

Report Number 1A

Size of the Inherited Estates

A summary of Aviva's perspective in connection with the reattribution of the inherited estates of CGNU Life and CULAC with-profits funds

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Annexe by: Aviva UK Life – 8th September 2009

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This annexe was first published on 3 September 2009 but was revised on 8 September to correct a typographical error (which is annotated in the text at the end of paragraph 2.01).

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1.00 Context

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

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

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

With that in mind, both the Aviva and the Policyholder Advocate want to understand the size of the inherited estate and how the value has changed since 31st December 2008.

This appendix analyses the value (prior to external review) that Aviva has placed on the inherited estates at 31st May 2009; 30th June 2009 and 31st July 2009 and looks at the factors which can, and have, caused it to change over time.

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2.00 Realistic Balance Sheet for CGNU Life and CULAC

As explained in the appendix “Size of the Inherited Estates” (appendix 35a) the inherited estate is the difference between the realistic assets and realistic liabilities of the with-profits company, both of which are highly volatile and susceptible to external influences such as interest rates, equity movements and property markets.

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

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

2.01 Investment mix for assets backing asset shares

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

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

From time to time, maximum and minimum exposure and performance benchmarks are set for the different groups of assets.

The published mix of investments for the CGNU Life and CULAC with-profits funds backing asset share are set out in the table below:

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	30.04.09	31/12/08	31/12/07	31/12/06	31/12/05	31/12/04
		%	%	%	%	%
UK shares	17.7	24.2	35.3	43.2	41.3	42.9
International shares	12.5	13.6	17.8	9.8	13.1	8.0
Property	18.2	17.9	18.4	21.0	18.0	16.0
UK Fixed Interest	15.3	11.8	6.8	6.7	9.7	12.1
Corporate Bonds	27.1	23.8	9.9	9.6	9.7	11.9
International Bonds	5.0	6.9	5.3	4.2	2.9	3.7
Cash	4.2	1.8	6.5	5.5	5.3	5.4

The equity backing ratio for CGNU Life and CULAC investments backing asset shares has reduced to 48%* (from 56% at 31st December 2008).

* In the version of this annexe published on 3rd September 2009 this figure was shown as 44% due to a typographical error

2.02 Investment mix for assets backing the inherited estate

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

The Risk Appetite Framework that applies to CGNU Life and CULAC does envisage that the investment strategy of the inherited estate would be used as a mechanism to control the level of risk in the fund, and in particular that the mix of assets would be altered to reduce risk in adverse conditions.

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Consistent with this, and in response to the continued market volatility, the asset mix for the inherited estate was changed in 2008 and 2009 so that less is invested in equities. This has the effect of making the value of the inherited estate less volatile, but it does not stop the size of the inherited estate varying.

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3.00 Inherited Estate Valuation at 31st May 2009

3.01 Results Summary for Mid-Year Reporting

RBS May 2009				
Results summary				
		Assets	Liabilities	
		for WP	for WP	Estate
CGNU		11,975	11,509	466
CULAC		11,733	11,168	565
Total		23,708	22,677	1031

RBS December 2008				
Results summary				
		Assets	Liabilities	
		for WP	for WP	Estate
CGNU		12,762	11,998	765
CULAC		12,410	11,646	764
Total		25,172	23,644	1529

As can be seen from the tables above, since the 31st December 2008 Realistic Balance Sheet valuation:

- Assets of the CGNU Life and CULAC with-profit fund reduced in value by £1,464m;
- Liabilities estimated for the CGNU Life and CULAC with-profit fund reduced more slowly by £967m;

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- As a consequence, the value of the CGNU Life and CULAC inherited estates reduced by £498m to £1,031m at 31st May 2009.

This movement is analysed in more detail below. Further information is also provided on post reporting adjustments that have now been applied which bring the value of the inherited estate to £1,055m¹ at 31st May 2009. This higher valuation is that which Aviva proposes (subject to external review by Aviva's auditors) to use for the balance sheet economic impact projection.

3.02 Detailed Breakdown for CGNU Life and CULAC

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

- Investment performance;
- Changes in assumptions;
- Modelling improvements;
- Cost of Guarantees on claims exceeding those assumed.

