

## **Appendix 16 B**

### **The Scheme**

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

**July 2009**

**Report by:** Freshfields Bruckhaus Deringer LLP

## Contents

1.00	Introduction	3
2.00	The role of the policyholder advocate in relation to the Scheme	7
3.00	Commentary on aspects of the Scheme	10
	Annex 1	20

## **1.00 Introduction**

The reattribution of the inherited estates in the Commercial Union Life Assurance Company Ltd (CULAC) and CGNU Life Assurance Ltd (CGNU Life) with-profits funds is being carried out as part of a fund transfer of the entire businesses of these two life assurance companies to Aviva Life and Pensions Limited (AVLAP). All these companies are wholly-owned subsidiaries of Aviva plc.

### **1.01. How are the transfer of CULAC's and CGNU Life's businesses achieved?**

The transfers of businesses are carried out by virtue of a scheme of transfer under Part VII of the Financial Services and Markets Act 2000 (FSMA). This type of scheme transfers, by means of an order of the High Court, all the assets, liabilities and business of an insurance company to another insurance company. Normally it is not possible for an insurance company to transfer its liability to its policyholders on to another insurer without the policyholders' specific consent. But under this legislation, such a transfer is possible if the Court is satisfied that the interests of the affected policyholders are properly protected.

### **1.02. Is a Scheme necessary for a reattribution?**

Reattributions can be achieved in other ways, but a transfer scheme is a convenient vehicle. Aviva has indicated that it would in any event have proceeded with these transfers from CULAC and CGNU Life to reduce the number of separate life insurance companies in the Aviva Group, and would continue with the fund transfer (via the alternative scheme) if the reattribution did not go ahead. Since the reattribution is to be effected by way of a Scheme, under Part VII of the FSMA, it will require the sanction of the High Court.

### **1.03. Why is the Scheme so long and complicated?**

Schemes of transfer are usually very detailed and complex documents, in particular where the business to be transferred contains with-profits and unit-linked insurance policies and their related assets. With-profits and unit-linked policyholders' rights, interests and expectations are very specifically related to the assets and liabilities of the particular insurance fund in

which their premiums are invested. It is therefore necessary to be very precise about which assets and which liabilities will be allocated to which sub-fund of the transferee company, and as to how the transferee will manage its enlarged business going forward, in order to be comfortable that the interests and expectations of both transferring policyholders and the existing policyholders of the transferee company are appropriately protected.

#### **1.04. Additional complexity from reattribution**

The Scheme in this case is even more complex, as a result of the proposed reattribution. The Scheme details how the policyholder incentive payments (PIP) will be paid, and who is eligible to receive them. The Scheme also has to allow for the fact that the transferring with-profits funds will be divided between:

- (1) the New With-Profits Sub Fund (NWPSF), to which those policyholders who elect for the PIP will have their policies and their appropriate share of assets and liabilities allocated;
- (2) the Old With-Profits Sub Fund (OWPSF), to which those who choose not to elect and their appropriate share of assets and liabilities (including their share of the inherited estates) will be allocated; and
- (3) the Reattributed Inherited Estate External Support Account (*RIEESA*) to which the rest of the inherited estates will be allocated.

As well as the establishment of these three funds, and the allocation of the correct assets and liabilities to each of them, the Scheme has to provide detailed rules governing the future management of these funds (and in particular the inter-relationship of these funds as well as their relationship with other sub-funds of AVLAP). Of particular importance in this context are

- (i). the mechanisms by which the RIEESA will remain available to provide security for the policy benefits of both electing and non-electing policyholders;

- (ii). the rules with respect to the writing of new business in the OWPSF, NWPSF and RIEESA;
- (iii). the rules restricting or requiring distributions from the RIEESA and the OWPSF respectively; and
- (iv). the governance protections for policyholders where there is a potential conflict between policyholder and shareholder interests.

### **1.05. The general approach of the Scheme**

Aviva's intention in structuring the Scheme is that policyholders' current rights and expectations with respect to their policies and the companies' current rights with respect to the with-profits funds should, with certain exceptions, only be changed to the extent that is necessary to give effect to the reattribution. In very brief summary, the Scheme is intended:

- (1) to move the ultimate ownership of the inherited estates in CGNU Life and CULAC with-profits funds (to the extent that policyholders elect to accept the PIP offer) to a fund which is 100% owned by shareholders, but to preserve the estates' role as a provider of security and of investment flexibility for the benefit of CGNU Life and CULAC's with-profits policyholders, whether or not they elect for the PIP offer;
- (2) to create a separate with-profits fund to which non-electing policies will be allocated, and to which the proportion of the inherited estates that is referable to such non-electors will be allocated, and another separate fund to which the electors' policies will be allocated.

