- strategic assets – we do not agree that the remaining assets of the Old WPSF should be invested in any form of strategic asset;
- the AVLAP Board will retain the right to change the basis of allocation of single premium increments and switches on eligible with-profits policyholders in the future so that they are allocated to the New WPSF with proportional reinsurance to the Old WPSF. We believe that the AFH should recommend that the With-Profits Committee (WPC) be required to approve such a decision; currently they are not.
- we believe that the timing and manner of the distribution of any potential “Old WPSF Bonus Amount” should be set out clearly in the Scheme, rather than being at the discretion of the AVLAP Board with the approval of the WPC.”

6.36 We note that the PPFM for the old with profit sub fund (Old WPSF) and the new with profit sub fund (New WPSF) and the Independent Expert’s report are now available on the Aviva’s website, and do discuss how the WPC needs to be made aware of, and consulted on, industry levies being charged to asset shares, and that the Board will properly consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies. However there remains no power of veto by the WPC.

6.37 We note here that the AFH has not updated his views in respect of these areas and so our comments stand. KPMG notes that the AFH will be producing a supplementary letter to the supplementary report.

The WPA's supplementary report

Introduction

6.38 The WPA has provided a supplementary report which considers whether any of the conclusions set out in the WPA report need to be changed in light of developments that have taken place that report was finalised.

Purpose of this report

6.39 KPMG has reviewed the supplementary report of the WPA and has commented on the impact of the WPA's conclusions in light of recent developments. KPMG has not considered conclusions with respect to the Alternative Scheme.

6.40 KPMG notes and accepts that no specific guidance from any source exists in relation to the role of the WPA in a reattribution situation, and that different WPAs will have different views as to how they should exercise their role in a reattribution.

Summary of the WPA's updated conclusions

6.41 In this section KPMG comments on the key updated conclusions set out in the WPA report, and those set out below in bold are direct extracts from the WPA report.

6.42 **Section 2.2.1 "In Section 3 of this supplementary report I consider whether my conclusions relating to the impact of the Scheme and the Alternative Scheme on the fair treatment of with-profits policyholders as set out in Sections 4, 5, 6 and 7 and in Section 9 of my report respectively, continue to apply in the light of the development of the financial position of the Transferor Companies and NULAP between 31 December 2008 and 30 June 2009. In particular I consider the impact on the fair treatment of policyholders of merging the CGNU Life and CULAC With-Profits Funds in the light of the change in the relative financial strength of those funds.**

I conclude that:

On the basis of the financial position at 30 June 2009 the conclusions set out in Paragraphs 2.5.2, 2.5.3, 2.5.4, 2.5.5 and 2.5.7 of my report continue to apply."

6.43 The WPA considers the fact that the financial strength of CULAC was stronger than that of CGNU Life at 30 June 2009, and goes on to explain the impact this could have on the EBRs of the two funds. The WPA refers to the AFH's argument that the CGNU Life and CULAC funds have effectively been run as one fund since 1998, with a balance of financial strength being maintained through the reinsurance of a proportion of the new with-profits business written by CGNU Life to CULAC. The WPA also bases his conclusions on the fact that there has been a historic practice of determining the Benchmark EBR for the combined funds of CGNU Life and CULAC which would be likely to continue in the absence of the Scheme.

6.44 KPMG agrees that the WPA's conclusions do not need to change.

6.45 **Section 2.2.2 "In section 4 of this supplementary report I consider the impact of any other developments since the date of my report which are relevant to the Scheme or the Alternative Scheme.**

I conclude that:

- **I see no reasons to change any of the conclusions in my report as a result of any of the objections raised up to the date of this supplementary report.**
- **I am satisfied that the actions taken to correct the error in the PIP calculation for Self Employed Deferred Annuity contracts, including the notification provided to the affected policyholders and the provision of a revised voting pack, are consistent with the fair treatment of policyholders."**

Section 2.2.3 In the remaining sections of this supplementary report I have not specifically considered:

- **the current rights and expectations of with-profits policyholders in relation to distributions from the Inherited Estates of CGNU Life and CULAC and whether the current generation of with-profits**

policyholders have contributed to the build up of the Inherited Estate as set out in Section 3 of my report;

- **the fairness of the reattribution process as set out in Section 8 of my report;**

and

- **the governance arrangements that will apply after the Effective Date of the Scheme as set out in Section 10 of my report. In these respects there have been no developments which have taken place since the date of my report which are relevant to the considerations set out respectively in Sections 3, 8 and 10 of my report.**

I conclude that:

The conclusions set out in Paragraphs 2.5.1, 2.5.6 and 2.5.8 of my report continue to apply.”

6.46 The WPA has considered the impact of recent developments since the date of his report: KPMG agrees that of the recent developments commented on by the WPA, there is no reason for the WPA to change his conclusions.

6.47 KPMG notes however that a recent development not considered by the WPA in his conclusions is the fact that Aviva stopped selling with-profits business with inflation linked guarantees in April 2009. We believe that the WPA should have considered whether this may have an impact on the levels of expected future new business which in turn could impact the VPDP calculations. He has not done so.

Other comments made by KPMG in appendix 18B

6.48 In appendix 18B to the policyholder advocate’s June 2009 report KPMG commented as follows:

“The WPA has concluded that with-profits policyholders as a whole have a right to receive a proportion (at least 90 per cent) of the relevant inherited estate to the

extent that it is distributed, but not otherwise, and that individual policyholders have very little specific rights to participate in a distribution from the inherited estate.

The WPA also states that legally, policyholders as a whole do not have a right to participate in profits arising during a period that are not distributed nor do they have a right to participate in the undistributed profits of prior periods unless and until they are distributed.

Our perspective is different. We believe that the effect of the COBS rules and the fact that the PIP is being offered, must mean that, by definition, the combination of all these factors does lead to a material interest in the estate.

It is also the case that the current generation of policyholders' contingent interest in the inherited estate is directly dependent on the levels of future new business. If for example, in the extreme, there were no future new with-profits policies sold, then the full amount of the inherited estate would fall 90 per cent to the current generation of policyholders. We believe that the WPA in his role could usefully have considered the range of possibilities that might arise. Clearly, given the presence of the policyholder advocate, we would not expect the WPA to act as a second advocate, or get involved in negotiations. Nevertheless, in our view, the WPA would need to have satisfied himself that the PIP is in the interests of policyholders under a plausible range of scenarios.

We therefore believe that the WPA should have commented on Aviva's forecasts for new business and his view of their appropriateness. The WPA does state that he believes that the risk appetite is in his view fully consistent with the expectations of policyholders, but we believe that he should also have commented on how the chosen risk appetite of the fund affects the amount forecast to go to future policyholders.