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

¹ At the date of this annexe, this figure is still in the process of being reviewed by Aviva's external auditors and could therefore be subject to change.

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

3.03 Investment Performance Summary

The key market drivers of recent performance are set out below:

Economic data	Dec-08	May-09	Jun-09	Change Dec08- May09	Change May09- June09	Change Dec08- June09
FTSE 100	4,434	4,418	4,249	-0.37%	-3.82%	-4.17%
15 yr gilt	3.74%	4.22%	4.12%	+48 bps	-10 bps	+38 bps
Equity vol – 5 yr term	34.4%	28.0%	27.6%	-6.40%	-0.40%	-6.80%
Equity vol – 10 yr term	34.6%	28.9%	28.2%	-5.70%	-0.70%	-6.40%

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

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

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

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

3.04 Assumption Changes

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

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

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

3.05 Post Reporting Adjustments and Modelling Improvements

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

These changes reduce the reported 31st May 2009 valuation by £26m taking the figure to £1,005m.

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

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This adjustment will be taken into account when calculating the 30th June 2009, 31st July 2009 and 28th August 2009 inherited estate valuations used to determine the aggregate PIP payable to those eligible policyholders' who elect to accept the offer.

3.06 External Review of Results

In line with the statements made in the Actuarial Function Holders report, the 31st May inherited estate valuation for CGNU Life and CULAC will be reviewed by the company's external auditors who will conduct a reasonable assurance review of the hard close valuation as at 31st May 2009. This review will be more rigorous than the normal review performed for half year interim reporting purposes. In particular the review will conform to ISAE 3000.

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

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4.00 Inherited Estate Valuation at 30th June 2009

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

Three balance sheet economic impact projections are then required as at 30th June 2009, 31st July 2009 and 28th August 2009 (i.e. “5 plus 1”, “5 plus 2” and “5 plus 3” valuations) by

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

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

4.01 Economic roll-forward to June 2009 – using basis agreed with FSA

The economic roll-forward methodology was reviewed by Aviva’s auditors and agreed with FSA prior to the conclusion of negotiations. The methodology has also been reviewed by the policyholder advocate’s advisors, who concluded that they agree with this methodology. Using this methodology gives a combined inherited estate valuation for CGNU Life and CULAC at 30th June 2009 of £1,174m.

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4.02 30th June 2009 Inherited Estate Valuation to be used for the Purposes of Calculating the PIP Payment

Aviva has concluded that the valuation of the CGNU Life and CULAC inherited estates used for the purposes of calculating the PIP payment to eligible policyholders who elect to accept the offer will be £1,174m² at 30th June 2009 (subject to external review by Aviva's auditors).

The AFH report noted that this figure may be different to that published by Aviva Plc at the half year.

The difference in valuation results from:

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

4.03 External Review of Results

In line with the statements made in the Actuarial Function Holders report, the 30th June 2009 inherited estate valuation for CGNU Life and CULAC will be reviewed by the company's external auditors.

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

² At the date of this annexe, this figure is still in the process of being reviewed by Aviva's external auditors and could therefore be subject to change.

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5.00 Inherited Estate Valuation at 31st July 2009

Using the same methodology as outlined above, Aviva has concluded that the valuation of the CGNU Life and CULAC inherited estates used for the purposes of calculating the PIP payment to eligible policyholders who elect to accept the offer will be £1,257m³ at 31st July 2009 (subject to external review by Aviva's auditors).

5.01 External Review of Results

In line with the statements made in the Actuarial Function Holders report, the 31st July 2009 inherited estate valuation for CGNU Life and CULAC will be reviewed by the company's external auditors.

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

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

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6.00 Inherited Estate Valuation at 28th August 2009

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

6.01 External Review of Results

In line with the statements made in the Actuarial Function Holders report, the 28th August 2009 inherited estate valuation for CGNU Life and CULAC will be reviewed by the company's external auditors.

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

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7.00 Aviva's View of the policyholder Advocate's Approach

The Policyholder Advocate has suggested how, for the purposes of the reattribution, the value of the inherited estate should be adjusted.

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

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

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

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