

## APPENDIX 1

### POLICIES AND UNDERLYING DOCUMENTATION

1. We have considered, for the purposes of our Opinion, a sample of the policy documentation and other underlying material which forms an important part of the issues set out in the Opinion.
2. The documentation can be divided into 3 main categories:
  - (1) Corporate documentation, memorandum and articles of association of CGNU and CULAC;
  - (2) Policyholder documentation, policies, brochures and with profits guides; and
  - (3) Principles and Practices of Financial Management ('PPFM').
3. We consider each in turn, setting out where relevant any material terms and our views in relation to them.

#### I. Corporate Documentation

4. We have seen information in relation to the constitution of the Aviva companies, particularly, Memoranda and Articles of Association.

##### **(i) CGNU Life Assurance Limited<sup>1</sup>**

---

<sup>1</sup> This company has a long history. By Deed of Settlement in 1838 the General Life Assurance Company came into existence. This was incorporated as an unlimited company on the 20<sup>th</sup> December 1927. On the 1<sup>st</sup> January 1969 the company was re-named and known as Yorkshire General Life Assurance Company and re-named again on the 9<sup>th</sup> November 1970 as the Yorkshire-General Life Assurance Company Limited. On the 1<sup>st</sup> January 1985 the company was named General Accident Life Assurance Limited. On the 1<sup>st</sup> October 1998 it became known as CGU Life Assurance Limited. As of the 2<sup>nd</sup> October 2000 it has been named CGNU Life Assurance Limited. The Memoranda and Articles originally refer to General Accident Life Assurance Limited but we understand that reference should now be made to CGNU Life Assurance Limited.

5. The Memorandum of Association, reprinted on the 14th October 1991, states that the company has as its objects:

"3.(a) To carry on the business of life assurance in all its branches ...

...

(g) To give to any class or section of those who are assured or have other dealings with the company any rights over or in relation to any fund or funds held or established for the purposes of the business of the company or a right to participate in the profits of the company or in the profits of any particular branch or part of its business or any other special privileges, advantages or benefits.

(h) To carry on any other business which may seem to the company capable of being conveniently carried on in connection with the above or calculated directly or indirectly to enhance the value of or render profitable any of the company's property or rights" [Pages 1-2]

6. The Articles of Association were adopted by special resolution by General Accident Life Assurance Limited on the 19<sup>th</sup> September 1991.

7. Articles 9 and 10 provide as follows:

"Ordinary Long Term Insurance Business Profits

9. The directors shall every twelve months cause an Actuary to investigate the financial condition of the company in respect of its life assurance and annuity business and of any other long term insurance business ... for the time being carried on by the company. The profit (if any) of each of the said businesses shall be ascertained by such methods as the directors on the advice of the Actuary shall think fit and shall be declared by them either by anticipation or otherwise and they shall determine the amount of such profit (if any) which may be distributed. All such profits so declared distributable shall, subject as otherwise provided in the following Article or by the directors, be appropriated to the members of the Company.
10. Of the profit of the life assurance and annuity business so declared distributable, such proportion as shall be determined by the directors (not being less than 90 per cent) shall be appropriated to the life policies and annuity contracts of or binding upon the company which carry rights of participating in profits in accordance with the terms of such policies and contracts in such manner as the directors shall from time to time determine, and the balance of such profit shall be

appropriated to the members of the Company ... in aggregate the proportion of the distributable profit appropriated shall not be less than 90 per cent." [Page 2]

8. On the 5<sup>th</sup> April 2001, a special resolution was passed by CGU Life Assurance Limited and an amendment was made to the Articles of Association. The purpose and effect of the amendment was to make certain provisions in respect of Stakeholder policies defined in the amendment to the Articles of Association. By this special resolution, inter alia:

(1) The directors of the company became obliged to maintain a separate sub-fund within the life assurance and annuity business and to segregate all liabilities of the Stakeholder Fund from all other long term business liabilities of the company;

(2) The holder of Stakeholder policies would only be entitled to profits arising out of and in respect of the Stakeholder Fund; and

(3) The proportion of profit of the Stakeholder Pensions Business declared to be distributable shall be apportioned to holders of Stakeholder Policies and shall be not less than 100%.

## **(ii) Commercial Union Life Assurance Company Limited**

9. It is not clear from when the Memorandum of Association dates. However it is clear that it existed before August 1992. It is expressly set out that the objects of the company are, inter alia:

"3.(A) To carry on the business of insurance in all its branches ...

...

(C) To appropriate and pay or distribute to or among the holders of policies of the Company or other persons with whom it may have dealing or any class ... of such persons any part of the general profits of the Company or of the profits derived from any one or more of its several categories of business and either in cash or by any deferred payment or by the diminution of any premiums or in any other way and by the terms of any policy or prospectus to bind itself to make any such appropriation, payment or distribution.

...

(V) To distribute any of the property of the Company among its members in specie.

(W) To carry on any other business or activity whatsoever which may seem to the Board of the Company capable of being advantageously carried on in connection or conjunction with or as ancillary to any of the foregoing businesses or activities or which the Board of the Company may consider expedient with a view to rendering profitable or enhancing directly or indirectly the value of the Company's undertaking or any of its property or assets." [Pages 1 & 5]

10. The Articles of Association were adopted by special resolution on the 18<sup>th</sup> August 2002. The material articles comprise articles 15 and 16:

"CATEGORIES OF BUSINESS AND SEGREGATION OF ASSETS

15.01 The Board may from time to time distinguish any part of the insurance business transacted by the Company as a separate category of business by reference of any criteria whatsoever (and in particular but without limiting the generality of the foregoing by reference to the types of risk, the types, terms or purposes of policies or contracts, the status of persons interested in policies or contracts or the time or the location of business) and may from time to time sub-divide any such category into two or more separate categories and consolidate any two or more categories into a single category. Separate accounts shall be kept for each category of insurance business.

...

15.03 The Board may from time to time determine to appropriate to any category of insurance business (or to any group of such categories) and segregate from other assets of the Company such assets as appear to the Board proper. The assets so appropriated to a particular category or group and the receipts derived from such assets and from the insurance business of that category or group shall be treated as segregated assets appropriated to that category or group available to meet the obligations of the business of that category or group and to the extent that such assets represent profits of that category or group for distribution as profits of the Company and/or amongst holders of policies or contracts (if any) entitled to share in the profits of that category or group.

15.04 Segregated assets may be charged as security for borrowings made or indebtedness created for the purposes of the business of the category or group to which such segregated assets are appropriated but not otherwise. No lender or other person dealing with the Company shall be concerned to see or enquire whether assets offered

by the Company are or are not segregated assets or with the purposes for which any borrowing is made. No security given by the Company over segregated assets shall be invalid or ineffectual even if the lender or the recipient of the security had at any time express notice that the giving of the security was in contravention of the provisions of this Article.

#### ORDINARY LONG-TERM INSURANCE BUSINESS

16.01 Policies and contracts issued in pursuance of the ordinary long-term insurance business of the Company may be effected with or without participation in profits

16.02 The Board shall once every 3 years or at such shorter interval as may be determined by it cause an investigation (hereafter called a "periodic investigation") to be made into the financial condition of each category of the ordinary long-term insurance business of the Company. The actuarial basis and method of valuation for each such category shall be such as the Board may think fit and after making such provisions as it shall think desirable for any special or reserve funds the Board shall determine the amount of profit available for distribution to holders of policies or contracts (if any) entitled to participate in the profits of that category and for transfer to the general funds of the Company.

