

The policyholder advocate's report foreword & executive summary

An extract from the report by the office of the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life Assurance Ltd (CGNU Life) and Commercial Union Life Assurance Company Ltd (CULAC) with-profits funds.

Contents

Foreword	4
Executive Summary	
Part 1 Introduction to the proposed reattribution	7
<i>Chapter 1</i> The reattribution: roles and process	7
<i>Chapter 2</i> The approach of the policyholder advocate	7
<i>Chapter 3</i> Access to information and due diligence	8
Part II The scheme and related reports	8
<i>Chapter 4</i> Aviva's scheme	8
<i>Chapter 5</i> The actuarial function holder's report	9
<i>Chapter 6</i> The with-profits actuary's report	10
<i>Chapter 7</i> The independent expert's report	10
<i>Chapter 8</i> The FSA's fairness review	11
Part III Context	12
<i>Chapter 9</i> Contributions to the inherited estates	12
<i>Chapter 10</i> Qualification for the pre-reattribution distribution	12
<i>Chapter 11</i> Eligibility for reattribution	12
<i>Chapter 12</i> Consultation and communications with policyholders and other interested parties	12
Part IV Legal and regulatory issues	13
<i>Chapter 13</i> Legal issues arising in respect of rights and interests in, and uses of, the inherited estate	13
<i>Chapter 14</i> FSA guidance letters and responses	14
<i>Chapter 15</i> The House of Commons Treasury Committee report: inherited estates	15
Part V Fund management	16
<i>Chapter 16</i> Policyholders' future security and risk appetite	16
<i>Chapter 17</i> Investment policy, smoothing and bonus policy	16
<i>Chapter 18</i> With-profits governance arrangements	17
<i>Chapter 19</i> Principles and practices of financial management (PPFM) and consumer-friendly PPFM	17
<i>Chapter 20</i> The position of non-electing policyholders	17

Part VI Key issues in the numerical analysis of Aviva's offer	18
<i>Chapter 21</i> Modelling for the purposes of the reattribution	18
<i>Chapter 22</i> Tax matters in relation to the reattribution	18
<i>Chapter 23</i> The size of the inherited estates	19
<i>Chapter 24</i> The pre-reattribution distribution	19
<i>Chapter 25</i> Valuation of the reattributed estates	19
<i>Chapter 26</i> Aviva's new business assumptions	20
<i>Chapter 27</i> The impact of FSA guidance on policyholders	21
<i>Chapter 28</i> Analysis of potential special distributions to policyholders and shareholders	21
Part VII Numerical evaluation of Aviva's offer	22
<i>Chapter 29</i> The Aviva offer	22
<i>Chapter 30</i> Evaluation of the aggregate PIP offer	23
<i>Chapter 31</i> Allocation of the aggregate PIP between policyholders	23
<i>Chapter 32</i> The position of non-electing policyholders	24
<i>Chapter 33</i> Formulation of guidance to policyholders	24
Part VIII Conclusions	25
<i>Chapter 34</i> Overall conclusions of the policyholder advocate	25

Foreword

Aviva is proposing a reattribution of the inherited estates of CGNU Life and CULAC by offering a policyholder incentive payment (PIP) to buy out CGNU Life and CULAC policyholders' rights to participate in any future special distributions from the inherited estates of those firms.

Aviva announced a proposed offer in July 2008. Subsequently the volatility and the fall in value of stock markets and other financial assets led Aviva to propose a re-structured offer in February 2009. The value of Aviva's PIP offer depends on the value of the inherited estates in summer 2009. If, for example, the value of the estates is £1200 million, then the total value of Aviva's PIP offer will be £500 million.

As set out in more detail below, I am required to advise policyholders within the confines of the current regulatory rules. On this basis my advice may be summarised as follows:

- the offer is in the interests of the great majority of policyholders;
- for that majority the cash offer is more than might reasonably be expected to be received from future special distributions from the inherited estates;
- those policyholders for whom the PIP is most likely to be attractive are typically policyholders with short to medium terms to maturity (or surrender);
- those policyholders least likely to benefit from the offer are typically policyholders expecting to hold their policies for more than 15 years;
- policyholders have a genuine personal choice; and those policyholders who do not wish to accept the offer will be broadly in the same position as they would be without a reattribution.

The Financial Services Authority (FSA) requires the firm to appoint a policyholder advocate if there is to be a reattribution. My role as the policyholder advocate for Aviva's proposed reattribution includes negotiating the PIP offer with the firm and then making my views known to policyholders and giving

them guidance as to whether Aviva's proposals are in their interests. The FSA considers the fairness of Aviva's offer, to determine whether it appropriately balances the interests of policyholders and shareholders and prepares a statement for the High Court which has to approve Aviva's proposals.

Aviva has provided me and my advisers with a substantial volume of information to enable me to undertake an in-depth analysis of its reattribution proposals. I have considered and challenged all aspects of the with-profits funds that I believed to be relevant to my role, including aspects of the rules which the FSA has established to regulate the with-profits sector. I believe that some of the FSA's rules, in particular concerning how companies may use inherited estates, favour shareholders over policyholders and that this has constrained the value of Aviva's reattribution offer to CGNU Life and CULAC policyholders. The FSA has issued a consultation paper which proposed no longer allowing compensation payments for mis-selling to be met from inherited estates, but has otherwise confirmed that it does not foresee making any further changes to its rules in the near term. I have therefore had to evaluate Aviva's reattribution proposals against the background of the current FSA rules.

The FSA's rules, together with the present practices of with-profits insurers, allow inherited estate capital to be used to support new policies as well as existing ones, thereby causing capital to be retained in the with-profits fund and ultimately distributed to future policyholders rather than current policyholders. Each generation of policyholders subsidises the next, rather than paying for the cost of the capital needed to support its policies. Current policyholders were beneficiaries of such a subsidy when their policies were created.

This traditional 'intergenerational transfer' of inherited estate capital means that, depending on the value of the estates and on the assumptions about new business sales, current policyholders may receive only a relatively small proportion of policyholders' possible future distributions from the CGNU Life and CULAC estates, with the remainder being passed on to future policyholders.

For example, if the value of the estates is £1200 million on 1 October 2009, using Aviva's new business assumptions of 5 per cent growth each year from 2011 onwards, current policyholders as a whole could receive about £83 million over the lifetimes of their policies, or around 7 per cent of the total amount that policyholders might receive in future special distributions from the inherited estates in the absence of a reattribution. Using the same value of the estates, but the lowest new business assumptions I have made in evaluating Aviva's reattribution offer (minus 15 per cent each year from 2011), current policyholders might receive about £431 million or around 36 per cent of the policyholders' share of possible future special distributions in the absence of a reattribution. It is possible that new business sales assumptions could be sufficiently high that current policyholders could receive no special distributions at all from the inherited estates.

I consider this free transfer of estate value to future policyholders is wrong in principle. It will not continue after the reattribution once shareholders own rights to all the special distributions from the reattributed estates.

Moreover, this intergenerational transfer of estate capital can be particularly unfair to policyholders in a reattribution without strong regulatory intervention. This is because the firm's reattribution offer to current policyholders is to purchase 100 per cent of all policyholders' rights to possible future special distributions from the inherited estates, including the distributions which, without a reattribution, would be paid to future policyholders. Since, under present FSA rules, current policyholders are likely in practice to receive only a small fraction of total policyholders' distributions from the inherited estates, they may well find it benefits them to accept a relatively small PIP offer, in which case the shareholders would obtain the bulk of policyholders' rights in the inherited estates for free.

Because of this potentially very unfair outcome of the reattribution, I asked the FSA to give guidance on the issue. In response, the FSA said that the amount which would, under its rules, go to future policyholders without a reattribution should be shared with current eligible policyholders as part of the firm's reattribution offer.

The work that I have done has led me to conclude that, as outlined above, under current FSA rules, since Aviva's offer is far higher than the average eligible policyholder would expect to receive in the normal course of events, this is an offer that is good for the great majority of policyholders. I consider therefore that it should be put to policyholders so that they can each make their own choice as to whether or not to accept the offer. I believe that policyholders can do this with the assurance that, if they decide not to accept the offer, their position will be properly protected in terms of the security of their benefits and any future special distributions from the inherited estates.

Aviva has said that the offer will return around 13.5 per cent per year on its investment to shareholders, and it expects cash payback on its offer within three years. The FSA is responsible for deciding if this is a fair return to shareholders.

I have worked closely with my advisers on all the issues that had to be addressed in order to evaluate Aviva's reattribution offer thoroughly. This report expresses my own views, where necessary after consultation with my advisers. Where views are expressed by advisers, I am in agreement with them. I have added personal statements on two principal issues where I have gone further than my advisers: I consider that both are particularly important for the protection of eligible policyholders in the reattribution and that present arrangements fall short of what I consider would be desirable.

The first of these issues concerns the free 'intergenerational transfer' of the inherited estates to future policyholders, the consequences of which are outlined above and set out in more detail in my personal comment in Chapter 13. The other relates to the role of the With-Profits Actuary (WPA), who is appointed by the firm and who has the responsibility to consider the fair treatment of policyholders. There are no FSA rules or guidance which deal with what the duties of the WPA are or should be in a reattribution and I consider the WPA's relationship with the firm makes it awkward for him to challenge management on behalf of policyholders' interests. It is particularly difficult if he is challenging practices which have been followed for many years (and especially so when the practices are permitted by the

FSA and the firm has significant discretion). As my personal comment in Chapter 6 explains, much of the governance problem would disappear if the FSA's rules did not create incentives for the firm to transfer value from policyholders' potential special distributions from the inherited estates to shareholders.

This report, and its associated appendices, will be made available to policyholders, to Aviva, to the FSA and to other interested parties. It will also be provided to the High Court to assist in its assessment of Aviva's reattribution proposals. As a matter of good practice the report, together with its appendices, describes in detail the basis and outcome of my negotiations on key aspects of the reattribution including my guidance to policyholders.

I have also written to all eligible policyholders, giving them guidance as to whether the firm's offer is in the interests of particular groups of policyholders, as well as additional summary information about the reattribution. This guide is being sent out to policyholders in conjunction with the Aviva communication to policyholders, which includes the voting form enabling each policyholder to indicate whether or not they wish to vote to accept Aviva's reattribution offer.

Clare Spottiswoode CBE, policyholder advocate.

Executive summary

Part I Introduction to the proposed reattribution

Chapter 1: The reattribution: roles and process

1. Aviva plc proposes to `reattribute` the inherited estates of the CGNU Life Assurance Ltd (CGNU Life) and Commercial Union Life Assurance Company Ltd (CULAC) with-profits funds, in conjunction with a transfer of those funds to Aviva Life & Pensions UK Limited (AVLAP) as part of a programme to simplify the group's structure. An inherited estate is that amount in a with-profits fund over and above what is expected to be required to meet the fund's liabilities including normal bonuses payable to policyholders but is used to meet the fund's working capital requirements. In a reattribution, which is governed by Financial Services Authority (FSA) rules and guidance, a firm offers to pay policyholders a policyholder incentive payment (PIP) to buy out their right to any future special distributions from the inherited estate.