With regard to the uses of the estate (section 3.5 of the WPA report), we would have expected the WPA in his report to have given more consideration to the existing rules around surplus distributions and, given the COBS rules, to have

considered more fully the potential impact on the current generation of policyholders of the uses to which Aviva can put the estate.

The WPA does not express an opinion in his report as to size of the aggregate PIP, and we would have expected the WPA to have done so

There is one potentially important area of the Scheme on which there is no conclusion or comment by the WPA. The power to allocate some or all of future industry levies to asset shares has been introduced, and is solely for the Board to determine. There is no right of veto from the WPC on the charging of such levies to asset shares. However, we do note that the draft PPFM for the Old WPSF and the New WPSF does state that the WPC will be made aware of and be consulted on such levies being charged to asset shares, and that the Board will properly consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies.

Such levies have not been significant in the past, and have not been charged to asset shares in the past. However, due to the regulations having changed to include levies in respect of the banking sector such levies could become large in the future.

Clearly what is important is whether the treatment of such levies after the Scheme is implemented is likely to be different from the treatment of such charges before the Scheme. We acknowledge that the amounts of such levies are impossible to predict and they could be classified as expenses incurred in running the business. However, we believe that the power to charge some or all of such levies to asset shares rather than the inherited estate means there is a very clear potential conflict of interest between the shareholders and policyholders.

KPMG believe that the WPA should have considered this and commented on whether he believed that there being no requirement for WPC approval for charges to asset shares in respect of future industry levies is appropriate.”

6.49 KPMG notes here that the WPA has not changed his views in respect of the areas set out above and so our comments stand.

A further comment by the policyholder advocate

6.50 In chapter 6 of the policyholder advocate's June 2009 report, the policyholder advocate commented as follows:

“The With-Profits Actuary (WPA) has the responsibility to consider the fair treatment of policyholders. He has a counterbalancing role within the firm and should consider and protect policyholders' interests.

This role is particularly important given that the firm acknowledges ‘that its directors are entitled to have regard to the interests of the firm as the proprietor of the with-profits business, although the requirement to comply with contractual obligations and TCF must also be observed’²¹.

This means that the firm can naturally be expected to put shareholders' interests first, to the extent that regulation and law and good customer relationships allow. FSA rules intended to protect customers are effectively most clear in respect of asset shares. However, where there is an inherited estate there are areas where the FSA permits that estate to be used but where the FSA prohibits assets shares being used. When the estate is used in this way there is a transfer of value from policyholders, who lose potential special distributions, to shareholders.

Given the duty of directors to pursue the firm's interests, and the fact that firm interests are usually judged by reference to shareholders' interests, there is a strong likelihood that the estate will be applied to further shareholder interests as far as possible. Therefore the role of the WPA in protecting policyholders' interests should be a particularly important one. The rules, standards and guidance (both of the FSA and the Board for Actuarial Standards) do not go far enough to require the WPA to be as explicitly an advocate for policyholder interests as required in the circumstances. Without this protection, policyholders are not protected adequately. This is an issue that should be addressed both by the Board for Actuarial Standards

²¹ Appendix 25, Legal Issues arising in respect of Rights and Interests in and Uses of the Inherited estates.

and the FSA. In addition it is my view that the actuarial profession should be setting guidance in this area.

To be effective the WPA must fully understand and value policyholders' rights and interests, and then look to protect these interests by arguing the policyholders' case within the firm. His deliberations should be transparent and reported to policyholders so that they can see how their interests are being protected.

Policyholders clearly have rights to at least 90 per cent of distributions from the fund, wherever those distributions come from, including from the estate. The Financial Services Authority (FSA) has stated that policyholders' expectations of special distributions from the estate are not zero. It is also apparent from the work that Aviva and the policyholder advocate have carried out that the value of policyholders' interests in future estate distributions can be estimated, under various assumptions, and can be attributed to individual policyholders. There is much uncertainty in these calculations, but that does not prevent the calculations being made.

In the policyholder advocate's view the fact that individual policyholders' interests in the estate are uncertain and hard to value can never justify uses of the estate which erode the value of policyholders' interest to the benefit of shareholders. Furthermore, the right to 90 per cent of distributions can never be affected by communications from the firm that try to manage policyholder expectations of the likelihood of distributions. Rights are rights, even if it isn't clear how much they are worth.

The task of the WPA should be to examine the value of policyholders' interests and question whether the firm is eroding those interests. The WPA should ensure that he identifies and values such transfers out of the estate and explain to policyholders the reasons why they have been permitted.

In addition the FSA permits the firm to write subsidised new business which transfers estate capital from current policyholders to future generations. This is the intergenerational transfer which has been a feature of most with-profits funds. The

loss of value to current policyholders from writing new business, which takes away estate value from the current generation of policyholders is the overwhelming driver which ensures that very little of the estate is expected to go to the current generation. The more new business the firm writes without compensating current participants for the transfer, the less current policyholders can expect to receive from the estate. Where the major driver of the reattribution is new business, the WPA should be expected to challenge the firm's projected levels of new business. He does not.

The challenges described above should be part of the WPA's role in protecting policyholders' interests. Those interests are key to understanding what policyholders are giving up in a reattribution. It is unfortunate that there are no FSA rules or guidance which cover what the duties of the WPA are or should be in a reattribution.

A reattribution makes the WPA role even more important since it is a unique opportunity for the firm to receive a lump sum to compensate it for all the transfers from policyholders to shareholders which the firm expects to receive from the estate in the future beyond the shareholders' normal 10 per cent. This is because the firm will no longer receive a transfer from policyholders' interests once the firm owns the reattributed estate and therefore the firm will not make an offer unless all the uses of the estate which benefit shareholders have been taken into account in the calculations..

A reattribution under the FSA rules is also a unique opportunity for the firm to receive a share of the 90 per cent of the estate which otherwise would have gone to future policyholders and which shareholders would not be able to access in any other way.

The WPA report does not critique the firm's assumptions. Without a critique it is not possible to say if the value ascribed to policyholders is robust or not.

The KPMG Appendix on the WPA report makes similar points. 'The report of the WPA contains no commentary or critique of the assumptions used to determine the

value of the policyholder's interest in the estate. KPMG would have expected the report of the WPA to include such consideration, and to confirm that the size of the PIP being offered corresponds to a scenario which the WPA regards as being plausible. Assumptions such as the levels of new business, for example, are key to the calculation, yet KPMG does not know whether the WPA considers these reasonable or not.' 'KPMG would expect the WPA in his report (section 3.6) to comment on the approach taken to risk appetite. In particular KPMG would have expected him to consider the balance between a high level of security and the potential for future distributions of the inherited estate, and to draw out the advantages and disadvantages of the proposal. The risk appetite is particularly important when there is an expectation of a high level of future new business because new business serves to increase capital requirements and delay potential releases of surpluses which has the effect of transferring more surpluses to future expected new business.'