16.03 When in the period covered by any periodic investigation any policy or contract with participation in profits (a) becomes a claim or (b) is surrendered or (c) is converted into a policy or contract without participation in profits the Board shall pay or allow to the then holder of such policy or contract such sum by way of interim bonus as it shall think just and equitable.

16.04 At the conclusion of each periodic investigation the Board shall in relation to each category of business in pursuance of which policies or contracts with participation in profits are issued declare a bonus equivalent to such percentage as the Board may from time to time determine of the profits of such category during the period of such investigation ...

16.05 As regards the holders of policies or contracts with participation in profits already at the date of the adoption of the is Article ... the percentage of the profits to be applied by the Board in determining the amount of bonuses to be declared in respect of such categories shall not be less than 90 per cent.

16.06 Subject to the rights of the holders of policies or contracts issued prior to the distinguishing by the Board of a separate category of business and unless otherwise determined by the Board, bonuses declared in respect of such category of business after the date of the distinguishing shall be allotted to the holders of with profits policies or contracts issued pursuant to that category of business alone and such

holders shall have no right to the allotment of any part of any bonuses declared in respect of other business of the Company" [Pages 4-6]

11. On the 5<sup>th</sup> April 2001, the company adopted by special resolution additional Articles in relation to Stakeholder Policies. The substance of these have been set out above and we do not propose to deal with them in detail again.

## **II. Policyholder Documentation**

12. We have seen a sample of these<sup>2</sup> and we set out here the more material parts of the relevant documents. It is not always clear from the documents the precise date when they were issued but it is clear that these are policies that were issued to policyholders over the last few years.
13. There are a range of different with profits products that have been offered in the past. We have also looked at sample policy documentation of the different products sold to policyholders and categorise our comments in relation to them accordingly.

### **(i) Endowment Policy Documentation**

14. The Policy issued by General Accident Life is itself expressly a legal document. In the Policy it is expressly stated that the Policy is a "written confirmation of a contract between General Accident Life Assurance Limited ... and the Policyholder..." [Page 1].
15. The Policy contains, inter alia (i) Life Cover Benefit (ii) Terminal Illness Benefit (iii) Critical Illness Benefit and (iv) Premium Protection Benefit.
16. The particular with profit product relates to Life Cover Benefit which is payable on the survival of the life assured to the pre-ordained maturity

---

<sup>2</sup> (i) Low Cost Endowment, General Accident Life (ii) Low Cost Endowment Booklet, General Accident Life (iii) Mortgages Low Cost Endowment, General Accident Life Assurance Limited (iv) Endowment Assurance, General Accident Life (v) Key Features, Endowment With Profits, General Accident Life (vi) Whole Life Assurance, Policy Conditions, General Accident Life Assurance Limited (vii) Key Features of Whole Life With Profits, General Accident Life (viii) With Profit Annuity, Policy Document, CGU Life Assurance Limited, 9<sup>th</sup> December 1999 (ix) With Profit Annuity, Key Features, CGU Life Assurance Limited, October 1999 (x) With Profit Annuity Booklet, CGU Life (xi) With Profit Annuity Application Form, CGU Life (xii) Homemaker Plus Policy, Norwich Union (xiii) Homemaker Plus Key Features, Norwich Union (xiv) Homemaker Plus Booklet, Norwich Union, October 2000 (xv) Lifetrack Policy Conditions, General Accident (xvi) With Profits Bond Policy, Commercial Union Life.

date or on the death of the life assured prior to that date. The policy states that:

“(c) The amount payable on the death of the Life Assured before the Maturity Date will be:

- (i) the Endowment Assurance Sum Assured ... together with any bonuses declared;
- plus
- (ii) ...” [Clause 2(c), Page 6]

17. There is a separate heading with several clauses entitled “With Profits” [Clause 9]. The clauses are as follows:

“(a) With Profit policies share in the profits generated by the fund in which the Premiums are invested by the Company. At least 90% of the profits are allocated to Policy holders, with the remainder being allocated to shareholders.

(b) Profits are allocated to Policyholders via bonus additions to the Endowment Assurance Sum Assured which comes in two forms:

- (i) reversionary bonuses are added to the Endowment Assurance Sum Assured on an annual basis. Once added they become a guaranteed benefit on death or maturity.
- (ii) terminal bonuses may be added to the Endowment Assurance Sum Assured and attaching reversionary bonuses at the time of death or maturity.

(c) Profits arise from various sources, the main contribution being favourable investment performance. Other sources include profits arising from Without-Profits business written by the Company.

(d) A more detailed description of the factors influencing bonus rates and recent bonus policy is available in the Company’s With Profits Guide.” [Clause 9, Page 13]

18. We have been provided with another specimen policy of endowment assurance offered by General Accident Life. This expressly states that the Life Policy is written confirmation of a contract between General Accident Life Assurance and the named policyholder. By this specimen policy:

(1) “With Profits” is defined as “sharing in the profits of General Accident Life Assurance’s investments. These profits are known as bonuses and are payable at the same time as the sum assured” [Page 3]; and

(2) “Benefits” is defined as the “sum assured and any bonuses payable by General Accident Life Assurance under this policy” [Page 4].

19. The Low Costs Endowment Booklet, also issued by General Accident Life, contains several passages which relate to the with profits fund.

(1) In explaining "What is a Low Cost Endowment?", the answer provided is:

"Premiums are paid onto the policy on a regular basis ... These premiums are then invested by the insurance company with the objective of building up a fund that will repay your mortgage loan at the end of the term"

(2) And further, under the same heading:

"...if actual investment returns turn out to be better than the growth rate assumed, there can be an additional amount, over and above what you will need to repay the mortgage loan and, at the end of the term, this would be payable to you as a lump sum"

(3) Under the heading "Are All Low Cost Endowments The Same?", the answer provided is:

"Your financial advisor will confirm that the three most important factors in choosing the product that is best for you are: Performance: You will want to choose a company with an excellent long term investment track record and with the financial strength to provide the security you require"

(4) Under the heading "Performance", the notes say:

"You will be relying on investment performance to ensure that your policy will repay your mortgage loan at the end of the term and it is therefore essential that you choose carefully who will be managing your money"

(5) Under the heading "Security with Performance", the notes say:

"You can invest in a General Accident Life Low Cost Endowment, secure in the knowledge that you will be investing in one of the UK's most financially strong life assurance and investment companies. This strength has allowed us to produce competitive, consistent and secure

performance for all our clients. So much so that we can confidently state: that every General Accident Low Cost Endowment policy which has matured has more than repaid our clients' mortgage"

(6) Under the heading "Price", the notes say that:

"You will want your Low Costs Endowment policy to provide you with the best possible return. Whilst investment performance is very important in achieving this, the level of charges deducted by the insurance company can also have a significant impact on the amount payable at the end of the term. The General Accident Life Low Cost Endowment not only has an excellent investment record, but also has some of the lowest charges for this type of policy... You can therefore be assured that with General Accident, more of your money is working towards building your investment"

(7) Finally, under the heading "General Accident Life" the Booklet states that:

"General Accident Life was established over 150 years ago. It is now one of the UK's leading life assurance companies with nearly 2 million policyholders and funds under management approaching £14 billion."