2. Under the relevant FSA rules, which came into force in 2005, a policyholder advocate is appointed so that with-profits policyholders have an informed and independent person to negotiate, on their behalf, with Aviva. The FSA's guidance says that the policyholder advocate should negotiate with the firm the benefits policyholders receive in exchange for the rights they give up, comment to policyholders on the reattribution proposals and tell them whether the firm's proposals are in their interests. The FSA itself assesses the fairness of the offer made to policyholders vis-à-vis the benefit to shareholders.

3. The Financial Services and Markets Act 2000 (FSMA) and rules made under it govern the transfer of the funds and require that an independent expert is appointed by the firm to report on the fund transfer and reattribution proposals and two actuaries employed by Aviva (the actuarial function holder and the with-profits actuary) also report on those proposals (see summary of Chapters 5-7).

4. Aviva has prepared a Scheme for the reattribution and fund transfer which goes to the High Court for approval. The first stage of the Court process is a case management conference (which took place on 8 May 2009),

following which Aviva is sending eligible policyholders a package of information, from both Aviva and the policyholder advocate, and eligible policyholders are asked to vote on whether or not they wish to accept the reattribution offer. The policyholder advocate is also holding roadshows to help inform policyholders. Policyholders who believe they would be adversely affected by the fund transfer or the reattribution are entitled to be heard in Court. The High Court hearing which is the culmination of the Court process is expected to be in September 2009. If approved, Aviva intends to implement the reattribution and fund transfer on 1 October 2009 (the Effective Date) and thereafter to make the policyholder incentive payment as soon as possible to those policyholders who elected to accept the reattribution offer.

Chapter 2: The approach of the policyholder advocate

1. The policyholder advocate engaged a number of advisers including specialist legal, actuarial, tax and financial modelling advisers. She also consulted widely. Policyholders were given opportunities to express their views via mailings, roadshows and other means. The policyholder advocate asked Queen's Counsel to give an opinion on rights and interests in, and uses of, the CGNU Life and CULAC inherited estates. The policyholder advocate also challenged some aspects of the FSA's rules which she considers allow uses of the inherited estates which favour shareholders over policyholders and delay and reduce future special distributions to current policyholders.

2. After detailed negotiations between Aviva and the policyholder advocate, Aviva proposed a final PIP offer in February 2009. The policyholder advocate then evaluated the offer, with the help of her advisers, and produced the policyholder advocate's report which comments on various aspects of the reattribution and gives guidance to policyholders about whether, in her opinion, Aviva's proposals are in their interests. In addition the policyholder advocate produced a shorter guidance booklet which is being sent to policyholders by Aviva in its voting pack.

Chapter 3: Access to information and due diligence

1. Aviva provided the policyholder advocate and her advisers with a great deal of information both before and during negotiations.
2. The policyholder advocate's legal advisers conducted due diligence covering rights and interests in and uses of the inherited estates, eligibility rules for the reattribution and the history of the inherited estates. Her actuarial advisers' due diligence included assessing the value of the inherited estates for the purposes of the reattribution, reviewing the reasonableness of Aviva's attitude to risk and reviewing Aviva's approach to the allowance for non-market risk in its calculations. Her tax advisers' due diligence reviewed Aviva's analysis of the impact of the reattribution on the company's tax position, advised on the tax implications of the reattribution (including the tax aspects of policyholder incentive payments) and other tax matters relevant to the reattribution. Financial modelling was used to assess the value of the reattribution to current policyholders and Aviva shareholders; to estimate how, for different groups of policyholders, the PIP offer compares with special distributions they could receive in the absence of a reattribution; to assess whether the position of non-electing policyholders is properly protected under Aviva's proposals; and to help provide guidance to eligible policyholders as to whether or not to elect to accept Aviva's offer.

Part II The scheme and related reports

Chapter 4: Aviva's scheme

1. Aviva's Scheme involves a transfer, under the provisions of Part VII of the FSMA, of the long term insurance business of CGNU Life, CULAC and Norwich Union Life (RBS) Limited to AVLAP, along with a reattribution of the inherited estates of the with-profits funds of CGNU Life and CULAC. Aviva explains that the reattribution proposals are unlikely to proceed unless a minimum threshold of acceptances is exceeded and the aggregate value of the estates is at least £1200 million on the Effective Date. It is also conditional on confirmation by the Boards of AVLAP and Aviva plc. Should the reattribution not proceed, there is an Alternative Scheme under which the fund transfer would still proceed.

2. Within AVLAP, two new with-profits sub-funds will be created: a New With-Profits Sub-Fund (New WPSF), to which policies which elect for the reattribution will be allocated, and an Old With-Profits Sub-Fund (Old WPSF) to which non-electing policies will be allocated. A proportion by value of the combined inherited estates determined in accordance with the Scheme will be allocated to the shareholder (the "reattributed inherited estate") and the balance will be allocated to the Old WPSF and form its inherited estate. The reattributed inherited estate will, through a Reattributed Inherited Estate External Support Account (RIEESA), remain in AVLAP so long as it is needed to provide capital support to the Old WPSF and the New WPSF, including if necessary capital to cover minimum regulatory requirements. If the interests of policyholders whose policies have been allocated to the Old WPSF in potential future special distributions from the inherited estates have not been preserved - which will be estimated by calculating and comparing the value of potential special distributions to policyholders (VPDP) immediately before and after the reattribution - additional assets up to £100 million can be transferred from the RIEESA to the Old WPSF. Provided that a VPDP adjustment is not required to be made, assets of the Old WPSF may be loaned to the RIEESA (the "BSF Adjustment") if there is a difference in the financial strengths of the Old WPSF and the New WPSF and RIEESA together, which exceeds a specified threshold. No release may be made to the shareholder from the reattributed inherited estate until any such loan has been repaid in full.

3. The PIP for each policy will be calculated broadly by reference to the liability for each eligible policy but adjusted in some cases to allow for the term of the policy still to run and to reflect a minimum payment. The minimum aggregate PIP offered to eligible policyholders will be £500 million, assuming a value of the inherited estates on the Effective Date (the Reattribution Estate) of £1200 million. The actual value of the Reattribution Estate will be calculated as the average values as at three dates in successive calendar months, 30 June, 31 July and 28 August 2009, plus two months' interest. If the Reattribution Estate exceeds £1200 million then the incentive payments made to holders of Elected Policies will be proportionately increased. Policyholders who elect to receive a PIP

will receive the PIP as soon as reasonably practicable after the Effective Date and, in any event, within 180 days of that date.

4. The overall investment objectives of the Old and New WPSF will be substantially the same as those that would have been adopted had the Scheme not become effective. Bonus policy will also remain the same as it would have been and the AVLAP Board is to adopt consistent policies for managing with-profits business in the New WPSF and the Old WPSF.

5. Annual investigations will take place of both the Old and the New WPSF/RIEESA to determine whether they have assets which exceed those required to meet liabilities and capital requirements (including in respect of the new business which might be written in the future). If excess assets are identified, distributions will take place only if there is no significant risk that the relevant fund would not be able to meet its obligations to policyholders or its capital requirements following such a distribution. No release from the RIEESA can be made, however, until at least the first investigation after the Scheme has been effective for six years.

6. Aviva has established a With-Profits Committee (WPC) with a majority of independent members to judge, among other things, Aviva's compliance with its Principles and Practices of Financial Management (PPFM) and its compliance with the Scheme.

7. A mortgage endowment promise was made to certain CGNU Life and CULAC with-profits endowment policyholders, subject to an Affordability Condition. If the reattribution goes ahead, the promise will no longer be subject to the affordability condition although any other conditions will continue to apply.

8. The policyholder advocate considers that in general the Scheme, which was reviewed by Freshfields Bruckhaus Deringer, achieves its intentions and improves policyholders' position in two respects - entrenching the role of the WPC and removing the affordability condition previously attached to the mortgage endowment promise. Moreover, the detailed provisions for allocating the PIP between policies are satisfactory, as are the VPDP and BSF adjustments.

9. However, some concerns that the policyholder advocate has about the Scheme have been brought to

the attention of both Aviva and the FSA. Presently the FSA rules allow tax on shareholder distributions to be paid from an inherited estate. It is possible that the FSA may change its rules some time in the future so that shareholders have to bear the tax on their distributions from with-profits funds but the Scheme would not automatically require Aviva to apply such amended rules to the Old WPSF. The policyholder advocate would like the Scheme to be amended to make clear that Old WPSF policyholders would benefit if such a change is made. The policyholder advocate also considers that the approval of the WPC should always be required for adoption of a new management policy that results in a material benefit to shareholders (not just those that would not have benefitted shareholders but for the Scheme), even if the change is needed in order to treat policyholders fairly; that allowing with-profits policyholders' normal investment returns to suffer the effect of industry levies should be subject to WPC approval; and that there should not be a general provision that allows the continuation of pre-existing practices as yet not identified by Aviva that could otherwise be a breach of the Scheme.

Chapter 5: The actuarial function holder's report

1. Under FSA rules, firms which carry on long term insurance business must appoint an Actuarial Function Holder (AFH) who must advise managers of the relevant fund about the risk the fund runs, in so far as they have a material adverse impact on the firm's ability to meet liabilities to policyholders as they fall due, and the capital (including regulatory capital) needed to support the business. On a Part VII fund transfer, the Court will normally be given a report on the transfer by the AFH and, when a reattribution is also involved, in practice the report will cover the reattribution proposals.

2. Aviva summarises the AFH's main conclusions as being that in nearly all cases it will be in the financial interest of policyholders to elect for the reattribution; that the Boards would be fully justified in recommending eligible policyholders to accept the PIP; that holders of Non-Elected Policies will be treated fairly; and that there will be no material impact on benefit security for existing policyholders. If the reattribution does not go ahead and the Alternative Scheme is implemented, there is unlikely to be any adverse effect on policyholders' benefit security.

3. The policyholder advocate, taking into account advice from KPMG, does not disagree with most of the conclusions of the AFH's report. KPMG does, however, state that the AFH could have been more precise in the cases where he claims policyholders' interests would not be 'materially adversely affected'. KPMG would have liked to see some indication of the degree of materiality the AFH has in mind. KPMG also says that it would prefer more formal documentation of the facility for all 'strategic investments' to be held in the RIEESA. As regards governance arrangements for investment strategy, KPMG points out that those arrangements rely on the WPC being provided with all the information it requires. KPMG also considers that the Board's power, as set out in the Scheme, to deduct some or all of future industry levies from policyholders' normal benefits should be subject to the approval of the WPC.

Chapter 6: The with-profits actuary's report

1. With-profits insurers must, in accordance with FSA rules, appoint a WPA to advise on key aspects of the discretion exercised in the management of the with-profits business.

2. Aviva summarises the conclusions of the WPA's report on the Scheme as follows: the reattribution process has been undertaken in line with regulatory requirements, the negotiation has been robust with open access to information and policyholders have been treated fairly, the Alternative Scheme would have no material adverse impact on policyholders and post-reattribution governance arrangements are appropriate.