The WPA is appointed by the firm, and has usually been employed by the firm before taking up the WPA position, and will often be employed in a different capacity after being the WPA²². This means that the WPA's career is usually firmly embedded within the organisation. This makes it awkward for the WPA to challenge management on behalf of policyholders' interests. It is particularly difficult if he is challenging practices which have been followed for many years. This is especially so where they are permitted by the FSA, and the firm has significant discretion

Under these circumstances it is very difficult to believe that the governance which the WPA provides will be sufficient protection for policyholders. There is a requirement for a With-Profits Committee but it is not clear either that this provides the level of comfort policyholders need, particularly since the FSA requirement is mainly (but not solely) for the WPC to report on and confirm compliance with the PPFM. This is discussed in chapter 18.

²² Although it should be noted that this is not the case for Richard Myers who is the current With-Profits Actuary for CGNU Life, CULAC, AVLAP and NUL (RBS).

Much of the governance problem would disappear if the FSA rules did not create incentives for the firm to transfer value from policyholders' potential distributions in the estate to shareholders. It is the conflict of interest which is at the heart of the difficulty in protecting policyholders' interests."

6.51 The policyholder advocate notes that no changes have been made in respect of the matters referred to above.

Aviva's view

6.52 Aviva notes that the policyholder advocate continues to believe that aspects of the WPA's role in the reattribution have been inadequate. Aviva continues to disagree with these views for the reasons previously expressed in annexe 18A "With-Profit Actuary Report" to the policyholder advocate's June 2009 report.

6.53 Aviva is satisfied that the policyholder advocate's views on these points do not alter the conclusions reached by the Actuarial Function Holder, With-Profits Actuary, Independent Expert or FSA on the fairness of the proposals.

Chapter 7: Communications with policyholders, including feedback from the policyholder advocate's roadshows

Introduction

7.1 The 'election' period in respect of the reattribution offer from Aviva and a major communication effort from the policyholder advocate's office began on 1 June 2009. The communication strategy was to provide means for policyholders to study in depth the issues addressed by the policyholder advocate during the negotiations.

7.2 This was facilitated by a range of written materials, a new website, and use of DVD recordings of question and answer material. In addition, the policyholder advocate undertook a series of roadshows around the UK, and in the Republic of Ireland and Jersey. This was also an opportunity for the policyholder advocate to hear at first hand of policyholder concerns in the light of the information they had been given.

Policyholder advocate guidance booklet

7.3 In addition to her more comprehensive June 2009 report, the policyholder advocate produced a policyholder-friendly guidance booklet, which was sent to eligible policyholders together with Aviva's communications and the policyholder's voting form. The guide was also made available in electronic form on the policyholder advocate's website.

New website

7.4 A new website was built specifically to house, among other things, the policyholder advocate's report and the supporting appendices that were made available. At launch it included the policyholder advocate's guide, an extensive question and answer section, details of how to book to attend roadshows and a filmed question and answer session with the policyholder advocate.

7.5 The policyholder advocate's report was made available on the site on 19 June, prior to the start of the roadshows, and the first of the appendices from which the report was drawn appeared on 26 June, with all the appendices appearing by 16 July. The site also hosted the slides that the policyholder advocate used in her roadshow presentations and on

7 August a film of the last London roadshow, with the latest slide selection, was made available to viewers.

7.6 Policyholders who had registered on the site were kept up to date by email on additions to the site and other developments.

7.7 The policyholder advocate's previous website, launched on the occasion of her formal appointment on 21 November 2006, was kept in place as an archive site and clearly signposted as such.

7.8 Between 1 June and 21 August the new site was visited by 14422 unique visitors who viewed 93419 pages of information.

Questions and Answers recording

7.9 A filmed question and answer session with the policyholder advocate was posted on the new website from the outset. The questions were based on those most commonly asked throughout the negotiations and from the various consumer tests of the election guide. The 20 minute film was also available to policyholders in DVD form. Policyholders who used the call centre were advised of its availability. Some 52 DVDs were issued as a result. The film was viewed 2612 times on the website.

7.10 Additionally it was decided to film a number of roadshows (see below). On 7 August the film of the evening London roadshow of 23 July was posted on the site. In addition, questions and answers from a variety of other roadshows were made available. Care was taken to edit out any references to the names of those in the audience or any specific mentions of their personal financial details, which accounts for the time taken to post the film. The film was viewed 522 times on the website.

Roadshows

7.11 In January and February 2007 the policyholder advocate undertook, as part of a wider consultation, a series of public events – roadshows – to explain her role and listen to policyholder views. She committed to repeat the exercise once the negotiations had concluded.

7.12 It was anticipated that there would be a greater demand to attend roadshows once policyholders were given a specific offer by Aviva. It was decided that there would be events in ten towns and cities. This was more than in 2007 when some policyholders had been critical that there was not an event in the North West of England. Two roadshows were held in London at the start and end of the programme. In total some 2038 policyholders attended.

7.13 It was also decided that there should be two sessions in each venue; one beginning at 3.00pm and the other at 6.30pm. Events were scheduled to last for one and a half hours. Some Aviva employees attended events at the invitation of the Office of the Policyholder Advocate to help policyholders with policy-specific questions. This facility was appreciated by policyholders.

7.14 The format was simple. Policyholders were welcomed and guided as to the running order and the way in which questions would be organised. It was made clear that the policyholder advocate and the policyholder advocate's advisers present would remain after the formal end of the event to speak to policyholders individually. The policyholder advocate then spoke for about 35 minutes, illustrating her remarks with slides (see – <http://www.policyholderadvocate.org/downloads/090707-roadshow-slideshow.pps>). The presentation summarised key issues from the policyholder advocate's report and the guidance booklet.

7.15 To make the question and answer session as efficient and helpful as possible policyholders were given cards on their way into the venues. Cards were collected before and during the presentation. Questions were then grouped and the questioner invited to put his or her point to the policyholder advocate. At some events the policyholder advocate was joined by some of her advisers who also took questions. If time permitted policyholders were given the opportunity to ask supplementary questions.

7.16 Although covered in the policyholder advocate's presentation, at almost every event policyholders wanted to be reassured that accepting the offer would not have an impact on their main policy terms.

7.17 Similarly there was a significant degree of policyholder confusion between the pre-retribution distribution and the retribution. The pre-retribution distribution was frequently criticised on the grounds that it was spread over three years and that Aviva did not give details of the bonus addition to policies with policyholders' annual statements.