20. We have seen a smaller Key Features booklet<sup>3</sup> issued by General Accident Life entitled "Mortgages, Low Costs Endowment". In this booklet the following excerpts are relevant:

(1) Under the heading "Key Features of Low Costs Endowment, ITS AIMS", it is written:

- "To provide a lump sum which can be used to repay your mortgage at the end of the policy term
- If possible to provide some extra cash as well."

(2) Under the heading "Risk Factors", it states "The proceeds will depend on investment performance...";

---

<sup>3</sup> We have seen a further Key Features of Endowment with Profits booklet which contains materially identical terms.

(3) Under the heading "What might I get back at the end of the Policy Term?" it states:

- "The illustration gives an indication of what you might get back
- You are guaranteed to get back the Endowment Sum Assured
- Your policy receives bonuses based on a share of the profits of General Accident Life. These bonuses are declared and added annually. Once added they are guaranteed to be paid at the end of the policy term
- When the benefits are payable, you may also receive an additional bonus known as a terminal bonus
- Future bonuses cannot be predicted but depend on future profits"

(4) Finally, the booklet re-states that "General Accident was founded in 1885. The first of the companies which evolved into General Accident Life was founded in 1824. Our total funds under management exceed £15 billion and we have nearly two million policyholders."

## **(ii) Whole Life Assurance Documentation**

21. The Policy issued by General Accident Life is itself expressly a legal document. In the Policy it is expressly stated that the Policy is a "written confirmation of a contract between General Accident Life Assurance Limited ... and the Policyholder..." [Page 1].
22. The benefit under this Policy is the payment of Life Cover Benefit (the Whole Life Assurance Sum Assured With-Profits) with any bonuses declared.
23. There is a separate heading, identical mutatis mutandis to that which has been set out above in relation to Endowment Policies, with several clauses entitled "With Profits" [Clause 6]. The clauses are as follows:

"(a) With Profit policies share in the profits generated by the fund in which the Premiums are invested by the Company. At least 90% of the profits are allocated to Policy holders, with the remainder being allocated to shareholders.

(b) Profits are allocated to Policyholders via bonus additions to the Whole Life Assurance Sum Assured which comes in two forms:

- (i) reversionary bonuses are added to the Whole Life Assurance Sum Assured on an annual basis. Once added they become a guaranteed benefit on death.

- (ii) terminal bonuses may be added to the Whole Life Assurance Sum Assured and attaching reversionary bonuses on death.
    - (c) Profits arise from various sources, the main contribution being favourable investment performance. Other sources include profits arising from Without-Profits business written by the Company.
    - (d) A more detailed description of the factors influencing bonus rates and recent bonus policy is available in the Company's With Profits Guide." [Clause 6, Page 5]
24. We have seen a Key Features of Whole Life With Profits booklet issued by General Accident Life in or around April 1995. The relevant excerpts are:
- (1) Under the heading "Risk Factors", it is stated that "only the Whole Life Sum Assured is guaranteed on death. Anything above this depends on investment performance";
  - (2) Under the heading "What is a Whole Life With Profits Policy?", it is stated "The policy guarantees the payment of a lump sum (the Whole Life Sum Assured) on death. The lump sum payable is increased by the addition of bonuses throughout the duration of the policy";
  - (3) Under the heading "What happens When I Die?", it is stated that:
    - "Your policy receives bonuses based on a share of the profits of General Accident Life. These bonuses are declared and added annually. Once added they are guaranteed to be paid on death.
    - When you die an additional bonus known as terminal bonus may also be payable."
  - (4) The booklet states that "General Accident was founded in 1885. The first of the companies which evolved into General Accident Life was founded in 1824. Our total funds under management now exceed £5 billion and we have nearly one million policyholders."

**(iii) With Profit Annuity Documentation**

- 25. The Policy issued by CGU in or around December 1999, is itself expressly a legal document providing for the payment of an annuity.
- 26. The material clause in the Policy is clause 5.2, headed "With Profits":

“(a) With Profit policies share in the profits generated by the fund in which the Premiums are invested by the Company. At least 90% of the profits are allocated to Policy holders, with the remainder being allocated to shareholders.

(b) Profits are allocated to Policyholders via bonus additions to the With Profit Annuity which comes in two forms:

i) Reversionary bonuses are added to the With Profit Annuity on an annual basis ... Once added they become a guaranteed benefit ...

...

ii) Top-up bonuses may be added to the With Profit Annuity. These are not guaranteed and may be changed or removed at any time.” [Clause 5.2, Page 4]

27. We have seen a Key Features of With Profit Annuity booklet issued by CGU in or around October 1999. The relevant excerpts are under the heading “How can my pension increase?”:

- “Your pension can grow each year by the addition of bonuses
- An annual bonus may be added to your pension each year, although the amount may vary from year to year. Once added, it becomes a permanent addition to the pension and will also qualify for future bonuses in the same way as the starting pension
- A top-up bonus may be paid in addition to the annual bonus. The rate will vary from year to year, and in some circumstances could be changed more frequently. It is only payable during the period for which it is declared and does not form a permanent addition to your pension
- ...”

28. There is a Paragraph headed “About the Company”. It states “CGU Plc was formed in June 1998 with the merger of the two oldest and largest UK insurers – Commercial Union and General Accident. CGU Plc has operations in over 60 countries with total assets under management in excess of £120 million. CGU Life is a subsidiary of CGU Plc and has more than four million customers.”

29. We have seen a Guide to the With Profit Annuity offered by CGU. There are a number of material passages in this Guide:

(1) Under the heading “Pensions and Annuities”, it states:

“Our With Profit Annuity does not depend on interest rates when you retire. Instead of being locked into unfavourable interest rates, you can receive the benefit of investing in our impressive With-Profits Fund after you have retired. Any bonus we declare each year may increase your pension during payment”

(2) Under the heading “Why choose a CGU With Profit Annuity?”, it states:

“The company you choose must offer value for money together with a suitable balance between growth and security.

CGU is a financially strong company, so you will benefit from peace of mind, knowing that we will be there to provide you with an income each year

We have successfully invested our customers’ savings and are currently entrusted with over £120 billion. You will benefit from our investment expertise.

The charges for our With Profit Annuity are competitive, giving you value for the money invested. We will ensure that your money works for you from day one.”

(3) Under the heading “Why should I invest in CGU’s With-Profits Fund?”, it states:

“Our outstanding financial strength gives us the freedom to invest in the areas most likely to produce excellent returns.

Our ability to invest a high proportion of our With-Profits Fund in equities is one of the reasons we have been able to produce consistent market-leading returns...

By selecting CGU for your With Profit Annuity, you are choosing a company with a record of excellent with-profit performance and the financial strength to deliver high returns...

The market value of investments in the With-Profits Fund at 31 December 1997 was £16,800 million.

The way we invest our With-Profits Fund compared to the average with-profits fund is shown below.”

30. We have also seen a CGU Life With Profit Annuity application form. There is nothing in this that we consider to be particularly relevant to the issues set out in the Opinion.

#### **(iv) Homemaker Plus Documentation**

31. We have seen the Policy issued by Norwich Union in or around March 2002 which is expressly stated to be written confirmation of a contract between CGNU Life Assurance Limited and the Policyholder.

32. This Policy contains (i) Life Cover Benefit (ii) Critical Illness Benefit (iii) Moving House and Home Improvement Option and (iv) Terminal Illness Benefit.

33. Under Clause 11 of the Policy it states:

“(a) In order to calculate the benefits payable under the Policy, the Company will maintain a number of Unit-Linked Funds together with one or more With-Profit Funds.