3. KPMG, which examined the WPA's report on behalf of the policyholder advocate, says that one of the key protections for policyholders is the role of the WPA in advising the company whether or not policyholders are being treated fairly. KPMG's view is that the role of the WPA could have been used to challenge the company's discretion further as summarised in paragraph 4 below. KPMG does note, however, that no specific guidance from any source exists in relation to the role of the WPA in a reattribution, and that different WPAs will have different views as to their role in a reattribution.

4. In making statements that policyholders would not be 'materially adversely affected', KPMG would have liked to see more clarity from the WPA on the degree of materiality he has in mind. The WPA should also, in

KPMG's view, have considered and commented on the power under the Scheme to charge some or all of future industry levies to asset shares without the requirement for approval from the WPC. The WPA should focus on issues primarily from the policyholders' point of view according to KPMG, which means that he should have considered how possible future special distributions from the inherited estates depend directly on levels of future new with-profits business written in the funds. The WPA should therefore have commented on Aviva's forecasts of new with-profits business and its 'risk appetite' which is another factor affecting the likelihood and size of future special distributions. KPMG notes that the WPA does not, as KPMG would have expected, express an opinion about the size of the aggregate amount of the PIP in relation to the potential benefits which would be forgone, even though he says that the outcome of negotiations is fair to policyholders. The WPA's views about whether the deal is fair to policyholders are therefore, in KPMG's opinion, not clear.

5. The policyholder advocate adds that the WPA has a particularly important role in protecting policyholders' interests, especially at the time of a reattribution when the FSA's rules create incentives for the company to transfer value from policyholders' potential future special distributions from the inherited estates to shareholders. She notes that the WPA's report does not contain the critique of the company's assumptions which she would have expected. Since the WPA is an employee of the company, she is concerned that he may find it difficult to challenge long-standing company practices, especially when they are permitted by the FSA.

Chapter 7: The independent expert's report

1. KPMG summarises the Independent Expert's principal conclusions, with most of which it agrees, as follows: the aggregate amount of incentive payments appears favourable as compared with the estimated values of potential special distributions that policyholders might have received in the future in the absence of the reattribution determined by Aviva and by the policyholder advocate's team; the approach to allocating the aggregate amount of incentive payments among eligible policyholders is fair; it is unlikely that the current generation of policyholders has collectively contributed to the inherited estates; though current policyholders have no specific entitlement to future special distributions, it is quite possible that part of the

remaining inherited estates will become available for distribution during the lifetime of current policies; and the provision of capital support by the RIEESA to the Old WPSF and the New WPSF as required by the Scheme is appropriate.

2. One area where KPMG does not share the view of the Independent Expert is in relation to the Scheme not requiring the WPC to approve any charges to asset shares in respect of industry levies. KPMG believes 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 WPC's recommendations, and reliance on the WPC 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 WPC.

Chapter 8: The FSA's fairness review

1. The FSA has described its role in a proposed reattribution as scrutinising the fairness of the proposals, which it will do once the policyholder advocate and the firm have completed their negotiations. It will take into account the interests of all policyholders and the implications for the firm's financial position. In the case of a 90:10 fund, such as in this proposed reattribution, the FSA's starting point will be that the basis of distributions will be 90 per cent to policyholders and 10 per cent to shareholders. If the proposal is to divide value on a different basis, the FSA will assess whether or not that basis is fair. The FSA's assessment will focus on the fairness of the offer being made to policyholders vis-à-vis the overall benefit to shareholders.

2. The initial assessment will be made before the reattribution proposals are put to policyholders by the firm. If the firm and the policyholder advocate agree that a proposal can be put to policyholders and that it would be helpful to know the FSA's preliminary assessment, the FSA will inform them privately. The FSA's final view on fairness will be communicated to the Court to assist the Court with its decision whether or not to sanction the reattribution.

3. The FSA has made a preliminary assessment of the fairness of the Aviva reattribution offer. In considering the aggregate offer, it said that it assessed fairness in terms of the value gained by the shareholder relative to

the payment made to policyholders. The value gained by the shareholder was measured by the 'internal rate of return' on the transaction (the percentage return on the shareholders' investment in the reattribution). The FSA also considered the position of non-electing policyholders because it said it will only 'non-object' to a deal if such policyholders are no worse off than if the reattribution had not proceeded, both in terms of benefit security and benefit expectations. The FSA said that its assessment took account of the percentage of current policyholders for whom the offer would be greater than the expected value of future distributions, but it did not focus on this aspect because it ignores the value accruing to shareholders post-reattribution from distributions that would have gone to future with-profits policyholders, if the reattribution had not taken place.

4. The Aviva proposed reattribution offer of July 2008 and the revised offer of February 2009 were both put to the FSA. In both cases, using the approach described above, the FSA's preliminary view was that the offers were fair.

Part III Context

Chapter 9: Contributions to the inherited estates

1. Aviva concludes that the current generation of policyholders has not contributed to the inherited estates of CGNU Life or CULAC. The reattribution proposals have been formulated and negotiations with the policyholder advocate have been conducted assuming that neither current policyholders nor shareholders have contributed to these inherited estates.

2. KPMG, on the policyholder advocate's behalf, considers potential contributions to the inherited estates and concludes that the estates are likely to have mostly resulted from payouts to past policyholders having been less than past contributions. KPMG confirms that the negotiations assumed no contributions to the estates from current policyholders or shareholders. The policyholder advocate points out that in any case any past income flows are not relevant in assessing what policyholders should be paid in exchange for their rights to future benefits in the form of possible special distributions from the inherited estates.

Chapter 10: Qualification for the pre-retribution distribution

1. In February 2008, Aviva announced a special distribution from the CGNU Life and CULAC inherited estates, phased over three years, through the award of special bonuses worth an estimated £2.1 billion to qualifying with-profits policyholders. The qualification criteria are different from those for the retribution.

2. The policyholder advocate acknowledges the legal and practical problems of aligning the criteria for the distribution and the retribution, desirable though that might have been in principle. However, the policyholder advocate does not accept that the phasing of the distribution over three years strikes a fair balance between different policyholder groups.

Chapter 11: Eligibility for retribution

1. Aviva explains that the basic eligibility criteria are that the customer's product must have been in force and invested in with-profits on the day the policyholder advocate's appointment was announced

(21 November 2006 - Announcement or A Day) and must still be in force and invested in with-profits on the day the retribution is implemented (Effective or E Day). However, in certain circumstances a policyholder remains eligible even if his policy is no longer in force on E Day – essentially where the policy has terminated in accordance with its terms prior to E Day, for example where the policyholder retires on his selected retirement date between A Day and E Day.

2. An Eligibility Panel will review cases which are not clear-cut.

3. The policyholder advocate, advised by Freshfields Bruckhaus Deringer, considers the eligibility criteria and the Eligibility Panel proposal acceptable.

Chapter 12: Consultation and communication with policyholders and other interested parties

1. The policyholder advocate took steps to consult and communicate with policyholders, including sending a letter and leaflet to policyholders immediately after her appointment; establishing a

correspondence office, a call centre and a website, arranging consultative events for policyholders; and conducting online and telephone surveys and organising roadshows. In general, communications with policyholders during the retribution process worked well, though the policyholder advocate had some concerns about material she had prepared which was not issued by Aviva or sent out late. The policyholder advocate also communicated with numerous other parties, including the FSA, the Treasury Committee, government departments, MPs and independent financial advisers. Post-negotiations, policyholders are being sent a guidance document from the policyholder advocate, which is included in Aviva's voting pack and which includes her guidance to different groups of policyholders about whether the firm's offer is in their interests. A series of road shows has also been arranged. Policyholders can request copies of the policyholder advocate's report and this executive summary. The report, including its appendices, is being published on the policyholder advocate's website.

Part IV The legal and regulatory framework

Chapter 13: Legal issues in respect of rights and interests in, and uses of, the inherited estates

1. Policyholders' legal rights to receive special distributions from an inherited estate, and the firm's legal rights and obligations to use estate assets for purposes other than making distributions are at the heart of any retribution negotiation. Both the policyholder advocate and Aviva took legal advice on these matters. The legal advisers agreed on some issues but disagreed on some fundamental questions.

2. The policyholder advocate's legal advisers set out five principles which, in their view, impose restrictions on the uses to which a firm may put an inherited estate and which should therefore underlie the interpretation of FSA rules about fairness and the interests of policyholders. They concluded that, considered in the light of these principles, some of Aviva's uses of its inherited estates are questionable, including the making of strategic investments (investments in the equity or debt of companies to which Aviva companies have a strategic connection or interest), the payment of mis-selling compensation costs, shareholders' tax on

distributions from the with-profits funds and subsidies for new business. Aviva's legal advisers disagreed that there is any need to specify 'implied terms' of the contracts between policyholders and the companies, such as the five principles, and argued that the five principles do not satisfy the other basis on which to imply contractual terms, that they represent the mutual intentions of the parties.

3. Both sets of advisers considered the use of an inherited estate to provide capital support for new with-profits business and, in particular, the practice of pricing new business so that the estate is effectively transferred between generations of policyholders without charge. Aviva's legal advisers considered that this 'intergenerational transfer' is an inherent feature of with-profits insurance. The policyholder advocate's legal advisers decided that the intergenerational transfer cannot be said clearly to be in breach of the five principles, provided the estate is properly compensated for the risks in writing the new business and that the terms and scale on which the new business is written are consistent with policyholders' expectations.

4. The analysis carried out by the policyholder advocate's legal advisers lent force to the arguments she used in negotiating with Aviva and supported the arguments she used when seeking guidance from the FSA on the proper interpretation of its rules (see summary of Chapter 14). In her further comment on the regulatory issues arising from her legal advice, the policyholder advocate pointed out that, consistent with that legal advice, in her view an economic regulator would be very unlikely to permit capital in the inherited estate to be treated differently from other capital in the fund, as does the FSA, which allows shareholders to use the estate preferentially to pay for items which, if there were no estate, shareholders would have to pay themselves.

5. However, the policyholder advocate went further than her legal advisers on the issue of 'intergenerational transfer' of inherited estate capital from current to future policyholders, where the FSA rules, together with present practices of with-profits insurers, allow estate capital to be used to support new policies as well as existing ones, thereby causing capital to be retained in the fund and ultimately distributed to future policyholders rather than current policyholders. Since more new business will transfer more of the value of the estate to new policyholders,

current policyholders' interests lie in not writing new business. Thus shareholders' interests come into direct opposition to current policyholders' interests. The policyholder advocate considers that an economic regulator would require new with-profits business to be self-supporting and written so that it was profitable for the existing fund and its participants, both shareholders and policyholders.

