

Appendix 2

The Approach of the Policyholder Advocate

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

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1.00 Introduction

The policyholder advocate's objectives, as set out in the FSA rules and guidance and her terms of reference, can be seen to divide into three stages prior to the commencement of the High Court process. The three stages are:

- consulting with CGNU Life and CULAC policyholders prior to negotiations,
- negotiating with Aviva on behalf of the relevant policyholders, and
- reporting to policyholders, including commenting on various aspects of the reattribution proposals, and telling the relevant policyholders, with reasons, whether the firm's proposals are in their interests.

The policyholder advocate's approach to each of these stages is explained below. First, we explain Clare Spottiswoode's overall approach to her task and her challenge to the operation of with-profits funds.

2.00 The policyholder advocate's overall approach

The policyholder advocate set up a small independent office which included specialist economic and communications advisers and also engaged a number of outside advisers. In particular, legal advice was received from Lovells and from Freshfields Bruckhaus Deringer, actuarial advice was received from KPMG and tax advice from Deloitte. LECG constructed and ran the models upon which the policyholder advocate based both her analysis of Aviva's reattribution offer and her guidance to policyholders.

In addition, the policyholder advocate was advised by a number of academic specialists, Christopher O'Brien, Director of the Centre for Risk and Insurance Studies, University of Nottingham, Professor Julian Franks and Professor Richard Brealey of the London Business School, and Professor Philip Booth of City University.

The policyholder advocate was also supported by the Prism group, comprising eminent individuals in their professions, who were Sir Alan Budd, Sir Bryan Carsberg and Mr Bill Knight.

3.00 The policyholder advocate's challenge to the operation of with-profits funds

After she was nominated as policyholder advocate and before her appointment in November 2006, Clare Spottiswoode spent several months learning about the with-profits industry and its regulation from independent practitioners and experts, as well as her appointed advisers and from Aviva. The policyholder advocate's legal team negotiated her terms of reference and briefed her and her team about the law governing with-profits. The FSA also briefed her on the key issues in the reattribution from its perspective.

Throughout the course of her appointment the policyholder advocate continued to consult widely, including discussing the relevant issues with the Economic Secretary to the Treasury, the Chairman and the Chief Executive of the FSA, the Chairman and members of the House of Commons Treasury Committee, the Chairman and members of the FSA Consumer Panel, Which?, and the Association of Independent Financial Advisers.

As part of her challenge on behalf of policyholders to the operation of with-profits funds, the policyholder advocate obtained Queen's Counsel's opinion as to the legal rights and interests that with-profits policyholders have in the CGNU Life and CULAC with-profits funds, which included comment on the FSA's permitted uses of inherited estates (see Appendix 25 Legal Issues arising in respect of Rights and Interests in and uses of the Inherited Estates).

In addition, the policyholder advocate challenged the FSA's regulation of inherited estates, and in particular its permitted uses of such estates, some of which the policyholder advocate considers unfairly favour shareholders over policyholders. The FSA's rules concerning the permitted uses of inherited estates are particularly important in a reattribution. The rights and interests which current policyholders are being asked to give up in return for accepting the firm's reattribution offer comprise possible future special distributions from the inherited estates, the size and timing of which are in turn greatly influenced by FSA regulation (see Appendix 26 FSA Guidance Letters and Responses and also Appendix 39 The Impact of FSA Guidance on Policyholders).

In February 2008, the House of Commons Treasury Committee announced an inquiry into inherited estates, arising from its ongoing scrutiny of the FSA. The policyholder advocate gave written and oral evidence to the Committee in the course of its inquiry. The Committee's report was published in June 2008 (see Appendix 27 House of Commons Treasury Committee Report: Inherited Estates).