But otherwise it requires that the two funds continue to be managed after the Scheme is effected as if they were a single fund for purposes of investment management, expense allocation, new business, and bonus distribution, with the intention that electing and non-electing policies of the same category will enjoy the same normal bonuses and benefits. The sole exception is that only policies allocated to the non-electors' fund will participate in any

special distributions from the inherited estate in the non-electors' fund, and there will be no such special distributions for electors' policies.

The policyholder advocate agrees that the Scheme achieves this overall intention. She notes that the Scheme also contains certain additional protections that transferring policyholders do not currently enjoy, albeit that the costs of the second and third items have been specifically taken into account in the estate valuation process conducted for the purposes of the PIP negotiations:

- (1) the Scheme entrenches the role of the With-Profits Committee, requiring a majority of its members to be independent, and contains a series of detailed principles and practices of financial management, and other restrictions (including a codification of the funds' risk appetite), exceptions or changes to which will require approval by that Committee. This governance structure will place significant restrictions on the ability of Aviva to make future changes in the management of the funds which are adverse to policyholders' interests.
- (2) in 2000 CULAC and CGNU Life each made a promise to the holders of with-profits endowment policies (and certain other endowment policies to the extent that the policyholders switched their investment into with-profits by a certain date) in force as at 31 December 1999 which policies had been entered into in connection with a mortgage. This promise was made subject to the condition that there were sufficient investment earnings on the free reserves in the relevant with-profits fund of CULAC or CGNU Life to fund the top-up payments under the promise. This affordability condition will be removed if the Scheme proceeds, effectively turning the promise into a guarantee in respect of this condition.
- (3) the Scheme requires that with the exception of certain development costs only expenses or charges of a type that were being deducted prior to the effective date of the Scheme can be deducted from asset shares of transferring policies after the effective date, although the scheme does introduce expressly the possibility of industry levies being charged to asset shares.

The policyholder advocate is critical of certain aspects of how with-profits funds are currently managed, and of the Financial Services Authority (FSA) rules which permit this. To the extent that these aspects are expressly or implicitly endorsed in the Scheme, the policyholder advocate can be taken to be critical of the Scheme. Nevertheless, she recognises that it would be unrealistic for policyholders to expect that the reattribution scheme would put them in a significantly better position than that which is implied under the current FSA rules. She is also satisfied that with one exception, referred to in part 3.5 below, the Scheme contains sufficient flexibility that the benefit of any changes in the FSA rules, of which she is critical, will be passed on to the relevant policyholders.

### **1.06. The contents of this Appendix**

In the next section of this Appendix, we explain the role of the policyholder advocate in relation to the review of the Scheme. Because the Reattribution is achieved by virtue of the Scheme, and the future relationship between electors and non-electors and AVLAP is very substantially defined by the Scheme, the great majority of the views of the policyholder advocate and her advisers with respect to specific aspects of the Scheme are contained in other appendices. In section 3 we highlight those other appendices, and also set out our views on certain aspects of the Scheme that are of concern to the policyholder advocate but are not covered in other appendices. In the final section we comment on the adequacy of the Scheme summary which Aviva proposes to include in the Scheme circular provided for policyholders.<sup>1</sup>

## **2.00 The role of the policyholder advocate in relation to the Scheme**

### **2.01. The terms of reference**

Under the terms of her appointment, the policyholder advocate is required amongst other things to negotiate the terms and conditions of the reattribution proposals, and to produce a report that comments on those terms and conditions.

---

<sup>1</sup> See Annex 1 for correspondence between the policyholder advocate and the FSA about certain aspects of the scheme that are of concern to the policyholder advocate

In a sense, the entire Scheme can be regarded as part of the “terms and conditions” of the reattribution, in so far as it relates to the with-profits businesses of CULAC and CGNU Life. But policyholders are principally concerned to know how much PIP they are being offered, when it will be paid, how they can accept the offer if they want to, whether there are circumstances in which that offer may be withdrawn, what exactly they are giving up if they accept the offer, and whether anything else about the way in which their policy is managed or their benefits are determined will change as a result of the reattribution going ahead, particularly if they choose not to accept it.