6. The policyholder advocate also considers that the outcome of present regulation and practices which bring about the intergenerational transfer of capital can be particularly unfair to policyholders in a reattribution without strong regulatory intervention. This is because, if current policyholders accept the firm's reattribution offer, they are effectively selling 100 per cent of all policyholders' rights in the inherited estate, even though those current policyholders could in practice only receive a small fraction of such distributions. They may well therefore find it benefits them to accept a relatively small PIP offer in which case the shareholders would get the bulk of policyholders' rights in the estate for free (see 14).

Chapter 14: FSA guidance letters and responses

1. On several occasions the policyholder advocate sought guidance from the FSA about aspects of its regulatory regime. One of the main themes of the correspondence between the policyholder advocate and the FSA was the question of what uses of inherited estates are permitted under FSA rules. The policyholder advocate first wrote to the FSA in August 2007 when she pointed out that, if the FSA allows with-profits insurers to use their inherited estates for purposes that favour shareholders over policyholders, that will reduce the value of the special distributions that current policyholders might otherwise expect to receive, and hence the value of any reattribution offer. She explained that the uses of the estate that are particularly at issue are strategic investments, mis-selling compensation costs, tax associated with shareholder distributions and new business subsidies.

2. The FSA responded that firms may use their inherited estates to make strategic investments, provided it is being fair to with-profits policyholders; that it would consult in the first half of 2008 on whether it should change its policy of allowing

mis-selling compensation costs to be charged to inherited estates; that tax on shareholder transfers can be charged to inherited estates if it is consistent with established practice and is explained in a firm's Principles and Practices of Financial Management (PPFM); and that the initial costs of writing new business can be charged to the inherited estate if the costs are repaid to the estate over a 'reasonable period'. The FSA acknowledged that one of the results of writing new business into the fund is that the inherited estate is then effectively supporting the new policies as well as existing policies, and this transfers inherited estate between the 'generations' of policyholders. But the FSA said this is an intrinsic feature of with-profits business where a fund is open to new business.

3. The policyholder advocate replied that she found the FSA's response disappointing since it largely maintained the status quo in relation to permitted uses of inherited estates. She asked for an FSA statement about the treatment of 'intergenerational transfer' of capital in a reattribution – since instead of an inherited estate being transferred from current

policyholders to future policyholders, in a reattribution the future policyholders' interest in the estate is transferred to shareholders, potentially without compensation. The policyholder advocate said that she considered such an uncompensated transfer to shareholders to be inconsistent with the FSA's principle of Treating Customers Fairly.

4. The FSA replied that it would be reviewing new business assumptions as part of its fairness assessment. The policyholder advocate and the firm should negotiate about how the capital that would, in the absence of a reattribution, have passed from current to future policyholders should be reflected in the firm's reattribution offer to policyholders. The policyholder advocate should also negotiate to protect the position of non-electing policyholders. The FSA would assess fairness once negotiations are complete.

5. In April 2008 the policyholder advocate asked the FSA for guidance on Aviva's interpretation of the FSA's view that new business should not erode the inherited estate (Aviva said '...in adverse circumstances...the estate is available to meet the

costs of the business'). The policyholder advocate expressed 'profound disagreement' with the FSA's response which was that unexpected losses may be charged to the inherited estate. The policyholder advocate considered this position provides no incentive to firms, when they are forecasting new business and setting charges, to do so in a way that does not erode the estate. The FSA response was that if unexpected losses do occur and are charged to the estate, firms would be expected to take action to make future compliance more likely.

6. There was further correspondence about whether the FSA considered allocating strategic investments to the inherited estate to be fair to policyholders. If they did not, the policyholder advocate suggested that the FSA should instruct the firm to increase the value of the published estates accordingly. She asked the FSA to confirm that the investments in question had not breached its rules. The FSA replied that it was '...not aware of any reason why the assets you mention should not be included in the estate'.

Chapter 15: The House of Commons Treasury Committee report: Inherited estates

1. In April 2008, the House of Commons Treasury Committee took evidence as part of its inquiry into the inherited estates of with-profits funds. Evidence was given by Which?, the policyholder advocate, the Chairman of the FSA, Aviva and Prudential. The Committee's report, published in June 2008, made a number of recommendations relevant to reattributions.

2. The Committee noted that funding of new business from an inherited estate represents an intergenerational transfer to the future beneficiaries of the estate. It urged the FSA to make a rigorous assessment of the reasonableness of the new business assumptions made by a firm during reattribution negotiations because of the incentive the firm has to maximise the amount set aside for the funding of new business. Firms should not be permitted, after reattribution, to distribute to themselves these set-aside funds.

3. The Committee also commented on other uses of the inherited estate that might reduce policyholders' expected distributions. The vast bulk of mis-selling

costs should, the Committee said, be borne by shareholders and the charging of shareholder tax to the inherited estate should no longer be permitted: the FSA should consult on the charging of shareholder tax before the end of 2008.

4. On the issue of fairness, the Committee said that the bargaining position of policyholders is weak and so the FSA should ensure that the firm offers a fair price that takes into account not only the value of potential special distributions to policyholders but also the total value gained by shareholders. WPCs also have a crucial role and should have a clear commitment to protecting policyholders' interests.

5. One of the Committee's recommendations was addressed to the Office of Fair Trading (OFT) which should, the Committee said, consider looking more thoroughly at the competition aspects of the use of with-profits funds. The OFT, however, responded that it did not think its scarce resources should be employed in further competition analysis of the effects of inherited estates.

6. The FSA's response to the Committee stressed that it was considering ways of improving the reattribution process (by formal rule changes or informal clarifications) and that it planned a 'comprehensive review' of how the senior management of with-profits firms has implemented the FSA's new regulatory regime, to be published by end 2009.

7. On the issues raised by the Committee, the FSA thought it would be helpful to publish in more detail the outcomes it would expect to use when judging the fairness of a firm's reattribution offer. It said that, when assessing fairness, it would take account of the value to policyholders of possible future distributions and also of the value shareholders will unlock from the reattribution. The FSA would also expect policyholders' benefit security to be maintained. Its review of the way firms have implemented the with-profits regulatory regime would include an assessment of the implementation of its rules about the use of an inherited estate to provide capital for new business; it was considering the response to a consultation on charging mis-selling costs to inherited estates; and it was keeping under review the with-profits regime

generally including the practice of charging shareholder tax to inherited estates. WPCs, it said, are intended to be '...an integral and powerful part of a firm's decision making procedures'.

Part V Fund management

Chapter 16: Policyholders' future security and risk appetite

1. Aviva's 'risk appetite' determines its attitude towards accepting risks and hence determines the amount of surplus capital it decides to retain in its funds. The protection of policyholders' guaranteed benefits and the prospect of special distributions of excess surplus from the inherited estates are therefore both affected by the firm's risk appetite.

2. According to Aviva, the new AVLAP funds (into which CGNU Life and CULAC with-profits policies will be transferred following the reattribution) will be run in a way consistent with the way the CGNU Life and CULAC funds were run before reattribution. The firm's Risk Appetite Framework (RAF) uses a preferred range of surplus corresponding to a notional AA to AAA rating. If the surplus falls outside this range, the Board is responsible for corrective action after seeking advice from the WPA and the WPC. The Board has set a threshold of 120 per cent of a Moody's AAA credit rating, maintained for three years, to define when mandatory special distributions from the inherited estate of the Old WPSF must take place and a point of 110 per cent of AAA when a surplus may be released to shareholders from the RIEESA, after the reattribution. The Board retains its discretion to make a distribution from the Old WPSF at levels of estate below the mandatory distribution level.

3. KPMG examined Aviva's proposals on behalf of the policyholder advocate. It concluded that Aviva's acceptable range of surplus (AA to AAA) is appropriate but that the mandatory surplus distribution threshold for the Old WPSF of 120 per cent of AAA could be considered prudent. Although prudence may enhance policyholder security, it delays releases of potential surpluses, so reducing possible distributions to current policyholders and potentially reducing the amount current policyholders are prepared to accept to give up their rights to future special distributions.

KPMG also concluded that some of the assumptions used by Aviva in modelling its preferred management approach to dealing with surpluses were too prudent.

In calculating its estimate of the value of potential future special distributions forgone for the purposes of comparing it with the policyholder incentive payments, Aviva assumed that special distributions from the inherited estates would be made at a level of 105 per cent of AAA and the policyholder advocate assumed 100 per cent of AAA.

Chapter 17: Investment policy, smoothing and bonus policy

1. The way in which Aviva invests policyholders' premiums and its smoothing and bonus policy will affect what with-profits policyholders receive from their investments. Aviva describes its investment strategy as aiming to provide the highest long-term returns balanced against acceptable levels of solvency risk. There is a degree of matching between assets and liabilities, so as to ensure funds meet their policyholders' guaranteed benefits, achieved by maintaining a suitable ratio of fixed interest type assets with the balance being invested in equity-type assets (including property) to total assets backing asset shares (typically referred to as the Equity Backing Ratio or EBR). Given recent market volatility, application of the RAF has resulted in a smaller proportion of the inherited estate being invested in equities but, if conditions improve, Aviva expects the asset mix for the inherited estate to revert to being similar to the asset mix which backs asset shares. Aviva says that its long term aim is to pay out 100 per cent of asset shares when policies mature but, because of the variability of investment returns, it operates a smoothing policy for maturity payouts. The smoothing account is held and reported separately.

2. The firm recognises there will be increased potential for conflicts of interest between policyholders and shareholders after reattribution so it has introduced additional safeguards, including the requirement that, for similar policies in the Old WPSF and New WPSF, asset share investment strategy and bonuses (other than bonuses that arise as a result of future special distributions from the inherited estates of the Old WPSF, PIPs payable in the form of additional

benefits applicable to certain Elected Policies and in respect of any enhancement of the asset shares of Elected Policies arising from the new business clawback mechanism) will be identical.

3. KPMG, as adviser to the policyholder advocate, is in general agreement with Aviva's investment strategy. However, it has some concerns about investment in strategic assets and about smoothing policy. On strategic assets, KPMG believes that on reattribution all strategic assets should be transferred to the RIEESA rather than a proportion being held in the Old WPSF. As regards smoothing, KPMG suggests some changes to improve transparency. It would like to see Aviva measure unsmoothed asset shares alongside smoothed asset shares so that it is clear how much policies are affected by smoothing. It also suggests that the smoothing account should be subject to an annual independent external review.

Chapter 18: With-profits governance arrangements

1. The FSA's rules include a requirement for with-profits insurers to introduce an independent element into their decision-making. To meet this requirement, Aviva has chosen to have a WPC to help strike a balance between policyholder and shareholder interests. Its key purpose, according to Aviva, is to '...ensure that fairness to with-profits policyholders continues to be more deeply embedded in the Company's decision making'. The other elements in its governance framework are the AVLAP Board, which has a duty to treat customers fairly, and the WPA, who advises the Board on the exercise of its discretion (see summary of Chapter 6).