4.00 Consultation with policyholders

In her pre-negotiation consultation, the policyholder advocate attempted to give as many policyholders as possible the opportunity to make their views heard and to ask questions. After her appointment on 21 November 2006, a mailing was sent out to relevant policyholders from Aviva and the policyholder advocate's office. This mailing consisted of a letter and a leaflet from both parties. After the mailing was sent out, the policyholder advocate embarked on a series of road-shows in England, Ireland, Scotland and Wales.

In addition to these road-shows, the policyholder advocate also:

- (1) conducted a questionnaire (available online or over the telephone);
- (2) launched a website to provide policyholders with more information about the reattribution and the role of the policyholder advocate;
- (3) established a call centre for policyholders to call in order to ask questions or state their views;
- (4) produced a CD interview of the policyholder advocate with her legal and actuarial advisers;
- (5) met with other interested stakeholders, through special events and individual meetings; and
- (6) interacted with the media.

The pre-negotiation consultation period ended in February 2007. However the policyholder advocate continued to encourage policyholders to express their views throughout the

negotiations with the firm. (For more information see Appendix 24 Consultation and Communication with With-Profits Policyholders and Other Interested Parties).

5.00 Negotiation with Aviva on behalf of policyholders

Content of negotiations

Consistent with the policyholder advocate's objectives, the negotiations with the firm covered a range of issues, including:

- the reattribution eligibility criteria for CGNU Life and CULAC policyholders,
- the aggregate value of the firm's policyholder incentive payment ("PIP") offer to eligible policyholders in exchange for giving up their rights to any possible future distributions from the inherited estates,
- the allocation of the aggregate PIP among eligible policyholders,
- the position of non-electing policyholders, including the basis of allocation of the inherited estates between the new with-profits sub-fund (New WPSF), covering the portion of the estates associated with electing policyholders, and the old with-profits sub-fund (Old WPSF), into which the non-electing policyholders' proportion of the estates will be transferred,
- other aspects of the management of the with-profits funds as it affects both electing and non-electing policyholders, including governance arrangements.

Meetings and working papers

The policyholder advocate's approach to taking these and related topics forward with Aviva was by means of a series of face-to-face discussions, supported by detailed working papers setting out the parties' respective positions which were used to inform the writing of the policyholder advocate's report and are being published as a series of appendices to the report.

Modelling the future for the purposes of the reattribution

The reattribution involves the firm making, in the near future, an aggregate PIP offer, allocated between individual eligible policies, in return for policyholders giving up their

rights to any future special distributions from the inherited estates. In principle, therefore, the task is an example of a classic economic problem – namely, how to evaluate present versus future benefits in a situation of uncertainty – and involves estimating what the value of the future special distributions might have been which the policyholders are being asked to give up. Since the possible future distributions could be spread over a number of years, it is also necessary to estimate the profile of possible future special distributions over time.

Aviva developed a model for the purposes of assessing the financial implications of the reattribution. In addition, the policyholder advocate considered that she needed access to independent modelling facilities in order to consider a range of possible outcomes based on the advice of her specialist advisers.

The policyholder advocate commissioned LECG to construct financial models in order to inform her position, in particular, a) on the value of possible future special distributions from the inherited estates that policyholders electing for the reattribution would forgo, b) on the allocation of Aviva's aggregate PIP between policyholders, and c) on the position of non-electing policyholders.

The LECG models are not intended to reproduce the complexity of Aviva's modelling but instead to complement it. They take the underlying data supplied by Aviva and remodel it to take account, at a high level, of the effects of varying key inputs, such as the size of the inherited estates and the level of future new with-profits business assumptions. The LECG models produce projections of cash flows to the various groups of current policyholders, to future policyholders and to shareholders. These cash flows are valued at the average rates of return for the fund, as advised by Aviva, to give present values. (Appendix 33 gives further information about the modelling undertaken by Aviva and the policyholder advocate for the purposes of the reattribution).

Information provision and analysis

The policyholder advocate's legal, actuarial, tax and financial modelling advisers have requested and obtained large volumes of information and data from Aviva, consistent with the complexity of the reattribution project.