7.18 Policyholders also wanted to be certain about the form of payment under the retribution offer. The tax position of the cash offer was raised in Dublin and Jersey. More complex tax questions were referred either to Aviva or the policyholder was advised to seek independent financial advice.

7.19 Some policyholders also questioned and complained about aspects of the retribution. The responses on key issues which are relevant to the policyholder advocate's responsibilities may be found in Chapter 8 (Questions, objections and complaints received from policyholders).

7.20 A small number of individual policyholders who contributed to an internet 'chat room' prepared a leaflet which took issue with aspects of the retribution. This leaflet was distributed by the policyholders at events in London, Manchester and Birmingham.

Call centre

7.21 The most frequent issue for the call centre was inquiries about roadshows and how to book places. Thereafter questions centred on: the security of policy benefits after the retribution; eligibility; what a retribution comprised; the nature of the inherited estate; the group into which a policyholder fell in respect of the election guidance and questions about when policyholders could expect to receive their election mailing pack. Overall the centre took 4034 calls. A control measure was put in place and policyholders were invited to rate the quality of the responses. Satisfaction rates were high at between 73 and 90 per cent.

Correspondence

7.22 The correspondence centre is responsible for dealing with letters and emails generated from the policyholder advocate's website. Additionally it deals with any questions referred to it by the call centre agents.

7.23 The question areas were similar to those faced by the call centre. The most popular topics were: the roadshows, how they might be booked and whether a DVD was available for those who could not attend; the availability of the report; non-receipt of the mailing pack; eligibility; which policyholder group the inquirer fell into; and requests for advice on how to vote. Altogether the correspondence centre deal with 269 postal and 500 email inquiries.

7.24 The correspondence centre was also responsible for dealing with objections to the reattribution sent to the court via the Office of the Policyholder Advocate. Some 20 objections were received (as at 21 August 2009).

Chapter 8: Questions, objections and complaints received from policyholders

8.1 The policyholder advocate has received a number of questions, objections and complaints from policyholders, variously in written correspondence including formal objections to the reattribution, at her call centre and during her roadshows. The policyholder advocate has identified certain key issues arising from this correspondence as well as from objections to the reattribution which have been received by Aviva. The policyholder advocate's comments on those issues are set out below.

1. Independence of the policyholder advocate

A number of policyholders have challenged the independence of the policyholder advocate given that she is appointed (and paid) by Aviva. The fact that the policyholder advocate was appointed by Aviva follows from the FSA rules which require a firm seeking to make a reattribution to appoint a policyholder advocate. However, it does not follow that the independence of the policyholder advocate is necessarily compromised. Firstly, the rules expressly require the advocate to be free from conflicts of interest that may, or may appear to be, detrimental to policyholders and the FSA must (and did) approve the appointment. Secondly, as will be clear from her report and from her appearance before the Treasury Committee, in discharging her responsibilities the policyholder advocate has mounted a vigorous challenge to numerous aspects of Aviva's proposals and indeed to the regulatory framework for the management of with profits funds.

Some policyholders also wanted it to be clear that the policyholder advocate did not speak for them. The policyholder advocate was appointed by Aviva in accordance with FSA rules, in effect to represent the interests of all policyholders in the reattribution negotiations with Aviva but she cannot (nor does she claim to) act for or represent individual policyholders directly. Individual policyholders remain free to express their own views including by way of submitting to the court a formal objection to the reattribution proposals if they wish.

2. Division of the inherited estate between policyholders and shareholders

Policyholders questioned why the reattribution has not resulted in a 90:10 division of the inherited estates between current policyholders and shareholders. One questioner at a

roadshow asked whether the policyholder advocate had considered the 1991 articles of association of CGNU Life (which have since been replaced by new articles); the questioner implied that a 90 per cent share for policyholders was more firmly entrenched in these articles.

On the question concerning the articles, the legal due diligence carried out by the policyholder advocate and her legal advisers did address the articles of association of CGNU Life (and CULAC) and did include a consideration of the 1991 articles. The relevant provision of these articles, which were adopted by CGNU Life (which was then called General Accident Life Assurance Limited) on 19 September 1991, are in fact substantially identical to the current articles of CGNU Life which were adopted on 29 January 2007 (albeit that the new articles have additional provisions to deal with stakeholder pensions business which were not contained in the 1991 articles).

In essence, both the 1991 articles (see articles 9 and 10) and the 2007 articles (articles 132 and 133) provide that the directors are required every 12 months to determine the profits (if any) of the company's long-term insurance business, and to determine the amount of such profit which may be distributed. The articles then provide that of the profit so declared distributable, the holders of with profits policies are to receive not less than 90 per cent. Accordingly, insofar as the articles are concerned, a policyholder's right to distributions from the inherited estate arises only when the directors declare a profit available for distribution which includes an amount from the inherited estates (in which event policyholders are entitled to not less than 90 per cent of the distribution) and in this respect there is no difference between the 1991 articles and the current articles of CGNU Life.

3. Why have there been so many delays in reattribution payouts, given that policyholders expected a payout in 2008?

The policyholder advocate sympathises with the understandable concerns that some policyholders have expressed about how long the reattribution process has taken. The sheer complexity of the reattribution and fund transfer proposals inevitably meant that the process was going to take time. However, in the event it took even longer than either Aviva or the policyholder advocate anticipated and there were two main reasons for this.

The first concerned the very large volume of data which the policyholder advocate and her advisers (and Aviva) required for the purposes of evaluating Aviva's reattribution offer. It took a great deal of work to get that data into a state which the policyholder advocate could be confident would support her analysis of Aviva's reattribution offer.

The second reason for delay came out of the stock market crash in the autumn of 2008. This resulted in Aviva pulling the offer announced in July 2008. At the time of the July offer, Aviva had said (albeit not publicly) that they reserved the right to re-visit their reattribution offer if the FTSE 100 index moved outside the range of 5000 to 7000. At the time of the July offer, it was clear from the discussions with Aviva that it did not think that a fall below 5000 was at all likely. Aviva's rationale for this backstop was that their reattribution offer had been made on the basis of certain assumptions about the size of the inherited estates. If markets fell significantly, it was possible that those assumptions would turn out to be wrong since a big fall in stock markets might feed through to the inherited estates. Ultimately Aviva withdrew its proposed offer in February 2009.

4. The policyholder advocate failed to mention the FTSE 5000-7000 condition to the July 2008 offer

It is true that the FTSE condition described above was not covered in the public announcement of the July 2008 offer; it was not thought to be a significant issue at the time since the 2000 point range seemed robust. (On the day on which the July 2008 offer was announced the FTSE 100 closed at 5420.7.) Few can have foreseen the turmoil in world markets, including a dramatic fall in equity markets, that took place in October of that year.