On this basis the Scheme provisions which are likely to be material to policyholders, which have constituted for purposes of her terms of reference the “terms and conditions of the reattribution” and on which the policyholder advocate has concentrated her efforts and those of her team are as follows:

- The provisions defining eligibility for the PIP (discussed in 3.01)
- The provisions which set out how the PIP is calculated for different classes and cohorts of policyholder, when it is to be paid, and the circumstances when the reattribution may be cancelled and the PIP not paid (see 3.02)
- How the assets, and in particular those representing the inherited estates of CULAC and CGNU Life, are to be allocated as between the OWPSF, the NWPSF and the RIEESA, including the adjustments that are to be made to the initial allocation to restore, if appropriate, the value of non-electors’ interest in future special distributions, and to balance the respective financial strengths of the OWPSF and NWPSF/RIEESA (see 3.03)
- The allocation of transferred and future liabilities (over and above those derived from non-electing policies) as between the OWPSF, NWPSF and RIEESA (see 3.04)
- The future operation of the OWPSF, NWPSF and RIEESA, including in particular (see 3.05):-

- The future approach to investment allocations, charges, and bonus and smoothing policy
- The uses to which the inherited estate in the OWPSF can be put
- The extent to which new business (of any category) can be written (whether directly or by way of actual or notional re-insurance) in the OWPSF, the NWPSF or the RIEESA
- The manner in which the RIEESA and OWPSF inherited estate assets may be invested
- How financial support between the sub-funds is to be provided and when distributions from the OWPSF inherited estate assets are required or permissible, and when distributions from the RIEESA are permitted
- Governance of the various sub-funds, including the role of the WPC
- The ultimate merger of the OWPSF and the NWPSF

## **2.02. The role of the Independent Expert**

The Scheme has been the subject of detailed review and comment by the Independent Expert (and the FSA) throughout its development from initial drafts to final form. The policyholder advocate's review and comments on it have been limited to those aspects of it (see above under 2.01) which she considers to be of direct relevance to the reattribution and to her guidance to policyholders as to whether or not the firm's reattribution proposals are in their interests..

It clearly would be of relevance to policyholders in this respect if the decision whether or not to elect had any material effect on the security of their policy benefits or on the amount of their normal bonuses and benefits. Policyholder security, and the maintenance of reasonable bonus expectations, have been a particular focus of the Independent Expert's review and report. He has concluded that the transferring policyholders will not experience a significant reduction in the level of security for their guaranteed benefits, and that no transferring policyholder should experience a material reduction in his/her reasonable benefit expectations as a result of the Scheme.

In giving her guidance to policyholders the policyholder advocate has adopted the conclusions of the Independent Expert in this respect. In this connection, KPMG has reviewed and commented on the report of the Independent Expert, (and on the important underlying reports by the Actuarial Function-holder and the With-Profits Actuary, which enlarge upon the proposed management of the OWPSF, NWPSF and RIEESA) and has had a number of discussions with the Independent Expert and his team and with Aviva's actuarial team. Also KPMG has examined in particular the effect of the Scheme on investment policy, smoothing and bonus policy (its conclusions on these topics can be found in Appendix 29B). However, It is important to note that KPMG has not duplicated the detailed investigation carried out by the Independent Expert, which would be necessary in order independently to confirm his conclusions. KPMG's comments on the actuarial reports referred to above can be found in Appendices 17B and 18B and their comments on the Independent Expert's report in Appendix 19.

### **3.00 Commentary on aspects of the Scheme**

Those who choose to elect for the PIP are selling to the shareholders any interest which those policyholders have in possible future distributions from the inherited estates. After the reattribution their concerns about the Scheme will be limited to ensuring that the amount and security of their normal policy benefits will not be adversely affected as a result of the reattribution.

Those who choose not to elect are in a different position. They retain the possibility of future special distributions from the inherited estates and so are much more concerned to ensure that the business is managed in such a way that the amount and probability of such distributions is not reduced. This is a more complex issue, and has been the focus of particular attention from the policyholder advocate and her advisers, and the impact of the Scheme on those policyholders is addressed in Appendix 32B, "The Position of Non-Electors".

### **3.01. Eligibility for the PIP**

The provisions which explain which policies are eligible for the PIP and which are not are contained in certain defined terms set out in Schedule 1 to the Scheme. The most important are “Eligible Policy”, “WP Policy”, “In Force”, “Qualifying Date” and “Effective Date”

Appendix 23B, “Eligibility for reattribution” contains the policyholder advocate’s views on this subject. We can confirm that the eligibility criteria as described in that appendix reflect the detailed provisions of the Scheme.

