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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.](#)

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. ~~The~~ 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~~[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 ~~around~~[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.

(£millions)	31 December 2008			31 May 2009		
	CGNU	CULAC	Total	CGNU	CULAC	Total
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.

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 its view~~, in arriving at the value of the inherited estate for the purpose of calculating the PIP. ~~In addition~~, 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.

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 ~~appendices~~[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~~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 ~~24th July~~ 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

provided to the policyholder advocate. Aviva explain that there are three main reasons for the differences in the two IRRs:

- *“The stated IRRs differ, reflecting the different bases used in the IRR calculations”;*
- ~~the IRRs in the offer letter were “derived using the basis that had been developed over time as part of the negotiations [with the policyholder advocate]”;~~
- 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

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 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

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

¹⁹ The policyholder advocate's second [criteria/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.

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 ~~ensider~~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

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%

3.27 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-reattribution. 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 reattribution and post-reattribution 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. ~~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.~~

3.37 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 ~~believe~~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~~[this](#) will assume 100 per cent of the 2007 new business subsidy

- **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

[4.64.7](#) 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”.

[4.74.8](#) 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.

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 ~~are~~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 [Annex 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-

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 ~~direct~~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.

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

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 ~~have~~[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

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. ~~The~~ [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.**

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 ~~so~~ 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 ~~have~~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."

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 ~~none~~ of the recent developments ~~considered~~commented on by the WPA ~~would lead to~~ there is no reason for the WPA ~~changing to change~~ his conclusions; ~~KPMG believes~~.

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:

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

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.

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 ~~paragraph 2 and also 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.

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 ~~have~~[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

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.

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 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 ~~as noted above,~~ if the final estate

protect those policyholders with an MVR free date ~~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.

that it would have to conduct the reattribution 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,