(b) ...” [Clause 11, Page 17]

34. We have also seen a copy of the Key Features of the Homemaker Plus booklet. The material parts state:

“If you invest in our With-Profit Fund we may apply a market value reduction if you cash in all of your policy or switch out of the Fund...”

35. We have also seen a copy of a Guide to the Homemaker Plus issued by Norwich Union. This Guide:

- (1) Contains a page opening with:

“Welcome to Norwich Union

By choosing Norwich Union the UK’s largest insurance group, you benefit from our financial strength and the backing of over £200 billion of funds under management...

... Our size and efficiency give us even greater opportunities to provide an extensive range of value-for-money, quality products – investments, retirement, protection and health care ...”

(2) Under the heading “Why Norwich Union?” and “Consistent Investment Performance”, it states that “As part of the largest insurance group in the UK, entrusted with funds under management of over £200 billion, we have the size and strength to deliver. You will benefit from the knowledge and expertise of our Investment Managers” [Page 2];

(3) Under the heading “What investment funds are available?”, it states:

“One of the most important aims of Homemaker Plus is to build up a fund that will be sufficient to repay your outstanding mortgage covered by this plan. Your premiums are invested by our team of investment professionals who have the experience and expertise, backed by up-to-date information, technology and analysis, to know where to invest and when.

DESIGNED TO MEET YOUR ATTITUDE TO RISK

Homemaker Plus offers you a wide choice of funds ... Each of the 14 funds available is managed by our Investment Managers and has a specific investment objective. Our Investment Managers have demonstrated consistent success in making balanced and profitable investments for their customers.

...

Many people choose the option that aims to produce the best possible investment returns without exposing their savings to any undue risk. The With-Profit Fund shares in the profits of CGNU Life Assurance Ltd and is designed to smooth out the fluctuations of the stock markets over a number of years.” [Page 7]

## **(v) The With Profits Guides**

36. We have seen a sample<sup>4</sup> of these and we set out here the more material parts of the relevant documents.

---

<sup>4</sup> (i) With Profits Guide, Commercial Union Life Assurance, August 1993 (ii) With Profits Guide, CGU, 1998 (iii) Norwich Union With Profits Guide 2001 (iv) With Profits Guide, Commercial Union Life Assurance, August 1990 (v) With Profits Guide, Commercial Union Life Assurance, August 1996 (vi) Principles and Practices of Financial Management (PPFM), CGNU Life Assurance Limited & Commercial Union Life Assurance Company Limited (vii) Portfolio Guide to Investment in our With Profit Funds, Norwich Union.

37. Commercial Union Life Assurance produced a With Profits Guide in August 1993<sup>5</sup>. It states:

(1) As part of the Introduction that:

"All insurance companies ... which market with profits policies in the United Kingdom are required to make available a guide containing information about the company ... and its with profits fund. This is because the benefits under such policies depend in part and sometimes to a considerable extent, on bonus additions which are made by the company or the society from time to time and which cannot be known in advance. It is therefore important that potential policyholders and their advisers should have access to information about the most important factors influencing such bonuses."

(2) Under the heading "Factors Influencing Bonus Rates":

"Bonuses arise from surpluses which emerge as a result of periodic valuations of the Company's assets and liabilities.

The single most important influence on the size of the surpluses is the rate of return earned on investments ...

...

The company's financial strength also has an important influence upon the freedom that it can adopt with regard to investment strategy..."

(3) Under the heading "Investments":

"It is important to note that our freedom to choose our investment strategy from the whole range of available options arises because we have a high level of free assets in excess of our liabilities."

(4) Under the heading "Solvency Margins":

---

<sup>5</sup> We have seen an earlier version of this document produced by Commercial Union Life in August 1990 much of which has been incorporated and restated in the 1993 version.

“Commercial Union Life’s philosophy of distributing a substantial proportion of its surplus in the form of reversionary bonuses is evidenced by the declaration of special reversionary bonuses in the years 1985, 1986, 1987, 1989 and 1991.

...

Table 2 shows Commercial Union Life in a strong position with a high proportion of excess assets. Commercial Union Life has a strong valuation basis allied to a bonus philosophy requiring high reserves. As both of these features act to depress the amount of free assets, the company is even stronger than Table 2 would suggest.”

(5) Under the heading “Recent Bonus Policy”:

“Most of Commercial Union’s portfolio of with profits business is written in traditional form, with reversionary bonuses, but in recent years unitised with profits business has also been introduced. For both types of business a regular bonus is declared and this may be increased by a terminal (or final) bonus when the proceeds are taken.

Bonuses are payable from the profits of the Commercial Union Life Assurance Company Limited Life Fund, policyholders being entitled to not less than 90% of the profits. Currently shareholders receive an amount, after taxes borne in the Life Fund, equal to 1/9<sup>th</sup> of all sums allocated to policyholders, comprising cash bonuses together with the cost on the published valuation basis of the reversionary bonuses.”

(6) Under the heading “Conclusion”:

“We hope you have found the Commercial Union With Profits Guide informative; we would like to summarise key features:

- High level of assets over liabilities
- Strong reserves
- High reversionary bonus philosophy
- High proportion of equity investment”

38. A more recent version of this Guide was produced in 1996. Although this Guide follows and restates to a considerable degree the Guide produced in 1993, there are some material additions and repetitions:

(1) Under “Investments”:

“Financial strength gives us the freedom to choose our investment strategy from the whole range of available options. We can therefore select an

investment strategy to offer the best growth prospects over the medium to long term." [Page 3]

(2) Under "Free Assets":

"Any assets we hold in excess of our liabilities are known as free assets and are an important part of our financial strength.

At the end of 1995 these free assets were a safety margin equivalent to 30.6% of our liabilities.

This high free asset ratio together with a valuation philosophy and a bonus philosophy which both require high reserves clearly demonstrates the financial strength of Commercial Union Life." [Page 4]

(3) Under "The effect of new business growth":

"New business coming into Commercial Union Life is not placing an undue strain on the funds because we have a substantial margin of free assets to absorb the strain" [Page 5]

(4) Under "Recent Bonus Policy":

"Most of Commercial Union's Portfolio of with profits business is written in the traditional form with bonuses added to the sum assured, but in recent years we have also written unitised with profits business. Bonuses are payable on both types of business from the profits of the Commercial Union Life Assurance Company Limited Life Fund.

Policyholders are entitled to not less than 90% of the distributed profits with the remainder going to shareholders. Currently shareholders receive an amount ... equal to one-ninth of all sums allocated to policyholders." [Page 6]

(5) Under "Conclusion":

"The following key features summarise our position:

- A strong valuation basis  
Our valuation basis meant a high margin for security is built into the calculation of our liabilities
- A high free asset ratio

The high excess of assets over liabilities gives us freedom to choose our investment strategy

- An emphasis on equity investment  
Investing a high proportion of the assets in shares has produced good investment performance for our policyholders
- High reversionary bonuses  
Our bonus philosophy is to provide "Growth with security" by building policyholders' returns on a strong foundation of regular bonuses."  
[Page 13]

39. In 1998 CGU produced and distributed a With Profits Guide. In this Guide, we note the following statements:

(1) Under "Company Information" it states that following the merger between Commercial Union Plc and General Accident Plc on the 2<sup>nd</sup> June 1998 to form CGU Plc "The combined market value of investments of the two companies was some £16,800 million at 31 December 1997 of which 67% was in equities and property" [Page 2];

(2) Under "Solvency Margins":

"Both CGU Life and Commercial Union Life are financially strong companies and ... this position will be maintained following the merger of the funds."  
[Page 4]

(3) Under "CGU Life and Annuity Fund With Profits Guide":

"Funds entrusted to CGU Life are managed by the Group's investment managers, based in London. The market value of investments at 31 December 1997 was some £8,200 m ..." [Page 6]

(4) Under "Bonus and Surrender Value Policy":

"The amount available for distribution amongst with-profits policyholders and shareholders is determined from time to time by the Directors on the advice of the Actuary. Under the Articles of Association, not less than 90% of the distributed profits are allocated to with-profits policyholders with the remainder being allocated to shareholders.