5. The policyholder advocate wrote to policyholders in September 2008 when she knew that Aviva would not proceed with the July offer

The FTSE 100 index did close slightly below 5000 on two days in the middle of September 2008 (and on the last two days of that month) and so strictly Aviva's FTSE condition was not met. However, at the time of the September 2008 mailing, and based on the policyholder advocate's discussions with Aviva, she did not believe that the July 2008 offer was in serious jeopardy. It was not until early October that the index fell rapidly and remained substantially below 5000. Aviva did not in fact withdraw the July offer until February 2009.

6. Eligibility of segmented policies

Questions were raised during the roadshows about so-called segmented policies and why such policies were treated as a single policy for the purposes of the reattribution. The Scheme provides that for the purposes of calculating the incentive payment, “groups, segments or clusters of Policies issued to a policyholder shall be treated as one Policy.” (Schedule 3, Part 5, paragraph 8 of the Scheme.)

The policyholder advocate understands that in practice there is only one class of policy that falls within this provision of the Scheme and that is a savings policy, the Portfolio Bond.

Aviva has explained that it is common practice in the market to split an investment of this sort into a number of identical insurance policies (or segments) to facilitate a tax efficient way of withdrawing money (by encashing individual segments). On the basis that an investment of this sort is substantively a single investment, Aviva proposed, and the policyholder advocate accepted, that it should be treated as a single policy for the purposes of the reattribution. The effect of this treatment is that the holder of an eligible Portfolio Bond investment is offered the opportunity to make only one election for that investment – in other words he cannot elect on a segment-by-segment basis. The PIP will also be calculated on the basis that the investment is a single policy and accordingly for smaller investments, a Bond holder would be eligible for only one minimum PIP payment and not a separate payment for each segment.

To treat such investments as multiple policies for the purposes of the reattribution could be unfair on other policyholders whose policies are not segmented – holders of pension policies, for example. This is more than just a theoretical concern since the policyholder advocate understands that approximately a third of all policies eligible for the reattribution are Portfolio Bonds. If each segment (of which there may be 20) of a Portfolio Bond was treated as a separate policy, that would fundamentally change the structure of the reattribution to the potential detriment of the holders of un-segmented eligible policies.

With hindsight, the policyholder advocate acknowledges that a timely explanation of the eligibility rules for segmented policies should have been given to policyholders but was not. The policyholder advocate notes however that judging by the low level of complaints

arising on this issue, it would not appear to be a widespread concern among the large population of affected policyholders.

7. Why could reattribution not be delayed until financial markets recover?

The reattribution is a complex transaction for Aviva and one in which it has already invested a significant amount of time and money (these costs have been borne by the company and not by policyholder funds). Aviva could, of course, decide not to proceed with the reattribution for the time being, but if it did so, many of the costs it had incurred to date would in all likelihood be wasted. This is because, as and when markets did recover and assuming that this was accompanied by a significant increase in the size of the inherited estates (and this would not necessarily be the case), Aviva would in practice have to start the whole process again – for example, new financial data would have to be analysed, the policyholder advocate and her advisers, the independent expert and Aviva’s actuaries would all have to re-engage and at least update if not re-write their reports. That is likely to be an unattractive prospect for Aviva nor would it necessarily benefit policyholders since, other things being equal, increased deal costs will reduce the amount which Aviva would be prepared to offer policyholders in the reattribution.

8. Why has the estate declined in value?

The inherited estate of a with-profits fund is the excess of the assets over the realistic liabilities of the fund. The inherited estate will therefore fall if the value of the assets reduce without a corresponding decrease in liabilities of the same amount, or if liabilities increase without a corresponding increase in assets. There are a number of factors which could impact the assets or the liabilities in different ways. The specific factors driving the movement in the inherited estates of CGNU Life and CULAC are covered further in the Independent Expert’s supplementary report sections 11.18 – 11.26 (see the extract below) and in Appendix 35B to the policyholder advocate’s June 2009 report which is summarised above in KPMG’s view in chapter 1 under the section entitled “summary of the inherited estates”.

The Independent Expert in his report considers how the combined inherited estates of CGNU Life and CULAC have reduced over 2008:

“Over 2008 the combined assets of the CGNU Life WPSF and the CULAC WPSF fell in value by approximately £3.0 billion, while basic liabilities fell by £3.2 billion. Taken together, the movement in the values of assets and basic liabilities led to an increase in the combined inherited estates (calculated before allowing for the consequential changes to the cost of options and guarantees) of £0.2 billion. However, this was more than offset by an increase of £1.4 billion in the cost of options and guarantees; this arose because the fall in asset values, and hence in asset shares, meant that there were more policies for which guaranteed minimum benefits were expected to exceed asset shares at the date of claim. The overall impact was a reduction of £1.2 billion in the combined inherited estates. The reduction in the combined inherited estates over 2008 was therefore a direct consequence of the fall in asset values and the way in which realistic liabilities are calculated – it did not represent a transfer to shareholders. Nor did the increases in the inherited estates in earlier years represent a transfer from shareholders.”

9. Should the policyholder advocate ask the court to throw out the reattribution proposals?

As will be clear from the June 2009 report, under the current regulatory framework, the policyholder advocate has advised that Aviva’s reattribution offer is in the interests of the great majority of policyholders. Therefore, and given the constraints of that regulatory framework, it would not be in the interests of policyholders for the policyholder advocate now to seek to urge the court to reject the reattribution proposals (always assuming that she had the standing to do that in court, which is by no means clear). Furthermore, even if the reattribution did not proceed for whatever reason, it does not follow that a 90:10 distribution of the inherited estates would take place to the current generation of policyholders. Indeed, again given the current regulatory framework, it seems clear that there would be no such distribution to current policyholders given the effect of the “inter-generational transfer” which is explained in the June 2009 report (at chapter 13 and in Appendix 25).

10. Will the policyholder advocate be heard in court?

The policyholder advocate will be represented by counsel at the hearing and will also be present in court herself and available should the judge require her assistance during the hearing.

11. The multipliers applied by Aviva to different policy types are prejudicial to policyholders

The purpose of Aviva's proposed multiplier is to improve the relationship between the PIP that is being paid and the potential future special distributions forgone by the policyholder. The multiplier will increase the weighting given to certain types of policy, in particular some with additional future premium payments due and longer terms to run.

As noted in the June 2009 report and expanded in Appendix 42, the aggregate value of the Aviva offer to policyholders is expected to be superior to the potential value of future special distributions from the inherited estates to existing, eligible policyholders across a wide range of potential outcomes.