2. Freshfields Bruckhaus Deringer examined these governance arrangements, as adviser to the policyholder advocate. Freshfields Bruckhaus Deringer acknowledges that Aviva has given the WPC the right to 'whistle blow' to the FSA if it believes the company is not complying with the Scheme or otherwise is not treating policyholders fairly. However, in such circumstances, the policyholder advocate considers the WPC should also report to policyholders. In any case, the policyholder advocate considers that the WPC (and the WPA) should report to policyholders at least once a year. Freshfields Bruckhaus Deringer made a number of

other suggestions about the constitution and operation of the WPC, which were designed to enhance its independence, but these were not adopted by Aviva.

Chapter 19: Principles and practices of financial management (PPFM) and consumer-friendly PPFM

1. The FSA requires with-profits firms to produce a Principles and Practices of Financial Management (PPFM) document which deals with issues that significantly affect a firm's management of its with-profits funds.
2. Aviva says that it has modified its PPFM to reflect the new fund structure post-retribution. The new PPFM describes the management of the Old WPSF and the New WPSF. The policyholder advocate is critical of some aspects of the PPFM, noting in particular that in respect of the Old WPSF it enshrines various uses of the inherited estate to which she objects and does not make clear (i) that these uses will, other things being equal, reduce special distributions from the estate or (ii) that the terms on which new business will be written have the effect of transferring the inherited estate, without payment, from current policyholders to future policyholders. The new post-retribution CFPPFM was not available at the date of this report but the policyholder advocate notes that the current (pre-retribution) CFPPFM has some key omissions, such as scant mention of the inherited estate and the possibility of distributions from it.

Chapter 20: The position of non-electing policyholders

1. The FSA has made clear that non-electing policyholders should be no worse off after the retribution than they were before. Aviva states its aim as being to ensure that all policyholders are treated fairly. As regards non-electors, it has sought to maintain their position in two major respects – reasonable expectations and benefit security. For the first, it uses the VPDP method and for the second it uses the 'Effective Date Benefit Security Factor'(BSF) (see summary of Chapter 4).
2. The policyholder advocate's aim for non-electors is to ensure that their position is, as far as practicable,

unaffected. The policyholder advocate considers that aim is achieved by Aviva's proposals in all material respects, subject to one exception. The exception is that any change in future FSA rules which currently permit shareholder tax to be charged to inherited estates is not certain to apply to the Old WPSF estate. Although the possibility that the FSA would not insist on this is remote, the policyholder advocate considers that the Scheme should be changed to put this beyond doubt.

Part VI Key issues in the numerical analysis of Aviva's offer

Chapter 21: Modelling for the purposes of the retribution

1. In formulating its retribution, Aviva says that it carried out extensive modelling, using a wide range of economic assumptions, so as to assess the benefits of the offer to policyholders and shareholders, the fairness of the offer and the treatment of non-electing policyholders. It relied primarily on 'stochastic' models which attempt to estimate the probabilities of various outcomes, and which also have built-in management reactions to events. Towers Perrin, a firm of consulting actuaries, provided Aviva with an opinion that the model was materially 'fit for purpose' with regard to the projection of the balance sheet assets and liabilities of the combined CGNU and CULAC funds, and the calculation of the initial AAA threshold capital requirement.
2. KPMG, as the policyholder advocate's adviser, examined Aviva's modelling but did not carry out a detailed audit. In general, KPMG believes that the outputs of the models are reasonable for the purposes of the retribution and can be relied on in a review of Aviva's valuations of the size of the inherited estates, its risk appetite and its assessment of capital requirements.
3. The policyholder advocate's detailed modelling work was undertaken by LECG. It developed two financial models which used data provided by Aviva to provide quantitative analysis of the division of aggregate benefits between policyholders and shareholders, the allocation of Aviva's aggregate PIP offer among groups of policyholders, the impact of

Aviva's proposals for safeguarding non-electing policyholders' interests in the inherited estates, and to assist in the formulation of guidance to policyholders. LECG checked the Aviva data for consistency and reasonableness and also used continuous testing and other checks on the outputs of the models. The Aviva data LECG has used for its analysis are based on policies in force on the first date for eligibility (21 November 2006). During the summer Aviva is providing updated data as at end 2008.

Chapter 22: Tax matters in relation to the reattribution

1. Aviva considered the impact of tax both on policyholders and on shareholders. It says that for UK residents a cash PIP will not normally be subject to UK income tax or capital gains tax. In some overseas countries, tax could be payable either on a cash PIP or, on maturity, on any capital gain from a non-cash PIP. Neither the fund transfer nor the reattribution will affect the tax position of non-electing policyholders. The value which the fund transfer and reattribution create for shareholders may result in some future tax charges, though the long term impact on the tax position of the funds seems likely to be broadly neutral.

2. Deloitte advised the policyholder advocate on tax matters¹. It agrees with Aviva's view that cash PIPs to UK residents will not be subject to UK income tax. Deloitte points out that, because of the uncertainty of the future and the complexity of the life tax rules, there is a range of possible outcomes for the rate of tax shareholders will pay. Deloitte remarked that it is possible that there may be a change to FSA rules which at present allow shareholder tax to be charged to inherited estates (see summaries of Chapters 14 and 15). If the change occurs, the value of inherited estates will increase since shareholder tax liabilities will no longer be deducted from the estates.

¹ Deloitte's advice was intended only as a general overview of certain aspects of UK tax legislation and what is understood to be current practice of HMRC in relation to matters relevant to the reattribution. As such it does not constitute tax or legal advice to any person and may not be relied upon as such. Policyholders should consult their own professional advisers as to their tax position.

3. There may be some reduced tax rate benefit to Aviva from maintaining reattributed inherited estate assets in the AVLAP long term fund but it is difficult to value and was not taken into account in the negotiations.

Chapter 23: The size of the inherited estates

1. Aviva's PIP offer is based on the size of the combined CGNU Life and CULAC inherited estates (referred to in this report as the Reattribution Estate) close to the date that the reattribution and fund transfer is effected. If that date is 1 October 2009 then the Reattribution Estate will be calculated by Aviva as an average of the values as at 30 June, 31 July and 28 August 2009 (plus two months' interest), using as the 'key reference point' the 'Realistic Balance Sheet' (RBS) values prepared for the FSA.

2. KPMG, as adviser to the policyholder advocate, agrees with the use of RBS valuations of the Aviva inherited estates as the basis for calculating the Reattribution Estate value and agrees also with the proposed averaging procedure.

3. However, 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 therefore made a number of detailed adjustments to the RBS values which raise the value of the combined inherited estates from £1570 million at end December 2008 by £177 million to £1747 million (the figure of £1570 million is the published value of the estates at end 2008 including an estimated Aviva post year-end adjustment). The policyholder advocate used the KPMG-adjusted value of the inherited estates in her assessment of the Aviva offer.

4. In response to the continued market volatility, the negotiated offer has been restructured so that the inherited estate valuation can be based on the size of the inherited estate close to the Effective Date. The valuation of the inherited estate on which payment of the PIP is made to policyholders who elect to accept the offer will be calculated using an unweighted average valuation of the CGNU Life and CULAC inherited estates across three consecutive months prior to the effective date. At the time of writing this report, detailed discussions were still in

progress between Aviva, the FSA and KPMG as to the exact nature of the assurances around the setting of assumptions, and methodologies to be used for the valuation of the inherited estate on which payment of the PIP is made to policyholders. KPMG's review of the assumptions and methodologies used in Aviva's calculation of the Reattribution Estate, compared with those used for the realistic balance sheet figures for December 2008 will be detailed in its supplementary report which will be published on the policyholder advocate's web-site in due course.

Chapter 24: The pre-reattribution distribution

1. A pre-reattribution special distribution from the inherited estates was announced by Aviva in February 2008. The distribution, which came after Aviva had changed the way it manages the CGNU Life and CULAC with-profits funds so as to reduce some of the investment risk, was of about £2.1 billion² to policyholders, spread over three years.
2. KPMG, as adviser to the policyholder advocate, agreed that the size of the pre-reattribution distribution is appropriate. However, there is a point of contention between the policyholder advocate and Aviva related to the spreading of the payments. KPMG also argued that spreading the distribution over three years is not appropriate. Any such distribution should, in its view, be carried out immediately as otherwise it introduces a source of inequity for policyholders who exit before the end of the three years.

Chapter 25: Valuation of the reattributed estates

1. 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 estate that would otherwise go to future policyholders may instead be transferred to shareholders (see the summaries of Chapters 13 and 14 above). The FSA made clear to the policyholder advocate that its fairness review of the reattribution would take into account the value accruing to shareholders post-reattribution from distributions that would otherwise have gone to future policyholders and that the firm and the policyholder advocate should also take this value into account in their PIP negotiations.

The policyholder advocate and her advisers therefore estimated the 'residual value' of future policyholders' share of the potential special distributions from the inherited estates, using various new business assumptions and after taking account of the potential benefits policyholders and shareholders would forgo as a result of the reattribution, together with some one-off reattribution costs.

2. Aviva based its method of assessing whether its offer is 'fair value' to policyholders on calculations of the VPDP (see the summaries of Chapters 4 and 20 above), using assumptions about the various factors that would be expected to influence future special distributions over the next 25 years. It then estimated the 'PIP break-even period' – the length of time it will take for the VPDP to equal the PIP. Aviva concluded from its analysis that its offer is 'good value'³ for 99 per cent of eligible customers and 'excellent value'⁴ for at least 95 per cent (see summary of Chapter 29). It pointed to the extra costs incurred by shareholders as a consequence of the reattribution and the extra risks they would be exposed directly to in relation to the reattributed inherited estate. Aviva acknowledged that the FSA saw a value in the capital which passes to shareholders in a reattribution but which would otherwise have gone to future policyholders and that this value should be reflected in the PIP offer.

3. LECG analysed the residual value of the inherited estates on behalf of the policyholder advocate, using KPMG's estimate of the size of the inherited estates (see summary of Chapter 23). LECG made deductions from the inherited estates to allow for costs that shareholders must bear as part of the reattribution, for risks that shareholders will have to bear that the inherited estates would have borne in the absence of a reattribution, and for the value of FSA 'concessions' that allow shareholders to charge to the estates costs that they are not allowed to charge to asset shares and will have to fund themselves after a reattribution. In total, these adjustments (net of the additions made by KPMG) reduce the value of Aviva's published end 2008 inherited estates from £1570 million to £1197 million⁵. Adopting Aviva's new business assumptions, and after deducting the value placed on eligible policyholders' and shareholders' possible future

2 The original value announced. The 2009 and 2010 instalments may be less or more depending on investment performance of the inherited estates.

special distributions from the inherited estates, the residual value of the estate, to be divided between eligible policyholders and shareholders in the reattribution, is estimated by LECG at £834 million⁶, using Aviva's new business assumptions. The larger the volume of new business assumed, the higher is the residual value, because a smaller amount of the potential future special distributions from the inherited estates are projected to be distributed to eligible policyholders and so more, in the absence of a reattribution, would go to future policyholders.