...

Asset shares represent the accumulation of past premiums allowing for the actual investment performance, expenses, mortality costs, surrender payments and shareholders' profits, together with profits arising from without-profit policies.

...

Current practice is to support maturity values where, as at the bonus declaration for 1997, it is considered appropriate, by a contribution from free reserves. Free reserves are the excess of the assets over the liabilities calculated on a realistic but prudent basis. For with profit policies such liabilities exceed the sum of the asset shares." [Page 11]

(5) Finally, in the "A-Z Glossary of Terms":

"With Profits Fund: The fund maintained by CGU Life or Commercial Union Life in respect of its long-term business other than permanent health business ..."  
[Page 28]

40. We have seen the With Profits Guide produced by Norwich Union in 2001. The material excerpts of this Guide are:

(1) Under "Company Information":

"Funds entrusted to the Company and managed by the Group's investment managers, based in London. The market value of investments ... at 31 December 2000 was some £11,500 m." [Page 5]

(2) Under "Factors Influencing Bonus Rates":

"Bonus rates depend on the experience of the fund in which the premiums are invested or, more specifically, on how that experience compares with the assumptions made in determining the premium rates. As a result, future bonuses depend on future profits, which cannot be foreseen.

...

- Bonus policy – the Company determines the appropriate level and timing of distributing profits to policyholders. Profit is distributed by adding bonuses to policies and the policy of the Company in making such distributions is covered in Section F.

- Other factors – bonus rates are also affected by miscellaneous sources of surplus and these are described in Section J, though this has had less impact in recent years ...” [Pages 6-7]

(3) Under “Investments”:

“The financial strength of the company permits a high degree of freedom in selecting investments which offer the best prospects for long-term performance and can provide assistance in supporting bonuses during temporary periods of low investment returns.

Investment strategy is framed with the objective of achieving long-term secure growth of both capital and income.” [Page 7]

(4) Under “Solvency Margins”:

“Solvency margins, defined here as the excess of admissible assets over liabilities, are affected by a number of factors ... Some of the more important factors are as follows:

Valuation bases ... A company may adopt a very cautious view of the future by, for example, assuming a lower rate of investment return than could be justified by current experience. Additional reserves may be held for other contingencies such as a higher rate of mortality or an excess of maintenance expenses ...

Bonus structure ...

Product mix ...

New business growth – a company which has recently experienced rapid growth in its new business will suffer a reduction in its solvency margin as a result of new business strain. This strain arises where expenses incurred in connection with the issue of the policy are only gradually recouped out of premiums as they are paid or, in the case of single premium contracts, out of charges made over a period of time. For annual premium contracts, this strain can be mitigated somewhat by taking credit for the initial expense loading in future premiums, known as a Zillmer adjustment [defined as Method by which new business strain is mitigated by anticipating the receipt of expense loadings in future premiums]” [Page 9]

(5) Under “Bonus and Surrender Value Policy”:

“The amount available for distribution amongst with-profits policyholders and shareholders is determined from time to time by the Directors on the advice of

the Actuary. Under the Articles of Association, not less than 90% of the distributed profits are allocated to with-profits policyholders with the remainder being allocated to shareholders...

...

On average the Company aims to share our between half and two-thirds of the profits through regular bonus with the balance paid as final bonus.

Regular bonus declarations take into account the rates which we expect to be able to maintain over the terms of both existing and new policies. For this purpose, account is taken of the premium rates charged, the expected future experience, particularly with regard to future investment returns, and the financial resources of the Company.

...

Fairness of treatment between investors holding policies issued at different times is achieved by assessing maturity and surrender payments having regard to the results of asset share calculations. Currently, for contracts other than stakeholder pensions, asset shares represent the accumulation of past premiums allowing for the actual investment performance, expenses, mortality costs, surrender payments, shareholder's profits and other factors as set out in Section J...

...

The Company may, when it considers it appropriate, support maturity values by a contribution from free reserves. This is currently the case to a modest degree for certain policies in the non-stakeholder with-profits fund but there is no implication that this practice will continue.

Final bonus policy is not subject to frequent changes but the Directors reserve the right to alter the conditions for the payment of final bonuses at any time without notice. Factors which might lead to a change include major changes in financial circumstances, adverse future experience of an exceptional nature and high levels of new business growth." [Pages 11-13]

(6) Under "Other Factors":

"With profit policyholders pay a higher premium than without profit policyholders and in return are entitled to a share of the profits of the fund in the form of bonus additions ...

Profits arising from the transaction of without profit business have in the past been made available to with profits policyholders in the form of bonuses ...

With profit policies may share in other factors that affect the experience of the fund. Surplus may also arise from mortality being lighter than assumed in relation to life assurance business or heavier than assumed in relation to

annuity business. This surplus, together with any surplus or deficiency arising from the early cancellation or surrender of policies will enhance bonus rates ...

...

The costs of compensation for pensions mis-selling have been met from the free reserves of CGNU Life where profits from the policies involved fall to the with-profits fund. CGNU Life has low exposure to pensions mis-selling costs. Costs of pensions mis-selling are not charged to asset shares." [Page 16]

(7) Under "Expenses":

"The effect of expenses is shown as a reduction in the investment return. This is similar to that shown in the product particulars for new individual policies. Expenses can also be affected by the nature of the investments. For example the cost of managing equity and property portfolios is greater than that for fixed interest securities but we expect higher returns from such investments which justify the higher costs." [Page 20]

(8) As part of the "A-Z Glossary of Terms":

**"Free Reserves:** the excess of the assets of the Company over its liabilities. For this purpose, the assets are taken into account at market value and the liabilities are calculated on a realistic but prudent basis

...

**With-Profits business:** the part of the business which includes the issuing of with profits policies

**With-Profits Fund:** The assets held in respect of with profits business which can back a combination of with profits and non profits contracts" [Pages 22-23]

41. We have also seen a document produced by Norwich Union entitled "Portfolio Guide to Investment in our With-Profit Funds". This document states in the Contents page that it is "Your guide to investment in our With-Profit Funds". It also states that the Principles and Practices of Financial Management (PPFM) contains "more detailed and technical information" about how Norwich Union manage the With-Profit Funds. We deal with this latter document separately below.
42. Of particular note in this Guide are the following passages:

(1) Under the heading "What is a with-profits investment?":

"This is a type of investment that shares out the profits and losses of the fund to its investors. This is achieved through a system of bonuses.

...

Bonuses are paid from the "profits" earned in the With-Profit Fund ...

The With-Profit Funds offer some guarantees which are unique to With-Profit investments ... In deciding the bonuses we aim to provide either a smoothed return if you invest in the With-Profit Fund or With-Profit Inflation Protected Guarantee Fund, or a smoothed income if you invest in the With-Profit Income Fund.