However, it is not possible to produce a perfect allocation mechanism that would translate that superior value, at an aggregate level, into a superior value for each and every eligible policyholder because of the considerable uncertainty in the potential future special distributions that a policy might receive. This is due to uncertainty as to the value and timing of those potential future special distributions, the individual behaviour of policyholders over the 25 years of the projections; and the end date of policies which may not be specified or may be affected by surrender or the death of the life assured.

For individual policies that remain in force, the three main drivers of the potential value of future special distributions are the size of the policy at the date of any special distribution, whether premiums are paid in the future and the length of the policy's outstanding term. There is a positive correlation between outstanding term and the estimated value of potential future special distributions and this is even more pronounced for regular premium than for single premium policies. It is this feature that Aviva's multiplier seeks to address.

In conclusion, the policyholder advocate is satisfied that Aviva's allocation mechanism, despite its weaknesses, does produce a PIP allocation that is more aligned to the potential

benefits forgone by eligible policyholders who elect to accept the PIP and helps to ensure that a majority of such policyholders will receive a PIP offer in excess of their potential special distributions forgone on a wide range of assumptions about potential future outcomes.

For more detail on this, please consider chapter 31 of the June 2009 report and Appendix 43.

12. Why have policyholders not been asked to vote on whether or not the reattribution should take place? There is no real choice for policyholders – they effectively have to decide either to take some cash now or get nothing for 25 years

Some policyholders questioned why there was not an initial ballot of policyholders about whether or not there should be a reattribution. The difficulty with this is that if policyholders are asked to vote before the company has considered the terms of any offer it might make, policyholders would have no real basis on which to make an informed decision. Nevertheless it would have been possible for Aviva to conduct a vote on whether or not the reattribution should take place. However, if that were conducted on the basis that the votes of a requisite majority would bind those voting against or not voting, then that may be unfair on the minority.

The Aviva reattribution proposal does not bind any policyholder in this way since it is intended to enable each policyholder to decide whether to (1) accept the PIP offer or (2) to decline the PIP and in so doing, by staying in a fund with an inherited estate, to preserve his rights in relation to any future special distributions from the inherited estate as if there had been no reattribution.

13. Why is the reattribution proceeding when issues around the use of the inherited estate are unresolved?

As will be clear from the June 2009 report, the policyholder advocate has challenged the FSA on various aspects of the management of with-profits business and while the FSA has changed its rules in respect of the allocation of mis-selling costs, the FSA does not for the time being intend to make any other changes to its rules relating to with profits.

Accordingly, the policyholder advocate has negotiated with Aviva within the constraint of

the current regulatory framework. She does not believe it would have been in the best interests of policyholders to have refused to recommend any offer that might be made by Aviva on the grounds that policyholders might conceivably be able to get a better offer at some uncertain point in the future should the FSA decide to change its rules. Furthermore, the policyholder advocate has tested the Aviva offer against various scenarios which she believes are sufficient to allow for realistic changes to FSA rules.

14. Who meets the costs of the reattribution?

The costs of the reattribution, including the PIP payment and the costs of the policyholder advocate, are being met by Aviva from shareholder funds and not from policyholder funds. However, reattribution costs incurred by Aviva are a factor which they would have taken into account in determining the size of the incentive payment they were prepared to offer to policyholders and reattribution costs were taken into account by the policyholder advocate in her analysis of the offer.

15. Former policyholders whose policies matured before November 2006 have been adversely affected because they are not eligible for the reattribution and may have contributed to the estate

This issue is addressed in the June 2009 report (at paragraph 11.10) and in more detail in Appendix 23B (at paragraph 3.00).

In summary, the policyholder advocate did consider the question of “backdating” eligibility to participate in the reattribution but that raised a number of difficult questions. One fundamental issue would have been to determine which former policyholders would be entitled to participate: this could be those whose policies have most recently matured on the basis that they are closest to being eligible by reference to the date criteria; equally one could argue that it is those older policies which were in force at a time during the period when the inherited estate was accumulating which have the greater claim. Clearly the latter proposition is unworkable but it does illustrate the difficulty of introducing a backdating concept. Aviva also cited practical problems which may arise with re-establishing contact with former customers.

Taking into account the various factors and arguments on this question (set out more fully in the June 2009 report), the policyholder advocate accepted Aviva's proposal that policies which terminated before the date of her formal appointment (on 21 November 2006) would not be eligible for an incentive payment.

16. The policyholder advocate should have brought 'test case' on behalf of policyholders to test the ownership of the inherited estate

The question of bringing some sort of case to test the legal rights and interests in the inherited estate was considered early in the reattribution process. However, it was by no means clear how the policyholder advocate could in practice have brought such a case nor how it would have been funded. Furthermore, such a case may well have led to a protracted legal process which might in turn have resulted in Aviva deciding not to proceed with the reattribution. In the event, the policyholder advocate took detailed legal advice from counsel on the legal rights and interests in, and the uses of, the inherited estate (and that advice has been published in Appendix 25 to the June 2009 report).

17. The report by the boards of CGNU Life and CULAC to with-profits policyholders for 2007 makes it clear that the use of the inherited estates to support new business has ceased

The 2007 report by the boards of CGNU Life and CULAC to with-profits policyholders includes the following statement:

“The inherited estates were only used for the purposes as described in the PPFM. The Boards had previously determined that it was appropriate to use them to a limited extent to support new business. A specific limit was set and the amounts used were kept under regular review. This usage stopped with effect from 1 January 2008”.

It has been suggested to the policyholder advocate that this statement indicates that the whole question of the impact of new business on the reattribution is irrelevant since Aviva has stated that it no longer uses the estates to support new business. That is not correct. The reason for this is that Aviva makes a distinction between the use of the estate to cover regulatory and working capital requirements in respect of new business (this support is

expected to be temporary in that it ties up capital when policies are in force but that capital should be release when policies mature) and subsidies which permanently erode the estate. It is the latter use which Aviva has discontinued although it is true that this is not easy to deduce from the wording of the 2007 report set out above. The 2008 report is clearer on this point since it states that “The estate provided some capital support to new business which is expected to be repaid over the lifetime of the policy.”

There was also a complaint that the 2007 report by the boards of CGNU Life and CULAC to with-profits policyholders is no longer available on the Aviva website. Aviva has explained that its practice is only to publish its most current report on the website.

The 2007 report by the boards of CGNU Life and CULAC to with-profits policyholders is also addressed by the Independent Expert in chapter 10 of his supplementary report.

18. The policyholder advocate failed to investigate the origins of the inherited estate

Under normal circumstances, contributions from a policyholder to the inherited estate can only occur when his policy ends; current policyholders are therefore unlikely to have made any material contributions to the inherited estate. The current generation of policyholders could however have contributed to the inherited estate if their asset shares were not being allocated in line with actual experience in relation for example to investment returns, tax, miscellaneous profits and expenses²³. KPMG considered Aviva’s views on this question and concurred with Aviva that it is very unlikely that the current generation of policyholders has contributed materially to the inherited estates of CGNU Life and CULAC. The Independent Expert in his supplementary report has come to the same conclusion (see section 11.7-11.9 for further details). Chapter 9 of the policyholder advocate’s June 2009 report covers this matter in detail.