Chapter 26: Aviva's new business assumptions

1. For the reasons given above, under existing FSA rules, the amount of future new with-profits business which is assumed plays a crucial role in the assessment of Aviva's offer. Aviva assumes that, from 2011 onwards, the rate of growth of the value of new business will be 5 per cent per year. It accepts that there has been a downward trend in the with-profits market in recent years but it says that its own recent performance has been strong and it argues that it will have every incentive to continue to write new with-profits business post-reattribution. In its view, its growth assumptions are conservative.

2. The policyholder advocate and her advisers disagree with Aviva on this point. LECG concluded that the future of with-profits business is very uncertain and that to rely on one projection, as Aviva does, means that there is no indication of this uncertainty. LECG therefore analysed a range of assumptions about future new with-profits business which included Aviva's assumption of 5 per cent per year growth but also included two other assumptions a 5 per cent per year decline and a 15 per cent per year decline, both from 2011 onwards.

3 Meaning that policyholders would have to wait at least 10 years until the estimated value of future special distributions would exceed the offer.

4 Meaning that policyholders would have to wait until at least 25 years or if the offer would always exceed the estimated value of future special distributions.

5 Valued as at 1 October 2009, the Effective Date of the reattribution.

6 Valued as at 1 October 2009, the Effective Date of the reattribution.

Chapter 27: The impact of FSA guidance on policyholders

1. The impact of the FSA rules about the uses of inherited estates on the value of eligible policyholders' interest in potential future special distributions (see the summaries of Chapters 14 and 15) was analysed for the policyholder advocate by LECG which considered the effects of the FSA rules which allow an estate to be used to support new business (resulting in the 'intergenerational transfer' explained in the summaries of Chapters 13-15) and for other uses which benefit shareholders and erode the estate, such as to pay mis-selling compensation costs and shareholder taxes and to make 'strategic investments'. The policyholder advocate challenged these FSA rules vigorously. The FSA considered this challenge but has confirmed that it does not expect that its rules will be changed in any significant way for the foreseeable future. LECG estimates that uses of the estates allowed by the FSA erode the size of the CGNU Life and CULAC inherited estates for the benefit of shareholders by around £297 million⁷. These allowable uses reduce potential future special distributions to eligible policyholders by around £90 million for a published estate value of £1200 million under Aviva new business assumptions.

2. However, the largest impact from current regulation stems from the FSA rule that allows capital from the inherited estate to be used to support new with-profits policies. This means that that capital which might otherwise be available for distribution to one generation of policyholders is transferred to the next. Eligible policyholders were beneficiaries of this transfer of capital. Under this FSA rule, in the absence of a reattribution, and depending on the amount of new business written in the funds, much of the estate value and therefore the possibilities of obtaining future special distributions, would be passed on to future generations of policyholders. This intergenerational transfer represents a reduction of about £1.1 billion in the estimated value which would otherwise have been placed on potential future special distributions to eligible policyholders, assuming an estate value on 1 October 2009 (the Effective Date of the reattribution) of £1200 million plus adjustments to the estate value as advised by KPMG and using Aviva's new business assumptions.

LECG concludes that ‘...it is clear that FSA regulation of with-profits funds is the primary factor influencing the assessment of the reattribution offer’.

3. The FSA has said that the estimated value of potential future special distributions which, under its current rules, would go to future policyholders without a reattribution should be shared with eligible policyholders as part of the firm’s reattribution offer. LECG’s analysis indicates that such a sharing has occurred, since Aviva’s aggregate PIP offer exceeds the estimated value that has been placed on eligible policyholders’ possible future distributions from the inherited estates across a range of assumptions about new business. Assuming an estate value of £1200 million on the Effective Date, when Aviva’s aggregate PIP value would be £500 million, and Aviva’s new business assumptions, LECG has estimated eligible policyholders would be giving up around £83 million in possible future special distributions if they were all to accept the firm’s offer (see summary of Chapter 30).

Chapter 28: Analysis of potential special distributions to policyholders and shareholders

1. LECG carried out financial modelling to analyse the future distributions that eligible policyholders might have received in the absence of a reattribution so as to quantify the benefits that they might be giving up if they accepted Aviva’s offer. According to LECG, the three main determinants of future special distributions are the capital requirement of the funds; the amount of new business written, causing the ‘intergenerational transfer’ of capital; and the level of investment returns.

2. LECG shows that the division of potential future special distributions between eligible and future policyholders is significantly affected by new business support which defers potential distributions (by increasing the funds’ capital requirements) and dilutes the interest of eligible with-profits policyholders (because new with-profits policyholders would be eligible to participate in any such distributions).

For example, with an estate value of £1200 million on the Effective Date, the value of potential future special distributions to eligible policyholders is estimated at around £83 million under Aviva’s new business assumptions of 5 per cent per year growth from 2011 onwards (see summary of Chapter 27 above). If, however, the policyholder advocate’s lowest alternative new business growth assumption of a decline of 15 per cent per year from 2011 onwards is used, the estimated value of such distributions to eligible policyholders increases more than five fold to £431 million.

Part VII Numerical evaluation of Aviva’s offer

Chapter 29: The Aviva offer

1. Aviva explains its offer as follows (see also the summary of Chapter 4). The aggregate PIP offered to policyholders depends on the valuation of the Reattribution Estate, calculated as an average over three months as described in the summary of Chapter 23 above. With a Reattribution Estate of £1200 million, the aggregate PIP will be £500 million and the minimum PIP per eligible policy is £200: for every £100 million that the Reattribution Estate exceeds £1200 million, the aggregate PIP will increase by £55 million and the minimum PIP per eligible policy will increase by £22. Allocation of the aggregate PIP among eligible policyholders will be pro rata to a proxy for realistic liability at 21 November 2006 policy values as at the Effective Date but adjusted depending on type of policy and length of outstanding term. Policies with longer to run will, other things being equal, generally receive higher PIPs, reflecting the increased possibility that they would have received special distributions from the inherited estates over the period that their policies are in force. Payments of the PIP will generally be in cash.

2. The inherited estates will be allocated between the Old WPSF and the New WPSF with the aim of providing security for the benefits of existing policyholders and investment freedom. There is a safety net mechanism for non-electing policyholders to ensure that estimated aggregate value of potential special distributions from the inherited estates determined as specified in the Scheme (VPDP)

is broadly maintained. If the VPDP determined for such policies immediately before the Effective Date exceeds the corresponding VPDP calculated immediately after the Effective Date then the shortfall must be eliminated by a transfer of assets from the RIEESA to the Old WPSF (the VPDP Adjustment), subject to a maximum transfer of £100 million. If a VPDP Adjustment is not required to be made, assets of the Old WPSF may be loaned to the RIEESA (the 'BSF Adjustment') if there is a difference in the financial strengths of the Old WPSF and the New WPSF and RIEESA together (in each case determined as specified in the Scheme) which exceeds a specified threshold. No release may be made to the shareholder from the reattributed inherited estate until such time as any such loan has been repaid in full.

3. An additional benefit to certain policyholders of CGNU Life and CULAC is that Aviva's mortgage endowment promise (against shortfalls in repaying mortgages) is no longer to be subject to the affordability condition if the reattribution goes ahead (see paragraph 7 of the summary of Chapter 4).

4. Aviva states that its PIP offer fairly divides between policyholders and shareholders the potential value unlocked by the reattribution as well as compensating eligible policyholders for possible distributions forgone. Aviva considers that the individual PIPs represent good value for 99 per cent of eligible policyholders in the sense that they would have to wait at least 10 years before the estimated value of future distributions could exceed the offer. It is excellent value for at least 95 per cent of those eligible who would have to wait at least 25 years before the estimated value of future distributions exceeded the offer. Aviva also points out that all eligible policyholders have the opportunity to vote no and thereby retain their current rights.

Chapter 30: Evaluation of the aggregate PIP offer

1. LECG evaluated the Aviva offer on behalf of the policyholder advocate. LECG compared the benefits arising from the reattribution with those that might have been expected had there been no reattribution, using the three new business assumptions described in the summary of Chapter 26, KPMG's calculations of the size of the estates (see summary

of Chapter 23) and KPMG and LECG calculations of deductions considered to be appropriate to make from the estates to arrive at the residual value of that part of the inherited estates that without a reattribution would have been distributed to future policyholders (see summaries of Chapters 25 and 27). To do so, LECG modelled the pattern and magnitude of potential future distributions from the inherited estates to eligible policyholders, future policyholders and shareholders.

2. LECG's conclusion is that, across the range of new business assumptions considered, the value of Aviva's aggregate offer exceeds the value eligible policyholders might expect to receive as special distributions from the inherited estates, under current FSA rules, without a reattribution. Assuming the value of the inherited estates as at the Effective Date is £1200 million, the estimated value of eligible policyholders' possible future special distributions would amount to around £83 million on Aviva's new business assumptions, compared with the greater total value of the aggregate Aviva offer to policyholders of £500 million at that estate value. Thus eligible policyholders would receive a share of the residual value which is unlocked by the reattribution; this holds true across the range of estate values and new business assumptions assessed by LECG (see summary of Chapter 25). The policyholder advocate concludes therefore that, under these assumptions and current FSA rules, since Aviva's offer is higher than the average eligible policyholder would expect to receive in the normal course of events, this is an offer that is good for the vast majority of policyholders.

3. LECG also calculated the expected rate of return Aviva will receive on its investment in the reattribution (the Internal Rate of Return, or IRR) as ranging from 10.3 per cent to 11.5 per cent depending on the value of the inherited estates at the Effective Date of the reattribution (based on a range between £1200 million and £2500 million). Using its own methodology, Aviva says its return varies between 8.2 per cent and 10.6 per cent over the same range of estate values between £1200 million and £2500 million. However, Aviva has recently reported its expected IRR from the reattribution to be 13.5 per cent. At the time of writing, no explanation has been provided to the policyholder advocate

or her advisers to explain the projected return. The FSA has said that it will look at the shareholders' return in judging whether the reattribution offer is fair.

Chapter 31: Allocation of the aggregate PIP between policyholders

1. LECG, as adviser to the policyholder advocate, analysed Aviva's method of allocating the aggregate amount of the PIP between eligible policyholders. After estimating potential future special distributions from the inherited estates to groups of policyholders, they have then modelled the allocation of these distributions to individual policies. These individual policyholder estimates of potential future special distributions are then compared to the estimated PIP allocated to each individual to determine which value is greater. The value of future special distributions can only be estimated because the timing and amount of such distributions depend upon the future experience of the with-profits funds, and that experience cannot be predicted with any certainty.

2. LECG's modelling indicates that under current FSA rules and using Aviva's new business assumptions, for Reattribution Estate values ranging from £1200 million to £2500 million for between 84 per cent and 97 per cent of eligible policies the reattribution offer is likely to exceed possible future special distributions. On the policyholder advocate's lower alternative new business assumption (a 15 per cent per year decline from 2011 onwards), for between 78 and 87 per cent of policies the PIP is likely to exceed possible future special distributions.

3. For holders of policies with short terms to run, Aviva's offer in almost all cases exceeds the likely value of special distributions which would be forgone. For holders of policies with long outstanding terms, or for holders of single premium policies with no fixed maturity date that expect to remain in the fund for the long term, the offer is less likely to exceed forgone special distributions.