The effect of smoothing is that you're likely to see a steadier return or income year on year rather than watching the value of your bond and/or your income regularly rise and fall directly in line with stock markets." [Page 4]

(2) Under the same general heading but under the sub-heading "The Fund":

"Your money will be combined with that of other planholders who choose to invest in the With-Profit Fund ... The combined With-Profit Fund is invested in a mix of assets ...

Shares in companies and property are higher risk than the other types of investments but over the longer term they tend to produce higher returns. Because of the strength of the fund it currently keeps about two-thirds of its assets invested in shares and property.

...

Part of the combined With-Profit Fund directly backs the policy benefits. The rest is the fund's working capital (sometimes referred to as the "inherited estate") and can be used to provide:

- Investment flexibility
- Flexibility in the smoothing of payouts
- Finance for new business growth
- Cover against the cost of meeting some guarantees and other charges" [Page 4]

(3) Under the heading "What affects how much I might get back?":

"What you get back will depend mainly on:

- Your share of the profits or losses earned over the period of your investment in the fund
- The application of the smoothing process
- The effect of guarantees
- The charges on your bond which are set out in the illustration. As we are a shareholder-owned company these charges include an amount that will be paid to shareholders. The sharing of profits between planholders and shareholders will give at least 90% to planholders
- The business risks ...
- Any tax we pay ..." [Page 6]

(4) Under the heading "How do you decide the bonuses?":

"We decide the bonuses by looking at:

- Any profits not previously shared out through smoothing from earlier years
- Any profits earned by the fund in the current year
- What we expect to earn in future years

We then work out how much of the available profits to add to the units or pay out in the form of bonuses and how much to carry forward to future years.

Part of the profits are shared out through regular bonus. We aim to do this so that there is an appropriate balance paid as an additional or final bonus, taking into account the overall strength of the fund." [Page 8]

(5) Under "Final Bonus, How will the profits that the With-Profit Fund earns be reflected in my final payout?":

"Payouts in any one year could be more or less than the contributions paid and profits or losses earned in the planholders' share of the fund. We aim to limit the difference to within 20% above or below that asset share. Payouts couldn't be more than this amount over a long period because the funds would eventually run out of money. On the other hand, if payouts were significantly less than this amount over a long period, this would not be fair to planholders." [Page 9]

(6) Under "Additional Bonus, With-Profit Income Fund":

"This section describes how we calculate the additional bonus. This reflects factors similar to those stated above for the regular bonus but there will be a greater emphasis on the recent investment returns.

We aim to vary the additional bonus so that, on average, in the long term all the profits of the With-Profit Income Fund are paid out as income. You should expect the additional bonus to change more frequently and significantly than the regular bonus rate." [Page 9]

(7) Under "What if I decide to move out of the With-Profit Funds?":

"When you choose to leave the With-Profit Fund we aim to pay 100% of your share of the fund although this will be subject to the impact of smoothing ...

These profits or losses would then affect the bonuses that we can pay to those planholders who stay in the fund. Because of this, if you decide to move out of the with-profit funds, we may adjust the price of the units you sell." [Page 12]

(8) Under the heading "When we may pay less than the unit price":

"We may reduce the price of the units you sell if their quoted value is high compared to the market value of your share of the investments in our With-Profit Funds at that time. This is called a market value reduction (MVR).

...

We do this to achieve a fair level of future payouts to everyone invested in the fund. If we didn't, the extra amount that you would get would have to come from other planholders' share of the fund.

It is less likely that we'll apply a reduction over longer periods of investment. Our aim is to hold back some of the profits to pay a final bonus to investors in the With-Profit Fund and the With-Profit Inflation Protected Guarantee Fund. The profits held back build up over a number of years to protect the fund and planholders against periods of poor performance.

We constantly monitor investment conditions and the total amount of money being taken out of the fund, and may apply a reduction at any time if we believe it to be necessary to protect other planholders ..." [Page 12]

### **III. Principles and Practices of Financial Management ('PPFM')**

43. The PPFM is a document produced for CGNU Life Assurance Limited and Commercial Union Life Assurance Company Limited. We have been provided with Version 4 of this document and dates from October 2006. It is the most recently published document that we have seen.

44. The PPFM is described as being “a document that defines the Principles and Practices that a company follows when managing its with profits business as approved by the Board. The Board of Directors at CGNU/CULAC will certify to the FSA each year that its With-Profit Funds have been managed in accordance with the PPFM.”
45. The PPFM covers with profits business in the long term business funds of CGNU Life and CULAC, excluding business sold through overseas branches and Stakeholder Pensions. The PPFM only covers business directly written by CGNU Life or CULAC and does not cover with profits business reinsured from other companies in the Norwich Union Life Companies except where the PPFM for the with profits fund of such other Norwich Union Life Companies indicates it will directly follow this PPFM.
46. There is produced, a customer friendly version of the PPFM<sup>6</sup> that is issued to all potential with profits policyholders and annually to existing with profits policyholders although it appears from the terms of the PPFM itself that if there is any conflict in terms of the two guides, notwithstanding the fact that the customer friendly version is produced for the benefit of the customer, the PPFM takes precedence.
47. The “Principles” described in the PPFM are:
- “enduring statements of overarching standards followed by a company when managing its with profits fund bearing in mind its duties to with profits policyholders in both the current and future economic environments, its need to be fair to all policyholders and comply with any relevant legislation and policy terms and conditions.” [Paragraph 1.3, Page 4]
48. The “Practices” described in the PPFM are:
- “The With profits Practices provide more detail on the current approach taken by a company when managing a with profits fund” [Paragraph 1.3, Page 4]
49. In relation to changes to either Principles or Practices the PPFM states:
- “If we propose to change any Principle in this PPFM we will inform policyholders with a with-profits policy in the Fund at least three months in advance ...

---

<sup>6</sup> This is the “Portfolio Guide to Investment in our With-Profit Funds” document produced by Norwich Union to which we refer in this Appendix elsewhere

...

Regardless of any such changes we will review this document at least yearly to ensure that it continues to accurately reflect the Principles and Practices we apply.

We would only change a principle or a practice when we consider it justified by the need to:

- Respond to changes in the business or economic environment
- Protect the interests of policyholders
- Change a practice to better achieve a principle
- Correct an error or omission in the PPFM
- Improve the clarity or presentation of the PPFM" [Paragraph 1.3, Page 5]

50. The material points of the PPFM that we have noted are as follows:

(1) Under the heading "The amount payable under a with profits policy, Amount Payable, Principles" is written:

"The amount paid on maturity or death for a policy in the Fund will be the initial guaranteed benefits plus bonuses constituting an equitable share of the distributable surplus earned by the Fund over the period of investment, subject to the terms of the policy conditions which take precedence.

Where a policy is available for a surrender value, the amount paid on surrender will have regard to the initial guaranteed benefits and bonuses, and the desire to avoid surrenders causing a strain on the Fund remaining for continuing policyholders.

For the with profits annuity, the amount of each annuity payment may include bonuses in addition to the guaranteed benefits. Where payable, these bonuses constitute an equitable share of the distributable surplus earned by the Fund over the period of investment ..." [Paragraph 2.1, Page 6]

(2) Under the heading "The amount payable under a with profits policy, Amount Payable, Practices" is written:

"Where practicable, asset share calculations for specimen policies are used as a guide to determine bonus rates and the amounts payable to with-profits policyholders ...