In addition, the Aviva offer to buy out policyholders’ rights to future special distributions from the inherited estate is a forward looking offer. The policyholder advocate has not

²³ This “mis-match” does in fact strictly exist for unitised with-profits policies which by their nature have explicit charges which aim to cover expected expenses and shareholder transfers over time, but the differences between these charges and actual experience are expected to be small.

therefore looked backwards at the value of those uses of the estate which may have given shareholders more than their 10 per cent entitlement in previous years.

Throughout the negotiations it has been assumed that neither current policyholders nor shareholders have contributed to the CGNU Life and CULAC inherited estates.

If the intention had been to return part of the estate to earlier generations, rather than sharing the benefit between current policyholders and the current shareholder, then an investigation of the origins of the estate would have been relevant. In this case, details of the relationship between asset share and claim value for each policy which became a claim for the period over which the past generations of policyholders were to be considered would be required. In general companies do not keep such details. We agree with the Independent Expert's comments in paragraph 11.7 of his supplementary report, that from 2005 onwards an approximate analysis can be performed from the realistic balance sheet information in the FSA returns, but this information is not available for earlier periods.

19. Policyholders have to make their decision without knowing size of estate on which the final PIP is based

It is true that policyholders will not know the final size of the estate when they decide whether or not to accept Aviva's reattribution offer. This is a consequence of the structure of Aviva's offer under which the aggregate PIP will increase with any increase in the size of the inherited estates over £1.2 billion.

However, each policyholder should have been notified of the minimum PIP he would receive if he accepts the offer and the reattribution goes ahead. This minimum has been calculated on an assumed estate value of £1.2 billion and if the final estate value is greater than £1.2 billion, the PIP will increase. If the final estate value is below £1.2 billion, Aviva may well decide not to proceed with the reattribution but if they did proceed then the PIP payable would not be reduced below the minimum notified to the policyholder.

20. Impact of MVR free dates and money back guarantees on policyholders

Some policyholders have raised concerns in connection with the surrender of investment policies which have an MVR free date (i.e. Aviva has guaranteed that no market value reduction (MVR) would be applied if the policy is surrendered on that date) which falls

before the effective date of the reattribution. The concern is that if the policyholder wishes to surrender on that date, he will lose eligibility for the reattribution payment. On the other hand, if he holds on to his investment until the effective date he might lose the benefit of the no MVR guarantee. Aviva has stated that it had not intended to place policyholders in the position where they faced such a choice.

The policyholder advocate understands from Aviva that the vast majority of affected policies which have an MVR free date which falls in 2009 include a 'carry forward' promise under which the value of the no MVR guarantee at the MVR free date would be carried forward if the policy is not surrendered on that date. However, there is a small number of policies which Aviva has identified which do not have this carry forward promise. Aviva has stated that for those policies the following treatment will apply:

- Aviva will treat those which have been surrendered since 1 May 2009 as elected policies - these policyholders will therefore receive a PIP. (This treatment does not apply to policies surrendered before 1 May 2009 which are therefore ineligible for the reattribution in line with the eligibility rules – Aviva's rationale for this is that prior to the announcement of the offer in early May, policyholders did not have a definite choice to make between the MVR guarantee and the PIP since no reattribution offer had been made.)
- For those electing for the PIP who have not surrendered, the MVR guarantee will be carried forward until at least 31 December 2009 (this is designed to protect those policyholders with an MVR free date falling before the effective date of the reattribution).
- However, for those who have not yet voted, Aviva will explain to any who intend to surrender that their MVR guarantee will be rolled forward beyond the effective date of the reattribution and they can therefore retain eligibility for the reattribution. However should the policyholder still wish to surrender despite this they will become ineligible for the PIP (in line with the eligibility rules).

A similar issue arises in respect of policies with a “money back” guarantee under which a policyholder is guaranteed not to receive less than his original investment if the policy is surrendered on fixed dates (the 5 or 10 year policy anniversaries). Aviva has confirmed that affected policies (those taken out in 1999 and 2004) have positive returns and accordingly on surrendering in 2009 the policyholder would not be relying on the money back guarantee. In other words he would not be faced with a choice between surrendering to take advantage of the guarantee or waiting for the reattribution and losing the guarantee. On that basis, Aviva has concluded that no further action is required in respect of any such policy which has been surrendered in 2009.

21. The PIP offer should be a fixed percentage of the inherited estate

Some policyholders have argued that Aviva should be offering an aggregate PIP which is a fixed percentage of the inherited estate. In fact, the aggregate PIP offered by Aviva when measured as a percentage of the inherited estate increases as the estate value rises. So for example for an estate value of £1.2bn the offer equates to approximately 41.7 per cent of the estate whereas for an estate at £1.4bn, the offer equates to 43.6 per cent of the estate. This change in percentage reflects the fact that many of the costs of the transaction which are incurred by Aviva (apart from the PIP itself) do not depend on the size of the estate, so that as the value of the estate falls those costs correspond to an increasing proportion of the estate and the offer which Aviva is prepared to make corresponds to a smaller proportion of the estate.

22. The policyholder advocate failed to give any details of the sales of new with-profits policies

It was claimed that in failing to provide historical data relating to Aviva’s sales of new policies, it was impossible for policyholders to form an objective view of how new policy sales would correspond with the assumed levels of new business referred to in the policyholder advocate’s guidance.

The level of new business is a key factor in determining how likely it is that the value of potential future special distributions forgone by a policyholder electing for the PIP might exceed the PIP offer. However, the policyholder advocate does not agree that providing

policyholders with historical sales data would have been of much assistance in guiding policyholders as to the likely levels of new business in the future.

A question has also been raised as to whether views of Cazalet Consulting on the future of with profits (which are referred to in the policyholder advocate's June 2009 report) have been taken into account. The Cazalet report is pessimistic about the future of the with profits industry, but Aviva has seen an increase in sales recently. Neither the policyholder advocate nor anyone else can say what will happen in the future but her guidance looks at the impact of different levels of new business including an annual decrease of 15 per cent - at that rate, Aviva's new business sales would fall by about 50 per cent within four years.

23. The CGNU Life and CULAC with profits funds are effectively closed to new business and should be run off

The CGNU Life and CULAC with profits funds are not closed to new business. The supplementary report of the Independent Expert refers to £223m APE²⁴ of new with profits business being written in 2008.