4. LECG concludes that, although there are weaknesses in Aviva's allocation mechanism which tends to over-compensate policies with short terms to run, the firm has tried to match PIP offers to potential

benefits forgone. The policyholder advocate is therefore satisfied that, under current FSA rules, over a wide range of assumptions about the future, a majority of policyholders receive a PIP offer which exceeds their potential benefits forgone.

Chapter 32: The position of non-electing policyholders

1. Aviva, the FSA and the policyholder advocate are agreed that non-electing policyholders should not be disadvantaged by the reattribution. LECG analysed a particular aspect of Aviva's proposals to ensure that they preserved non-electing policyholders' interests in the inherited estates.

2. Because Aviva's PIP method of allocating the aggregate amount of the PIP between eligible policyholders is not perfectly correlated to the potential benefits which such policyholders would forgo, 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 has therefore agreed to top up the inherited estate of the Old WPSF with up to £100 million from the RIEESA (see summary of Chapter 29) to preserve non-electors' potential future special distributions.

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 business that Aviva might have written in the absence of a reattribution. Aviva concluded that in 80 of these scenarios, the value of non-electors' potential future special distributions would be at least preserved. LECG's conclusion was that, over a reasonable range of assumptions about the future, the safety net is likely to preserve non-electors' benefits at a level similar to what they would have been without a reattribution. The policyholder advocate is therefore content to assume that the 'safety net' mechanism proposed by Aviva to protect nonelecting policyholders' interests in future distributions from the inherited estates will be effective.

Chapter 33: Formulation of guidance to policyholders

Overall assessment of whether Aviva's PIP offer is in the interests of eligible policyholders

1. In assessing Aviva's offer, the policyholder advocate has had to accept the present framework of FSA rules for with-profits insurers, though she has on several occasions pointed out to the FSA the adverse impact of those rules on policyholders, particularly at the time of a reattribution and has asked the FSA to reconsider a number of the rules.

2. However, the policyholder advocate notes that, over a wide range of future circumstances, the aggregate PIP is greater than the aggregate potential future special distributions for eligible policyholders; it includes allowance for a reasonable share of the proportion of the inherited estates which might accrue to future policyholders; the method of allocating the aggregate amount of the PIP correlates as well as possible under the circumstances with potential benefits forgone by individual eligible policies; and the position of non-electing policyholders is generally preserved. Eligible policyholders have a choice between accepting the offer or having their interest in potential future special distributions from the inherited estates maintained. Overall, therefore, under the current FSA rules, the policyholder advocate is of the view that Aviva's PIP offer is in the interests of eligible policyholders.

Guidance to groups of eligible policyholders

3. In her guidance to eligible policyholders, the policyholder advocate points out that decisions about whether or not to accept the Aviva offer depend to a substantial extent on personal circumstances and policyholders may also wish to consider taking independent financial advice. However, to assist the policyholder advocate in offering general guidance to policyholders, LECG analysed the position of various types of policies by comparing the PIP offer with the value of possible future special distributions under a variety of scenarios.

The results were:

- Policies maturing before end 2016 are unlikely to receive special distributions that exceed their PIP offer and so will, in general, be better off accepting their offer.

- Policies maturing between 2017 and end 2021 could in some circumstances (for example, if Aviva new business declines) receive special distributions that exceed the offer.

- Policies maturing from 2022 onwards could, under all circumstances assessed, receive special distributions that exceed the offer.

4. For single premium policies, the decision whether to accept the offer depends primarily on how long the policyholder is prepared to leave his or her policy in the fund.

5. In her guidance to policyholders, the policyholder advocate made it clear that, to make these estimates, LECG has had to look many years into the future. The future is necessarily uncertain and therefore it is not possible for anyone to forecast with any certainty whether or not the Aviva offer is worth more than the benefits policyholders will be giving up if they accept the offer.

6. The data LECG has used to make its estimates have been provided by Aviva, based on policies in force on 21 November 2006. Aviva will be providing LECG with updated data as at end 2008. During the summer the policyholder advocate will be checking the guidance to particular groups of policyholders against Aviva's updated data. If this results in any significant change to the policyholder advocate's present guidance, Aviva intends to enable the relevant policyholders to decide whether or not to change their vote.

7. The policyholder advocate wrote to all eligible policyholders to explain her guidance to them, and her guidance leaflet is being sent by Aviva to policyholders as part of its voting pack.

Part VIII Conclusions

Chapter 34: Overall conclusions of the policyholder advocate

Key factors in the negotiations

1. The policyholder advocate's conclusions were reached after detailed discussions with Aviva, accompanied by an in-depth analysis, supported by her advisers, of key factors in the negotiations. These included the eligibility criteria for the reattribution, the legal and regulatory framework, Aviva's risk appetite and its investment, smoothing and bonus policies, the post-reattribution governance arrangements including the PPFM, financial modelling of those funds over 25 years from 2006, tax issues affecting policyholders and shareholders, the valuation of the inherited estates for the purposes of the reattribution, assessment of the 'residual value' of the estate (being the future policyholders' potential share of future special distributions from the estate after deducting reattribution costs and allowances) and new with-profits business assumptions.
2. At the same time, the policyholder advocate had continuing communications with policyholders and other interested parties.

The FSA rules and their impact on the negotiations

3. During the reattribution process it became clear that, although legally the assets of a with-profits fund (including the inherited estate) belong to the insurer, policyholders have potentially quantifiable rights in that estate which arise from possible future special distributions. The FSA confirmed that policyholders have a reasonable expectation of receiving some money from an inherited estate and that in a reattribution a value should be placed on that expectation.
4. However, the FSA's present rules allow inherited estates to be used by with-profits insurers for a number of practices which the policyholder advocate's legal advisers described as 'questionable' – such as making 'strategic investments', paying mis-selling compensation costs and paying shareholders' tax on distributions – which erode the

estates. Moreover, the policyholder advocate was particularly concerned about the FSA's rules on capital support for new business which permit the support of new policies and therefore allow capital to be retained in a fund and ultimately to be distributed to future policyholders rather than current policyholders. At the time of a reattribution the outcome of this regulatory practice can be particularly unfair to current policyholders unless there is strong regulatory intervention: if current policyholders accept the firm's reattribution offer, they are in effect selling 100 per cent of all policyholders' rights in the inherited estate, even though current policyholders might receive only a small fraction of future special distributions if the reattribution did not go ahead. Consequently, current policyholders might find it beneficial to accept a relatively low PIP offer so that shareholders obtained the bulk of policyholders' rights in the estate for free.

5. The policyholder advocate had an extensive correspondence with the FSA in which she challenged its rules on the uses of inherited estates, including its rules about new business support. The FSA said it would consult on mis-selling compensation costs but not on the other practices the policyholder advocate considers questionable. As regards new business support, the FSA considers that capital support for new business is acceptable provided the business is managed with a view to repaying the costs to the estate within a reasonable period. It accepts that one result of this is that it transfers the benefit of the inherited estate between the 'generations' of policyholders but the FSA says that this is an intrinsic feature of with-profits when a fund is open to new business. Nevertheless, the FSA said that in its 'fairness' evaluation of the reattribution proposals, it would take into account the value of the inherited estate which might fall to be distributed to future (rather than current) policyholders and that it considered that the firm and the policyholder advocate should also negotiate on that basis.

6. Since it appeared to the policyholder advocate that the FSA rules on uses of inherited estates would be unlikely to change significantly in the foreseeable future, the reattribution negotiations were conducted on the basis of the present regulatory framework,

and the policyholder advocate's guidance to policyholders as to whether the firm's proposals are in their interests was also set in the context of the current FSA rules.

Comments on particular aspects of Aviva's proposals

7. As regards particular aspects of Aviva's proposals, the policyholder advocate reached the following conclusions, taking into account the views of her advisers:

Eligibility for the reattribution - the policyholder advocate considers the criteria proposed and the Eligibility Panel proposal acceptable.

Allocation of benefits among policyholders

a) allocation of aggregate PIP: the policyholder advocate concludes that over a wide range of assumptions about the future, a majority of policyholders receive a PIP offer which exceeds their possible future special distributions from the inherited estates, b) the policyholder advocate notes that the form of the PIP offer, which is to be in cash except where a special bonus would be in policyholders' interests, is designed to benefit policyholders, c) the policyholder advocate is satisfied that Aviva's allocation of the inherited estates between the Old WPSF and the New WPSF/RIEESA, together with the adjustments to that allocation to (i) ensure the financial strength of the Old WPSF and the New WPSF are sufficiently similar and (ii) to ensure that non-electors' interests in any possible future distributions from the inherited estates are maintained, are likely to be effective in protecting non-electors.

Material terms and conditions - the policyholder advocate considers that in general Aviva's Scheme achieves its intentions to ensure that, whether or not eligible policyholders elect for the reattribution, the terms of their policies, their premiums and the normal bonuses that their investment earns will not be affected by the reattribution. However, the policyholder advocate has brought some concerns to the attention of both Aviva and the FSA. In particular, the policyholder advocate considers the wording of the Scheme should be amended to make it clear that if FSA rules change so that tax on

shareholder distributions can no longer be charged to inherited estates, non-electing policyholders will benefit from the change.

The Independent Expert concluded that the transferring policyholders (electing, non-electing and ineligible) will not experience a significant reduction in the level of security for their guaranteed benefits, and that no transferring policyholder should experience a material reduction in his or her reasonable benefit expectations as a result of the Scheme. (The latter conclusion does not take into account the scope for future special distributions from the inherited estates of CGNU Life and/or CULAC.) For the purpose of giving guidance to policyholders, the policyholder advocate adopted those conclusions.

The With-Profits Actuary's report on the Scheme concluded that in terms of the reattribution the process has been undertaken in line with regulatory requirements, the negotiation has been robust, with open access to information, and policyholders have been fairly treated. In the policyholder advocate's view, the WPA has a particularly important role in protecting policyholders' interests. She notes that the WPA's report does not contain a critique of the assumptions used by Aviva to place a value on the potential special distributions that would be forgone by eligible policyholders if they accept the offered incentive payments, which she would have expected. She believes that the WPA should have been more willing to challenge the company's long-standing practices on behalf of policyholders.

The policyholder advocate's conclusions as to whether the offer is in the interests of eligible policyholders

8. In determining whether Aviva's proposals are in the interests of eligible policyholders, the policyholder advocate considered the firm's aggregate PIP offer, under current FSA rules, to ensure that (i) it exceeded her estimated value of possible future special distributions from the inherited estates that would be forgone by those who accept the offer, and (ii) that it shared equitably the value of the estate capital, after deducting reattribution costs and allowances, that would be

retained to support new business and potentially distributed to future policyholders in the absence of a reattribution (the 'residual value'). Because assumptions about new business are so critical to both (i) and (ii), the policyholder advocate used a range of such assumptions.