Following the FSA's approval of Clare Spottiswoode as the nominated policyholder advocate in February 2006, and prior to her appointment in November 2006, the policyholder advocate's legal and actuarial advisers carried out preliminary 'due diligence' investigations to assist Clare Spottiswoode in forming a view of the likelihood of reaching agreement with Aviva on behalf of the relevant policyholders. This involved requesting and reviewing a large number of documents from Aviva.

When negotiations commenced, much time was taken up by Aviva compiling data, and by the policyholder advocate's advisers reviewing and analysing the information received. Thereafter analysis was concentrated on evaluating aspects of Aviva's reattribution proposals, leading to an agreed position between Aviva and the policyholder advocate which was announced in July 2008.

After that announcement, the volatility and the fall in value of stock markets and other financial assets led Aviva to reconsider its position. It proposed a restructured offer in February 2009, more consistent with prevailing financial conditions. (For further detail about information requested and provided by Aviva and the due diligence carried out by the policyholder advocate's advisers, see Appendix 3 Information: Access and Due Diligence).

6.00 The policyholder advocate's report and guide

In accordance with FSA rules and guidance and her terms of reference, the policyholder advocate's report is to include comments on a) the method used for the allocation of benefits between policyholders, b) the criteria used for determining the eligibility for the reattribution of the various with-profits policyholders, c) the terms and conditions of the reattribution proposals (to the extent that they materially affect the benefits to be offered, or the bonuses that may be added to with-profits policies), and d) the views expressed by the independent expert and the firm's with-profits actuary on the allocation of any benefits among the relevant with-profits policyholders. The policyholder advocate must also tell policyholders whether the firm's proposals are in their interests.

The policyholder advocate's approach to communicating with policyholders on these matters consists of producing:

- (1) A policyholder-friendly guide: this guide has been sent out to policyholders in conjunction with the Aviva communication to policyholders which includes the voting form for each policyholder to indicate whether or not they wish to vote to accept Aviva's reattribution offer. The guide, which is intended to be concise and jargon free, includes in particular guidance from the policyholder advocate as to whether the firm's reattribution offer is in the interests of groups of policyholders, as well as additional summary information about the reattribution. The guide also indicates to policyholders how they can obtain further information, including the policyholder advocate's report.
- (2) The policyholder advocate's report: the report is available free of charge to policyholders who request it. It is also available on the policyholder advocate's website. The report contains a foreword and an executive summary which are also available as a separate document to policyholders who request it. The policyholder advocate is additionally making appendices produced by Aviva and her advisers available on the policyholder advocate website, which, should it be required, give more in-depth information on each of the topics covered in the policyholder advocate's report.

This layered approach towards communicating with policyholders is intended to give policyholders and other interested parties, including independent financial advisers, the opportunity to find out as much information as they need to inform policyholders' decisions as to whether or not to accept Aviva's reattribution offer. The report also serves to inform the High Court. The policyholder advocate has in addition recorded a CD interview discussing the Aviva proposals and her guidance, and is conducting further road-shows during the election period.

The depth of information available to policyholders and other interested parties is intended to fulfil the policyholder advocate's aim to be as fully accountable and transparent as possible, in

terms of explaining how she has undertaken her role, the reasons for the outcome of her negotiations with the firm on behalf of relevant policyholders and in giving guidance to policyholders as to whether the firm's proposals are in their interests.

The policyholder advocate also expects to produce a supplementary report before the High Court hearing and, if she does, this will be made available to the Court and on the policyholder advocate's website. The main reasons for this report will be to explain the outcome of LECG's updating of its analysis based on revised end 2008 data being provided by Aviva and of KPMG's review of Aviva's calculation of the value of the inherited estates at the proposed Effective Date of the reattribution (1 October 2009). (If the relevant work has not been completed by the date of the Court hearing, the report will provide an update on these matters).