The Board of Directors determines the appropriate level and timing of distributions to policyholders. The bonus methodology has been

established and refined over many years and will be further refined as appropriate ...

The aim in the long term in determining final bonus is to return to maturing with-profits policies, as a group, on average 100% of asset shares.

...

Bonus rates are smoothed so that the full extent of changes in the market value of assets in the Fund is not always immediately reflected in claim payments. The aim of the current smoothing policy is such that changes in maturity payouts on comparable conventional with-profits policies from year-to-year are normally limited to no more than 15% ... The aim is that in normal circumstances the cost of smoothing will be broadly neutral over the long term. There is no specific overall limit to the accumulated cost or surplus of smoothing beyond the principle of maintaining regulatory solvency at an acceptable level." [Paragraph 2.2, Pages 6-7]

(3) Under the heading "Asset share methodology, Practices":

**"For conventional with profit policies (CWP)**

Asset shares for conventional with-profit policies are in general, the accumulation of:

Premiums paid

+ an allocation of investment return

+ an allocation of miscellaneous profits/losses from the With-Profit Fund

- the costs of selling and administering the business
- the cost of death or other risk benefits
- an adjustment for taxation appropriate for the class of business
- the shareholders' share of distributable surplus
- any contribution for the use of capital, provision of guarantees, glide path costs or smoothing" [Paragraph 2.4, Page 9]

(4) Under the same heading "Asset share methodology, Practices":

**"Cost of selling and administering the business**

For conventional with-profits policies the expenses of selling and administering the policies are allowed for in the asset share calculations. Certain development expenses charged to the Fund are not charged to asset shares but are instead met by the inherited estate, as agreed by the Board from time to time.

### **Cost of death or other risk benefits**

For conventional with-profits business other than With-Profit Annuities, mortality costs are charged to asset shares based on experience. For With-Profit Annuities, the annuity instalments deducted from the accumulation are based on the mortality rates assumed in the premium rates. The difference between actual and expected is charged to the inherited estate.

...

### **Adjustment for taxation**

Appropriate allowance for income and capital gains tax is made in the investment return, for Life business ...

...

Tax associated with shareholder transfers is met from the inherited estate. This practice is well established but subject to annual review by the Board following the review of the With-Profits Actuary

Any difference between the tax liability of the Fund and the aggregate tax allowances described above are attributable to the inherited estate.

...

### **Use of capital**

An additional charge may be levied on asset share to reflect the provision of capital, guarantees, and smoothing in the Fund, or to maintain the inherited estate or regulatory solvency of the current and potential future fund at appropriate level ... Such charges, if applied, accrue to the inherited estate." [Paragraph 2.4, Pages 9-10]

#### (5) Under the heading "Bonus Philosophy, Principles":

"Regular bonus rates are set with the aim of providing a progressive build up of guaranteed benefits over the lifetime of the contract with an overarching aim of retaining sufficient profits to provide an appropriate margin for final bonus. Regular bonus rates may be changed to reflect circumstances including past investment performance, changes in expected long term investment returns and any guarantees in the contracts to which they apply. Regular bonus rates will be smoothed to limit the changes in these rates from year to year...

...

Final bonus rates are set with the aim of distributing the balance of the distributable surplus earned over the lifetime of the policy, to the extent that

such profits have not previously been distributed by way of regular or other bonus additions ...

The Board may alter conditions for payment of final bonuses at any time without notice. Factors which might lead to a change include changes in the financial circumstances of the Fund and anticipated future experience of an exceptional nature." [Paragraph 2.5, Pages 11-12]

(6) Under the heading "Bonus Philosophy, Practices":

"In determining an equitable distribution of profits ... we will consider:

- The need to ensure that the Fund is able to meet its regulatory liabilities
- The current and projected capital needs of the Fund
- The investment strategy of the Fund
- The bonus philosophy of the Fund
- The need for an appropriate level of security for policyholders' benefits
- The need to ensure that policyholders' reasonable benefit expectations are maintained.

...

Suitable allowance will be made to finance final bonus, to reduce the risk of asset shares falling below initial guaranteed benefits plus previously declared bonuses. Part of the profits are shared out as regular bonus. We aim to do this so that there is an appropriate balance paid as a(n additional or) final bonus, taking account of the overall strength of the fund...

...

Final bonus rates are set to achieve the overall aim of returning to with-profits policyholders on maturity as a group on average 100% of asset shares in the long term, given the regular bonus rates determined as described ... They are set so as to achieve the smoothing objectives described ... Final bonus rates are influenced by the total return on investments and so are reviewed in the light of prevailing financial conditions" [Paragraph 2.5, Page 12]

(7) Under the heading "Market Value Reduction":

"It is the responsibility of the Board to ensure any current activity does not adversely affect ongoing policyholders and their rights. The use of a Market Value Reduction (MVR) is one of the key aspects in the protection of payouts for policyholders still invested in the Fund.

**Principles**

For unitised with profits policies, an MVR may be used whenever it is necessary to protect the Fund or other with profit investors in the Fund from losses arising from unit cancellations. An MVR may be used whenever there is a strain on the Fund ...

### Practices

...

The MVR is an adjustment to the value of units, including any final bonus and is intended to ensure the Fund doesn't incur a loss.

...

In deciding on the application of an MVR the company may take account of various factors including:

- The gap between the value of units (including final bonus) and the underlying value of investments supporting the plan
- The number and level of surrenders being experienced
- An element of smoothing, taking into account the cost or surplus to the Fund
- Policyholders' Reasonable Expectations (PRE) as established by policy literature, statements and other communications to policyholders
- The policy conditions
- The amount of the adjustment
- The regulatory solvency positions and scenarios of how they might develop in the future." [Paragraph 2.8, Page 14]

### (8) Under the heading "Investment Strategy, Principles":

"The investment strategy aims to provide the highest long term returns ... commensurate with acceptable levels of solvency risk having regard to:

- The nature and term of the with profit liabilities and the management of cashflows
- The current and expected level of guarantees
- Regulatory solvency requirements and future possible scenarios
- The size of the inherited estate and any freedom or restrictions in investment flexibility that may provide
- Advice from our Fund Managers
- Short term and long term anticipated returns in different asset classes
- Volatility of different asset classes

...

In normal circumstances, the investment strategy for the Fund will be determined according to the composition of the With Profit Fund alone. The Fund may have recourse to the assets in the shareholder fund, should this be necessary in order to meet guarantees or to give

more freedom to the With Profit Fund though this is entirely at the discretion of the shareholders.

...

The investment strategy of the Fund takes into account the nature and term of the liabilities, by considering appropriate assets for different classes of with profits policy and different generations of with profits policyholders." [Paragraph 3.1, Page 15]

(9) Under the heading "Investment Strategy, Practices":

"The Fund may invest in properties used by Aviva to administer CGNU Life and CULAC's business. Any such investments are on a commercial basis which allows for trading the assets if appropriate.

...

The Fund may make strategic investments in the equity or debt of companies in which Aviva Plc or CGNU Life/CULAC has a strategic interest, subject to the agreement of the With Profits Actuary. These investments will be made for strategic reasons considered to be to the long term benefit of shareholders and not the detriment of policyholders." [Paragraph 3.2, Page 17]

(10) Under the heading "Business Risk":

"The with profits policyholders are entitled to a share of the distributable surplus of the Fund, as determined by the Board, and are exposed to a general business risk of miscellaneous profits and losses that may arise from various sources within the Fund." [Paragraph 4, Page 19]

(11) Under the heading "Business Risk, Principles":

"The Fund may write new with profits and new non profit business either directly or through reinsurance accepted from other Group companies. New non profit business will only be written on terms which in the opinion of the With Profits Actuary provide an acceptable return to the Fund taking into account the risks associated with such business.