9. The policyholder advocate considers that analysis of Aviva's offer shows that across a broad range of new business assumptions, the aggregate PIP offer is likely to exceed eligible policyholders' interests in potential special distributions from the inherited estates and provide them with a share of the residual value. As regards the allocation of the PIP among eligible policyholders, the policyholder advocate is satisfied that, over a wide range of assumptions about the future, a majority of policyholders' individual PIP offers will exceed the estimated benefits they would forgo. The policyholder advocate is satisfied that the interests of non-electing policyholders are reasonably protected in terms of their interests in the inherited estates, and (in line with the Independent Expert's conclusions), that the security of benefits and the reasonable benefit expectation of both electing and non-electing policyholders are also protected.

10. The overall view of the policyholder advocate is therefore that Aviva's PIP offer is in the interests of eligible policyholders.

11. It is for the FSA to judge the fairness of Aviva's offer. The FSA's preliminary view is that the offer is fair.

12. The policyholder advocate's detailed guidance to groups of policyholders estimates the extent to which Aviva's PIP offer is likely, for a given group, to exceed possible future distributions from the inherited estates in the absence of a reattribution. That guidance also explains that future special distributions from the inherited estates are uncertain and dependent in particular on the assumptions made regarding future new with-profits business, future policyholder lapse rates and capital market conditions. In addition, some policyholders are likely to have personal reasons for wishing to take a cash PIP offer rather than await possible future special distributions from the inherited estates.

The guidance also makes clear that policyholders may wish to consider taking independent financial advice as to whether or not to accept Aviva's offer.

13. The data used by the policyholder advocate's adviser, LECG, to make its estimates was provided by Aviva, based on policies in force on 21 November 2006. Aviva will be providing LECG with updated data as at end 2008, and the policyholder advocate will be checking her guidance to particular groups of policyholders against Aviva's updated data. If this results in any significant change to the policyholder advocate's present guidance, Aviva intends to give the relevant policyholders an opportunity to decide whether or not to change their votes.

14. The table overleaf shows a summary of the policyholder advocate's analysis of the Aviva offer, across different sets of future new business assumptions. The analysis shown is based on an unadjusted estate size of £1200 million on the Effective Date. The percentage of policyholders with a PIP offer more than the present value of their expected future special distributions is similar for different estate sizes due to the link between the size of the estate and the aggregate PIP offer. The analysis assuming different estate sizes can be found in Appendix 46: *LECG conclusions regarding the Aviva offer*.

15. The figure opposite shows a pictorial representation of the policyholder advocate's analysis of the Aviva offer. The columns show the expected division of the inherited estate if there were no reattribution i.e. the baseline against which the Aviva offer has been assessed. If Aviva is assumed to write more

new business in the future, then the division of policyholder benefits between eligible policyholders and future policyholders changes so that less of the estate is expected to be distributed to eligible policyholders. Across a range of assumptions as to the level of new business written by Aviva in future,

Summary of the policyholder advocate's analysis of the Aviva offer

Size of reattributed estate £1200 million⁸

New business growth assumptions	+5% p.a. from 2011	-5% p.a. from 2011	-15% p.a. from 2011
Present value of expected future special distributions to eligible policyholders	£83 million	£292 million	£431 million
Aggregate PIP for 100% of estate	£500 million	£500 million	£500 million
Minimum PIP per policy	£200	£200	£200
Percentage of policyholders with PIP offer more than present value of expected future special distributions	96.6%	89.4%	86.8%

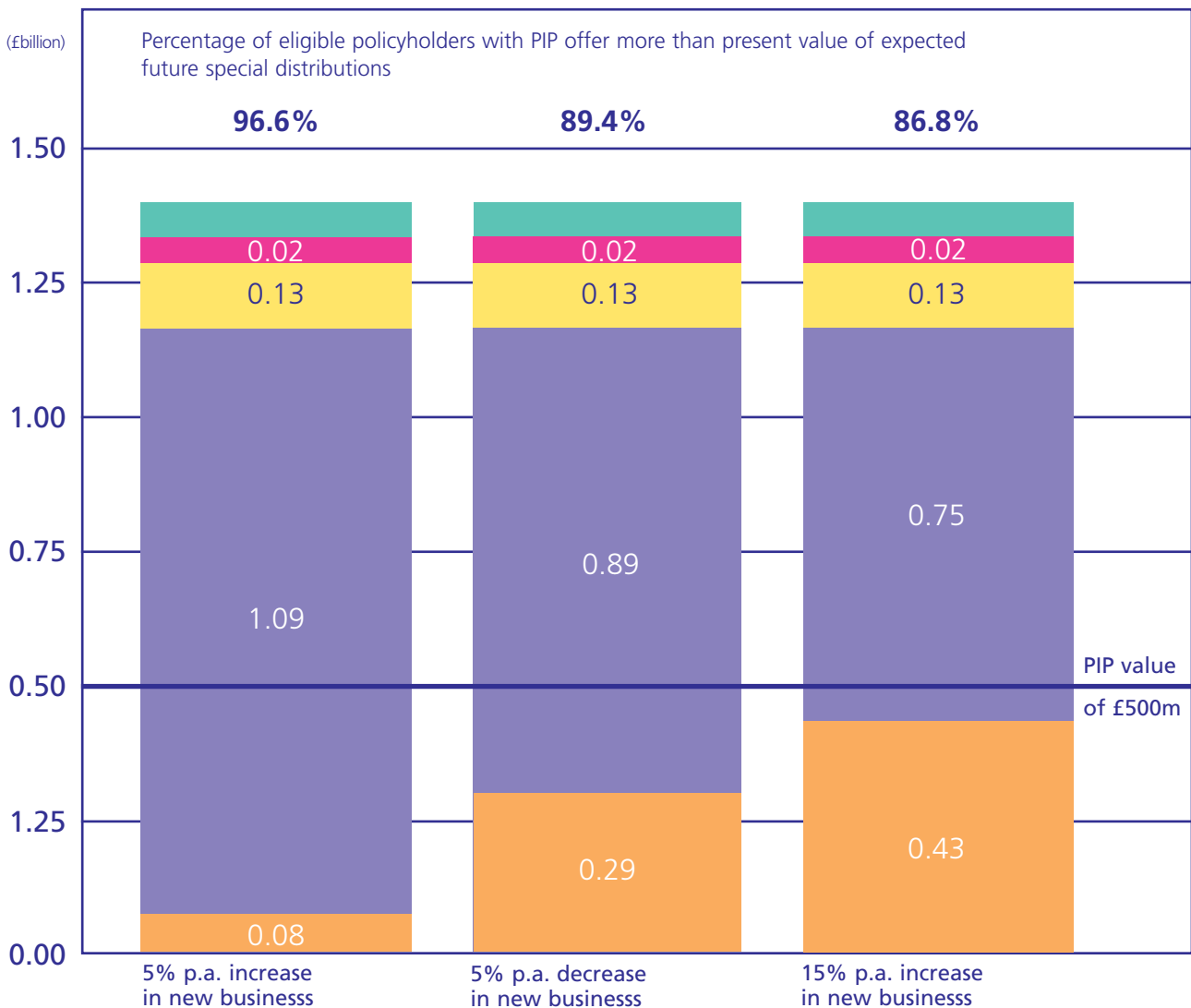
⁸ The size of the reattributed estate does not include the £177 million (as at 31 December 2008) of adjustments to the size of the estate as advised by KPMG.

the aggregate PIP value of £500 million (assuming an inherited estate of £1200 million at the Effective Date) is greater than the present value of the expected future special distributions to eligible policyholders. This however, does not necessarily imply that each policyholder would be better off

accepting their PIP offer due to the inefficiency of the PIP allocation mechanism. The percentages above the columns show the percentage of eligible policies for which the PIP offer is more than their expected future special distributions from the estate.

Summary of the policyholder advocate's analysis of the Aviva offer

- Eligible policyholders' expected future special distributions
- New policyholders' expected future special distributions
- Shareholders' expected future special distributions
- Shareholder tax
- Non-market risk and rounding



Estate value does not include KPMG adjustments of £177m at end -2008 (£185m at the Effective Date). Due to inefficiencies in the PIP allocation mechanism, increases in the expected future special distributions of eligible policy holders do not result in proportionate falls in the percentage of policyholders with a PIP offer more than their expected future special distributions.

16. A special distribution of £2363 million was announced in February 2008, of which £2080 million was allocated to policyholders. This special distribution and the aggregate Aviva PIP offer release a portion of the inherited estates to eligible policyholders. The table below shows the percentage of the overall value of the estates available for reattribution that is being offered to policyholders.

Assuming an estate value of £1200 million and that all policyholders accept, the Aviva PIP offer will release around 42 per cent of the inherited estates to policyholders, excluding the special distribution announced in February 2008. Including the special distribution announced in February 2008, in aggregate policyholders could receive up to 72 per cent of the available estates.

Percentage of estate offered to policyholders

Unadjusted reattribution Estate value (£m)	1,200	1,570	1,800	2,100	2,500
PIP (£m)	500	704	830	995	1,215
Policyholder share of estate excluding the special distribution announced in February 2008	42%	45%	46%	47%	49%
Policyholder share of special distribution announced in February 2008 (£m)	2,080	2,080	2,080	2,080	2,080
Total to policyholders, including the PIP and the special distribution announced in February 2008 (£m)	2,580	2,784	2,910	3,075	3,295
Policyholder share of estate including the special distribution announced in February 2008	72%	71%	70%	69%	68%

Statement by policyholder advocate relating to material prepared by Aviva

This document is an extract from the report prepared by the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds.

Certain sections of the report and certain of its supporting appendices have been prepared by Aviva. In the main body of the report these sections are headed 'Aviva's views' or 'Aviva's additional comments and 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 the report or light grey for those viewing a black and white copy). The relevant appendices are also clearly marked to show that they have been prepared by Aviva. These sections and appendices represent the views of Aviva and the policyholder advocate does not endorse those views or assume any responsibility for these sections or appendices.

Statement by Aviva relating to information provided by Aviva

Information contained in this report, its appendices or elsewhere which was provided by Aviva has been prepared by or commissioned by Aviva to facilitate its negotiations with the policyholder advocate. Aviva does not authorise the use of this information for any other purpose. Whilst Aviva has taken reasonable care that the information is accurate, it was prepared for use only by the policyholder advocate and her advisers and this information is not to be construed as advice by or on behalf of Aviva to any person, including policyholders and shareholders. No representation or warranty (whether express or implied) is given as to the future projections, estimates, returns or prospects, or any assumptions underlying them noted in this report. Aviva is not liable for any loss arising from any errors, omissions or misrepresentations in this report or other documents referred to in this report, or any third party action or decisions which may in any way be based on this report.

This information may not be published in any format or otherwise disclosed to any third parties without the express written permission of Aviva.

The report and appendices prepared by the policyholder advocate and her advisers do not necessarily represent the views and opinions of Aviva. Except where specifically stated otherwise, the views and opinions of the policyholder advocate, the office of the policyholder advocate and / or her advisers set out in this report, its appendices or elsewhere should not be taken to represent the views of Aviva.