### **3.02. Allocation of the aggregate PIP between policyholders**

Chapter 3 and Schedule 3 of the Scheme contain the detailed provisions for the calculation and allocation of the PIP between policyholders.

The conceptual basis of the PIP allocation is explained and discussed in Appendix 43 – Allocation of the Aggregate PIP between policyholders. In summary the total PIP amount is to be allocated among the holders of Eligible Policies pro rata to their policy size as of the Qualifying Date, but with some specific weighting factors applied, which are intended to achieve a better match between the PIP offered for each policy and the amount of future special distributions which policyholders will give up by electing for the PIP.

LECG has held detailed discussions with Aviva and is satisfied that the detailed allocation provisions set out in the Scheme achieve the intended effect described in the above Appendix 43. However, LECG is unable to confirm that the specific formulae contained in the Scheme, when applied to the in-force policies as at the date on which the PIP offer is made to policyholders will produce the correct aggregate PIP in accordance with the Scheme. Aviva have agreed in principle that policyholders require this assurance, although at the time of writing this appendix, the detail of this has yet to be agreed.

One other aspect of the PIP allocation provisions which the policyholder advocate and Aviva have discussed in particular has been Aviva’s ability to rely on its records for purposes of determining entitlements to the PIP, and in particular that Aviva will only be obliged to make good any shortfall in PIP paid as a result of errors in the records of CULAC or CGNU Life

that are discovered within the first 12 months after the Effective Date. Thereafter Aviva will have no obligation to compensate policyholders where errors are discovered, although it will retain the discretion to do so. The policyholder advocate considers that this is a reasonable compromise between the rights of policyholders and Aviva's legitimate interest in achieving a certain and final outcome to the reattribution as soon as reasonably practicable.

It is important to note that there is no certainty that the reattribution will proceed. It is subject to approval by the Court, as noted above. In addition it will be conditional upon final approval by the boards of Aviva Plc and AVLAP.

### **3.03. Allocation of the assets of the CULAC and CGNU Life with-profits funds (including their inherited estates) between the OWPSF, NWPSF and RIEESA.**

Chapter 4 and Schedule 2 of the Scheme contain the detailed provisions for the establishment of the new sub-funds of AVLAP to which the transferred assets and the policy and other liabilities of CULAC and CGNU Life with-profits funds will be allocated, and for their division and allocation between those sub-funds.

So far as the inherited estates are concerned, they are to be allocated between the OWPSF on the one hand and the NWPSF and RIEESA on the other in the same proportions as the aggregate PIP offered is allocated as between non-electing policyholders and electing policyholders. If the result of this division is that the aggregate value of potential special distributions to non-electing policies (to be determined on the basis of stochastic modelling as described in more detail in the Actuarial Function-Holder's report) is less than it would have been but for the reattribution, then assets, up to a maximum of £100m will be transferred into the OWPSF. This is known as the value of potential distributions to policyholders (VPDP) adjustment, and is described in Part 2A of Schedule 2 to the Scheme.

If and to the extent that the financial strength of the OWPSF exceeds the AAA level (which is the top end of the range which the Board of AVLAP considers consistent with its risk appetite), the excess will be held in a separate account and distributed over time as a special

distribution to non-electing policyholders whose policies are still outstanding at the time of the distribution. This approach was originally suggested as a mechanism to prevent the possibility that the VPDP adjustment might cause there to be an immediate distribution from the OWPSF. Aviva considers it should be applicable in all circumstances. The policyholder advocate can see no justification for that approach. Nevertheless, in current circumstances the likelihood that the OWPSF will have assets above the AAA level is rather remote, in any event.

The Scheme also provides (in Part 4 of Schedule 2) for a comparison to be made of the relative financial strengths (in terms of the probability of their being able to meet all liabilities as at the Effective Date) of the OWPSF on the one hand and the NWPSF and RIEESA on the other. If there is a difference of more than 0.5% in this probability (known as the Benefit Security Factor or BSF) between the two, then the stronger will make a payment to the weaker to equalise the two. This concept is in itself unexceptionable provided that there is no asymmetry in the projected outcomes of this adjustment. However, because the BSF is to be measured on the assumption that the RIEESA is available to meet OWPSF claims, it is almost impossible that a BSF adjustment in favour of the OWPSF can occur. The apparent unfairness of this asymmetry has been addressed by providing that any adjustment that may be necessary will be made by way of contingent loan. There is therefore no risk that the shareholder will capture any excess that is not actually needed for the security of policyholders allocated to the NWPSF, as this excess will be returned to the OWPSF. The policyholder advocate is content with the BSF proposal.