Some comment has been made about the fact that the new business in CULAC is reinsurance rather than direct new business. The policyholder understands that the reason for this is as follows. The CGNU Life and CULAC with-profits funds have effectively been run as one fund since 1998 and that for practical reasons, rather than writing new business directly into both funds, Aviva writes new business into CGNU Life with a proportion reassured to CULAC.

24. The policyholder advocate did not carry out any checks on Aviva's individual PIP calculations and she did not prevent Aviva from calculating some PIPs incorrectly

The policyholder advocate's role is set out in her terms of reference, which reflect the requirements of the FSA rules, and is summarised in chapter 1 of the June 2009 report. In essence it is to negotiate with Aviva the benefits policyholders receive in exchange for the rights they are asked to give up, comment to policyholders on the reattribution proposals and to tell them whether the Aviva's proposals are in their interests. The policyholder

²⁴ Annual Premium Equivalent, calculated as new annual premiums plus 10% of new single premiums.

advocate's role does not however extend to ensuring that the proposals are effectively and accurately implemented at an individual policyholder level.

25. The policyholder advocate should not have allowed the pre-retribution distribution to be made in three tranches

The policyholder advocate has stated in her June 2009 report that she does not accept that Aviva's decision to phase its special distribution announced in February 2008 over three years strikes a fair balance between different policyholder groups. However, since the policyholder advocate's appointment is in relation to the retribution proposals only, strictly she had no standing in relation to the distribution. While she did nevertheless make her objections known to Aviva at the time, the directors (with WPC approval) decided to proceed with a phased distribution.

26. Did the policyholder advocate play any part in the pre-retribution distribution?

The policyholder advocate was involved in discussion with the Financial Services Authority (FSA) and Aviva about how the estate would be treated after a retribution. It was felt that after a retribution the company would be likely to take action to reduce the level of risk in certain assets (and in particular assets held to back policy guarantees). Reducing risk in this way would have the effect of reducing the capital buffer required thereby releasing funds for distribution to shareholders. Aviva was informed by the FSA that it would have to conduct the retribution on the basis that the estate had been 'de-risked' in this way whether or not it had in fact de-risked. That in turn acted as a catalyst for Aviva to actually carry out a de-risking which in turn freed up capital which was available for distribution 90:10. Accordingly, a distribution of £2.4 billion was announced in February 2008.

27. Having a minimum incentive payment is unfair to some policyholders

The policyholder advocate is satisfied that Aviva's rationale for a minimum PIP payment (to avoid trivial payments) is reasonable. While it is true that the inclusion of a minimum PIP does have the result that some policyholders will receive a smaller PIP than they would have done absent the minimum, it is worth noting that a perfect allocation mechanism under which the PIP allocation would be precisely aligned with benefits forgone by

electing policyholders is in any event not feasible (on this see paragraph 31.4 of the June 2009 report). In paragraph 31.13 of the June 2009 report, the policyholder advocate concludes her consideration of the PIP allocation mechanism with the statement “Given the constraints faced by Aviva, the policyholder advocate is satisfied the [allocation] mechanism ensures that a majority of policyholders receive a PIP offer in excess of their potential benefits forgone on a wide range of assumptions about potential future outcomes”.

28. The policyholder advocate roadshows were advertised late and the content was fixed with no real debate

The details of the policyholder advocate’s roadshows were made known to policyholders through the election mailing. With the final details of the offer only being settled in May 2009 there was very little time to organise and advertise the roadshows, which had to be fitted in to the election schedule but also take account of the summer holiday season. This indicated a short period between 23 June and 23 July in which to hold some 22 events in ten cities. (London was visited at the start and end of the programme.)

The roadshows comprised a presentation lasting about half an hour given by the policyholder advocate followed by an hour for questions in open session. Questioners were asked to write their questions on cards, which was helpful for the better attended events, but elsewhere the nature other events lent themselves to more relaxed organisation and there was more time for dialogue and discussion. The policyholder advocate and her team and representatives from Aviva were also available at the end of the formal session to deal with individual queries.

The main objective was to explain to audiences with differing levels of understanding the nature of the choice they were being asked to make. Thereafter it was to respond to questions about the offer or the policyholder advocate’s role. Some policyholders who have been particularly interested in the reattribution process wanted to enter into extended debate about points of detail. While attempting to respond to such questions, it was important to recognise that it would have been unfair to others in the audience to concentrate on such matters. The policyholder advocate and her advisers did however remain after the formal session to deal with additional questions.

29. The “policyholder action group” was given insufficient help by the policyholder advocate

Representatives of the “policyholder action group” have claimed that they did not get sufficient help from the policyholder advocate. In fact the policyholder advocate, her staff and her advisers have spent a considerable amount of time dealing with correspondence from members of the group. Members of the group also attended and asked questions at several of the policyholder advocate’s roadshows. Indeed, arguably a disproportionate amount of time has been spent given that the policyholder advocate’s role is to represent the interests of all affected policyholders whereas the action group comprises a small number of policyholders.

The group did make two requests for assistance from the policyholder advocate which she declined. The first was that the policyholder advocate publish to all eligible policyholders a link to the action group internet chat room. It was initially agreed that this would be done, but in the event it became clear that this was not appropriate in light of the content of the action group website which in the policyholder advocate’s view, supported by her legal advisers, was likely to confuse and possibly mislead policyholders. The second request was for the action group to be given slots to address policyholders at the policyholder advocate’s roadshows but again the policyholder advocate did not think that this was appropriate.

30. The policyholder advocate has published too much information too late

The reattribution is a very complex transaction and the policyholder advocate was keen to ensure not only that she and her advisers examined the transaction in depth but also that she should report fully on that work. Inevitably therefore, the full report including its appendices is a very detailed document and some parts of the report are likely to be more readily understood by readers who have some familiarity with the concepts involved. With that in mind, the policyholder advocate also published a much more succinct guidance booklet for policyholders – “Making your choice”, which was posted to all eligible policyholders and was available from her website from June 2009.

On the question of timing, the report was published on 19 June 2009 which gave those policyholders who were interested in reading the full report some two months to do so

before the election period was due to close on 21 August (although the election window was subsequently extended). The last of the report appendices was however not published until 16 July and the policyholder advocate accepts that for those policyholders who were interested in the very significant level of detail to be found in these appendices, there has been a shorter period available to assimilate this information.

31. The estate should be used to help policyholders facing endowment shortfalls and not reattributed

In her first series of roadshows in 2007 the policyholder advocate sought attendees' views on this matter. The overwhelming response was that there should be no biasing of the benefits of reattribution to treat one group of policyholders more favourably than another. It should also be noted that Aviva has in place a Mortgage Endowment Promise to help some policyholders facing shortfalls.