...

Where compensation costs from a business risk will be borne depends on the nature of the compensation and the need to ensure fairness of treatment between policyholders and shareholders." [Paragraph 4.1, Page 19]

(12) Under the heading "Business Risk, Practices":

"In general when considering whether to undertake a business risk the Company will consider:

- Existing business risks
- Potential rewards to policyholders and shareholders
- Potential rewards to policyholders and shareholders of alternatives including risk free investments
- Size of, and possible impact on the Fund and inherited estate

...

The Fund may provide financial support to other long term business funds of the Company subject to the approval of the With profits Actuary. The inherited estate of the Fund may be required to provide financial support to the Stakeholder Fund where a deficit arises in that fund.

In considering whether the Fund may make a loan to, or investment in, any other Group company the With profits Actuary will need to be satisfied that:

- The extent and terms of the loan or investment are no less favourable than would be the case if the other company were not a Group company
- The loan or investment is appropriate for the Fund
- The reasonable benefit expectations of policyholders will not be impaired as a result" [Paragraph 4.2, Page 19]

And under the same heading:

"Compensation costs arising from maladministration are paid by NULS in accordance with the Management Services Agreement as agreed by the Board following the recommendation of the With profits Actuary

Investments in other Group companies and in strategic investments or loans to such companies are allocated to the inherited estate and profits or losses arising from such investments are applied accordingly.

...

There is no specific minimum level of profit or loss from business risks before the Fund will treat them as a determinant of the amounts

payable under with profits policies. The Board reserves the right to review this policy. Losses which are currently borne by the inherited estate may in future be applied to with profits policies where in the opinion of the Board (on the advice of the With profits Actuary) such action is required to maintain the regulatory solvency and the inherited estate at an appropriate level.

Except where stated otherwise in section 2.4 profits or losses from business risks are currently pooled across all with-profits policies. Should losses which are currently borne by the inherited estate be applied instead to with-profits policies, it is likely that a degree of differentiation will be made. The particular classes or generation of policies which will bear such losses will depend on the nature of the loss and the circumstances at the time.

Other than compensation costs in respect of maladministration, compensation costs from a business risk will generally be borne by either the inherited estate or shareholders, rather than as a charge to asset shares. There would only be a charge to asset share if the payments could not be met by the inherited estate or assets attribute to the shareholders." [Paragraph 4.2, Page 20]

51. In the PPFM there are two particular entire sections which deal with matters material to the points in issue in the Opinion and deserve special attention and for that reason we set these out in a separate paragraph. The first is Section 6 of the PPFM which is entitled "Management of the inherited estate":

(1) Under "Principles":

"The inherited estates of each of the CGNU Life and CULAC Funds are held and managed independently of other with profits funds within the Aviva Group and each other and are held within the respective With profits Funds. The Fund's inherited estate will be managed in accordance with any applicable legal and regulatory requirements, including the Company's duty to maintain adequate financial resources and to take reasonable care to organise and control its affairs responsibly and effectively.

The Fund's inherited estate may be used, at the Board's discretion, to:

- Provide investment flexibility by enabling a high proportion of the investment in potentially higher reward but higher risk assets than would otherwise be the case
- Provide a cushion of additional security against unexpected adverse events
- Permit flexibility in the smoothing of maturity and surrender payouts for with profits policies

- Finance new business growth
- Meet such other purposes as permitted by law and consistent with the Company's duty to maintain adequate financial resource.

The inherited estate constitutes the working capital of the Fund

Bonus rates and investment policy will be managed in order to keep the inherited estate of the Fund at levels which, in the opinion of the Board (on the advice of the With profits Actuary) is appropriate for the level of risk "run" by the business. In view of the fact that the Fund's inherited estate bears the risk associated with the provision of smoothing and guarantees an appropriate charge may be made to policies to maintain the inherited estate at an appropriate level ...

The inherited estate has been used in the past to support the writing of non-profit business on appropriate terms and may do so in the future." [Paragraph 6.1, Page 23]

(2) Under "Practices":

"In calculating the inherited estate, current practice is to use it to pay the costs of the following items:

- Tax associated with additional tax on shareholder transfers out of the Fund
- Meeting any costs of compensation for mis-selling of business that the Fund has an interest in
- Guaranteed annuity option costs in excess of those charged to policies and other guarantee costs where these exceed the policy value indicated by asset share
- Costs arising from payouts at MVR free points
- Costs arising in respect of payouts of money back guarantee being different to expected
- Costs arising from the Mortgage Endowment Promise
- Costs associated with restricting charges to asset shares for certain contracts, including the cost of shareholder transfers
- Any expenses not charged to asset share
- Cost of any approximations in the calculations
- Any financing of smoothing of payouts (over the longer term the cost of smoothing is expected to be neutral).

In addition the inherited estate may be used to pay other costs as agreed by the Board, following the recommendation of the With profits Actuary and is not expected to be distributed.

Investment strategy for the inherited estate may differ from that of the rest of the Fund.

...

The inherited estate is managed in line with the above Principles and Practices. The Board has no target for the size of the inherited estate. In exercising its discretion on the use and management of the inherited estate, the Board will consider the impact of the exercise of discretion on the investment prospects of policyholders and will aim to ensure that these prospects are not expected to be adversely impacted to a significant extent." [Paragraph 6.2, Page 24]

52. The second is Section 8 which is entitled "Equity between the With profits Fund and shareholders". The material parts of this section are:

(1) Under "Principles":

"The percentage of distributable surplus in the Fund to be apportioned to with profits policyholders shall not be less than 90% unless a different level is specified in the Company's Articles of Association or in a relevant court-approved insurance business transfer scheme. The remainder of the distributable surplus is to be appointed to shareholders, or as otherwise directed by the Board." [Paragraph 8.1, Page 26]

(2) Under "Practices":

"The proportion of distributable surplus that is apportioned to shareholders is currently at the maximum level." [Paragraph 8.1, Page 26]

53. In the PPFM there is attached Appendix A, a Glossary of terms used in the PPFM. Of particular relevance are the following:

**"Asset share**

The premiums paid, less deductions for expenses, guarantees, tax and other charges, plus any allocations of business profits, accumulated at the investment return achieved on the assets in the With Profit Fund.

...

**Conventional With profits**

Life and pension policies written with an initial guaranteed benefit and all charges are allowed for within the premium rates. The policies are

invested in the With Profits Fund and share in the return on the Fund through the addition of bonuses.

...

### **Inherited Estate**

The inherited estate is the excess of assets held within the long term fund over and above the amount required to meet the liabilities. The liabilities, for this purpose, include those that arise from the regulatory duty to treat customers fairly in setting discretionary benefits, such as final bonuses. The inherited estate acts as working capital of the business. It is used to support the business by, for example, providing investment flexibility and a "cushion" against adverse stock market conditions.

...

### **With-Profits business**

This is that part of the business, which includes the issuing of with profits policies.

### **With-Profit Fund**

This is the pool of assets held in respect of with profits business which can back a combination of with profits and non profit policies."