The Scheme provides in part 5 for the asset shares of policyholders who elect to accept the PIP offer to be enhanced by up to a maximum of £120m if there is a significant reduction in new business levels after the effective date. This is some recognition of the significance of Aviva's own projections of new business levels in estimating future special distributions. The policyholder advocate has adopted a neutral position on this provision. On the one hand she welcomes Aviva's recognition that a much lower level of new business than it is currently anticipating would have provided a rather different backdrop to the discussion with her regarding the PIP offer. On the other hand the policyholder advocate is not comfortable as a

matter of principle with provisions that may be inclined to distort Aviva's new business decisions going forward.

The way in which assets are allocated between the various sub-funds is also discussed and commented upon in Appendices 17, 18 and 19 (relating to the reports of the Actuarial Function Holder, the With-Profits Actuary and the Independent Expert).

### **3.04. Allocation of liabilities**

Under Chapter 4 of the Scheme, existing liabilities of the CULAC and CGNU Life with-profits funds are allocated between the various sub-funds of AVLAP. Liabilities under policies will be allocated to the sub-fund to which the relevant policy is allocated. Liabilities allocated to any linked funds of CGNU Life and CULAC will be allocated to the equivalent linked funds of AVLAP to which the linked fund assets are to be allocated. Other transferred liabilities are allocated as follows:

- (i). the total liability to pay the two instalments of the deferred special bonus that have not yet been allocated will be allocated between the OWPSF and the NWPSF in the proportion which their respective realistic liabilities bear to each other. When the deferred special bonus is eventually allocated there will be an adjustment as necessary to reflect the actual amounts to which electing and non-electing policies are entitled;
- (ii). capital gains tax liabilities are allocated in accordance with detailed principles described in the Actuarial Function-Holder's report (see Appendix 17B); and
- (iii). all transferred liabilities that are current liabilities, the liability that CULAC has to make additional payments in certain circumstances to the purchaser of its Canadian business, all misselling and other liabilities that relate to or arise from the conduct of a particular category of transferred business that is to be allocated to the OWPSF or the NWPSF, and (unless the WPC approves an alternative allocation) any other transferred liability that is not specifically allocated under any other provision of the Scheme, are to be allocated between the two sub-funds in the same proportion as the opening (pre-VPDP adjustment) allocation of the inherited estates as described above.

In relation to liabilities that arise after the Effective Date, the relevant provisions of the Scheme can be found in Chapter 5 and Schedule 4 of the Scheme. As far as the OWPSF is concerned (which is the principal focus of the policyholder advocate's concern, the Independent Expert having confirmed that all transferring policyholders are adequately protected in terms of benefit security), the primary sources of post Effective Date liability other than under transferred policies will be:

- (1) Insurance liability (including the allocation of administration of charges and expenses) under new policies which are allocated to the OWPSF. Under the Scheme, the OWPSF will not write new business except by means of (i) the internal reinsurance of its proportion (derived in the first case from the proportion in which the Inherited Estates are allocated as between the OWPSF and the NWPSF and RIEESA, but able to be adjusted with WPC approval in the future) of new with-profit or non-with-profit business written into the NWPSF/RIEESA, and (ii) the allocation of its proportion of internal reinsurance arrangements for other AVLAP or Aviva liabilities (but only where the NWPSF/RIEESA also takes its proportion, and the WPC has approved the arrangement);
- (2) Tax ( Appendix 34B, `Tax matters in relation to the reattribution` addresses the taxation of the OWPSF in some detail);
- (3) other non-policy liabilities (examples might be industry levies, misselling costs, or audit fees) which relate to the business written in the OWPSF or NWPSF after the effective date will be allocated in a manner that treats customers fairly, and after discussion with the WPC. The AFH report sets out the general principle that such expenses should be allocated pro rata to the proportions in which the underlying business from which they are derived was allocated as between the NWPSF/RIEESA and the OWPSF.

The policyholder advocate is satisfied that the allocation of liabilities as between the OWPSF on the one hand and the other funds of AVLAP (including the NWPSF and RIEESA) is appropriate except that:

- She does not (for reasons discussed in Appendices 25, Legal issues arising in respect of Rights and Interests in and Uses of The Inherited Estates and 26, FSA guidance letters and responses) consider that it is appropriate that any misselling liability should be borne by the OWPSF inherited estates, nor does she think it appropriate that the OWPSF inherited estates bear the cost of the additional shareholder tax payable when distributions are made to the shareholders' fund of its 10% share of profits. The policyholder advocate sought guidance from the FSA on its rules in these areas and the FSA confirmed that such uses of the inherited estates were consistent with its rules (see Appendix 26). To the extent that the FSA rules continue to allow the inherited estates to be used for these purposes, she is satisfied that the liabilities have been properly allocated as between the OWPSF and the NWPSF and RIEESA.
- The allocation of misselling liabilities to the OWPSF is expressly subject to FSA rules from time to time. The ability to charge shareholder tax (as referred to above) is not. Aviva has the right to make changes to the relevant provisions of the Scheme in the event of changes in law or regulation but no obligation to do so. The policyholder advocate is concerned that under the Scheme the Old WPSF policyholders could not be sure that they would benefit from such a change. She has discussed this with the FSA who have confirmed that:
  - (a) they do not in any way intend for an exception to be made to the general principle of non detriment to non electors;
  - (b) the Scheme does not in any way override future rule changes and if the rules were to change in the future they would expect Aviva to comply with them unless they had applied for and been granted a waiver; and
  - (c) to achieve a waiver, Aviva would need to satisfy FSA that (amongst other things) non-electing policyholders would be treated fairly if they

were deprived of the benefit of the rule change, something that would on the face of things be very difficult for Aviva to demonstrate.

- The policyholder advocate believes that policyholders should take considerable comfort from these confirmations, but the principle has been agreed with the FSA that non-electors should be expected to be in no worse a position as a result of the Scheme. If it is not clear that non-electors will benefit from any change in FSA rules then one cannot be certain that non-electors will not be negatively affected by the Scheme. She therefore continues to believe that, as with misselling, the ability to apply the estate to pay shareholder tax should be made expressly subject to FSA rules from time to time.

### **3.05. Future Operation of the OWPSF, NWPSF and RIEESA**

Chapter 5 and Schedule 4 of the Scheme set out the principal provisions which will govern the management of the OWPSF, NWPSF and RIEESA. The policyholder advocate's views on these are contained in:-

Appendix 29B as regards the future approach to Investment Policy, Smoothing and Bonus Policy. In general the policyholder advocate is content with these, subject to the question of strategic investments (including loans to and investments in other Aviva group companies) being made by the OWPSF

Appendix 32B, 'The Position of Non-Electing Policyholders', as regards the uses to which the inherited estate in the OWPSF can be put and the extent to which new business (of any category) can be written (whether directly or by way of actual or notional re-insurance) in the OWPSF, the NWPSF or the RIEESA. The policyholder advocate objects to some uses of the inherited estate, although she acknowledges that these are in accordance with current FSA rules.

Appendix 17B, 'The Actuarial Function Holder's Report' as regards the manner in which the RIEESA and OWPSF inherited estate assets may be invested, and the rules governing how financial support is to be provided between sub-funds, when distributions from the OWPSF

inherited estate assets are required or permissible, and when distributions from the RIEESA are permitted. She is broadly content with these, subject to the question of strategic investments (including loans to and investments in other Aviva group companies) being made by the OWPSF; and

Appendix 30B, `With-Profits Governance Arrangements`, as regards the governance arrangements for the OWPSF and NWPSF, with which she is broadly content.

Chapter 6 and Schedule 8 contain the provisions for the calculation and distribution of excess surplus (see Appendix 28B `Policyholders` Future Security and Risk Appetite`, for the policyholder advocate`s views on this).

Chapter 8 deals with the merger of the OWPSF and the NWPSF, and the policyholder advocate is content with those provisions, which can only come into effect after all transferring policyholders have ceased to be policyholders.

There are certain additional reservations that the policyholder advocate has about the Scheme that are not covered by other appendices.

- (1) paragraph 2.A.9 of Schedule 4 to the Scheme provides that where a policy being proposed for adoption in the management of the With-Profits business would result in a material benefit to shareholders (excluding any policy the adoption of which the AVLAP Board considers necessary in order to treat customers fairly) which shareholder benefit, in the reasonable opinion of the AVLAP Board, would not have resulted from the adoption of the policy had the Scheme not been implemented, the consent of the With-Profits Committee will be required to adopt the policy. The policyholder advocate considers that the WPC should always be involved before there is the adoption of a policy which results in a material benefit to shareholders, given the obvious conflict of interest;
- (2) Paragraph 5 of part 4 of Schedule 4 provides that, notwithstanding any requirement in the various relevant documents for the review, confirmation or

approval of the WPC to any aspect of the management of the OWPSF or the NWPSF, such review, confirmation or approval shall not be required where the management aspect in question is permitted or is the exercise of any right or option under (i) any contract or arrangement existing as at the effective date; or (ii) under any contract or arrangement, the agreement to which by AVLAP, has itself been approved by the WPC except for any renewal, replacement or amendment thereof unless the basis for such renewal, replacement or amendment is specified in the contract or arrangement. The policyholder advocate has been assured by Aviva that the only relevant provisions of which they are aware at today's date are the management services agreement with Swiss Re and the various internal reinsurance arrangements that will be replicated under the terms of the Scheme. Given that this provision is effectively an exception to all of the protective mechanisms in the Scheme, the policyholder advocate considers that Aviva should limit its applicability to these two categories of existing arrangement, and not reserve the right to discover others at a later date.

- (3) the Scheme expressly provides for the possibility of industry levies being charged to policyholders' asset shares, if the board considers it appropriate to do so, and subject to the overriding requirement to treat policyholders fairly. In contrast to the position for other new charges to asset shares, WPC approval is not required. Aviva's position is that the payment of industry levies could raise a financial security issue for the company, and therefore does not think it is appropriate for the WPC to have a veto. It also notes that the WPC will have a whistle-blowing right if it considers the charges or allocation of charges are unfair. The policyholder advocate's view is that this, along with any other charges to asset shares, should be subject to WPC approval

## **Annex 1**

Annexe 1: contains correspondence between the policyholder advocate and the FSA about certain aspects of the Scheme that are of concern to the policyholder advocate. The policyholder advocate's letter of the 13 March identified the relevant aspects of the Scheme and asked the FSA whether it considered that any of them merited further discussion as part of the FSA's fairness review. The FSA responded on the 25 March indicating that the FSA did not think there was anything in the policyholder advocate's letter which would cause the FSA to change their view of the Scheme.

**Confidential**

Philip Salter  
The Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

13<sup>th</sup> March, 2009

Dixon House  
No1 Lloyd's Avenue  
London EC3N 3DH

T +44(0) 20 7662 2618  
F +44(0) 20 7662 0606

Email@policyholderadvocate.org  
www.policyholderadvocate.org

**By Post and Email**

Dear Philip,

As you know we have been reviewing and commenting on successive drafts of the Scheme as it has developed. Some changes that we have asked for have been accepted, others not. I should confirm that I am in general comfortable that the Scheme provides appropriate safeguards for policyholders (given the current regulatory framework) and am glad (subject to an important point below) that it now allows for changes in the future in line with that framework. However, it has always been my intention that my report (or an appendix) should identify any aspects of the Scheme which I considered to be unsatisfactory and worthy of comment. I thought I should identify these for you at this stage, in case you feel that any of these merited further discussion as part of your fairness review.

The first provision that we have problems with is clause 5.6.2 of the Scheme. We understand and appreciate that the independent expert's scrutiny of the Scheme (and yours, no doubt) has focused on the particular conflict issues around the operation of the NWPSF and the RIEESA. However, occasionally this focus has somewhat anomalous effects. Here is an obvious example. There seems to be no good reason why a lower level of governance should apply to reinsurance out to other sub-funds of NULAP from the OWPSF, as distinct to the NWPSF. NU's justification is that the level of governance is still high, and the difference in treatment of the OWPSF and the NWPSF is because the position in relation to the OWPSF reflects the status quo, that COBS and TCF are still applicable, and

that they have conceded enhanced governance restrictions as it relates to NWPSF because the reinsurance out of the NWPSF creates a much starker conflict because of its relationship with the RIEESA. We still consider that it is anomalous that this one type of insider transaction involving OWPSF should not enjoy the same degree of governance protection as it would have if the reinsurance out were to another Aviva group company as distinct from another NULAP fund.

The second provision to draw your attention to is clause 5.7.15, as to which there are two aspects:

(a) previous versions of this clause had included Part 2 B of schedule 4 as one of the unchangeable provisions of the schedule. The reason why this was removed was to allow the necessary changes to the shareholder tax provisions in Part 2 B should the relevant COBS rule change. But Part 2 B also contains the basic 90/10 rule. I am a little alarmed that this provision can in theory now be changed, to the detriment of policyholders. I think that my concerns on this would be dealt with if you were to confirm that you cannot envisage circumstances in which you might grant the necessary consent to change the 90/10 ratio (at least as it relates to the then policyholders); and

(b) conversely, you will see that 5.7.15 is written in permissive terms, allowing Aviva to make adjustments to Schedule 4 as appropriate or necessary to allow for (inter alios) changes in law or regulation. I would much prefer that there be a positive requirement on them to make such changes in response to regulation change, but (subject to the tax point referred to below) can take sufficient practical comfort from my perspective if you could confirm that it would be your intention to require Aviva to make the necessary changes to Schedule 4 to respond to any change in your regulations as regards (in particular) the liabilities and charges that can be paid out of the inherited estate. In this context I think it is very important for non-electors in particular that the fact that the Scheme governs their rights and interests can never be a reason why they do not get the benefit of rule changes, which they would have enjoyed in the absence of a reattribution.

I should add that I am unhappy that Aviva's agreement that future rule changes in relation to shareholder tax should benefit transferring policyholders has not been adequately documented. It seems to me that an express cross reference to "applicable regulation" should be included in para 2.B

1 of Schedule 4. This would also ensure that the COBS prohibition on charging shareholder tax to asset shares is applicable and not over-ridden by the Scheme. Aviva's advisers take the view that if any future rule change “grandfathers” provisions in court schemes, they should be allowed to take advantage of it. I disagree with this. They also take the view that the COBS restriction could only be over-ridden if the wording in the Scheme were absolutely specific that asset shares could be charged (given the restriction on asset share charges of a type not currently being made). In general it seems to me that if everyone agrees that the intention is that tax should only be deducted if and to the extent permitted by applicable regulations from time to time, it would be a lot simpler for everyone (and particularly future FSA supervisors) if the relevant provisions actually said that.

Next I should mention clauses 5.12 and 5.13. These are quite difficult to decipher, but both NU and we are agreed that their overall effect is that certain “intra-group” transactions and investments are subject to “arms-length commercial terms” requirements; certain are subject to something like that (“no less favourable than if made to a non-Aviva group company”); certain are subject to neither; certain are subject to express WPC involvement and certain are not. It seems to me that all transactions of the type referred to in these clauses are particularly conflict sensitive; and that one would expect that they should be on arms length terms and subject to oversight by WPC. NU’s response is that these clauses reflect the status quo and are intended to maintain the position imposed in past schemes which predated the current COBS and the TCF principle, and that COBS and TCF are in any event applicable to many of these transactions.

Paragraph 2 A 9 of Schedule 4 has always caused us some difficulty, as it seems to us that any change in management policy that is specifically to the benefit of shareholders should be the subject of specific consent of WPC, irrespective of (a) whether such a benefit would have been applicable absent the Scheme; or (b) whether the board has concluded that such a change is necessary for TCF. NU feel that the directors should always have the final word on TCF, and that WPC will be free to review any such change, comment on it and if they think fit to whistle blow to FSA. I am concerned that WPC will justifiably feel bolder about this where it has a specific role as described in the Scheme, and less so where it does not; added to which, there is no guarantee that WPC would ever find out about this sort of change in policy.

You will note that para 4.5 of schedule 4 “grandfathers” any arrangements or agreements that are in force on the Effective Date and which would otherwise be a breach of the restrictions in the Scheme. We have asked for some comfort from NU that with the exception of the Management Services Agreement, the investment management arrangements, options or rights attaching to specific investments and the internal reinsurance arrangements, there are no other items caught by para 4.5. NU is reluctant to give this assurance, as they are not certain that it is the case. My position on this is that if they cannot bring to mind anything else, they should just accept that it is unlikely to be very important, and so they should just accept that it cannot be a continuing exception to the Scheme protections.

I should also draw your attention to Schedule 4 para 4.7. The “whistle blowing right” of the WPC is here drawn quite narrowly, and in particular is limited to breaches of the Scheme. I have been pressing for the broader rights now contained in the terms of reference for the WPC to be incorporated here in the Scheme. NU’s view is that the Scheme is not intended to replicate the terms of reference. That raises the possibility that at some point in the future the broader step-in rights of the WPC will be curtailed.

Finally, I should bring a new issue to your attention.

We have recently been alerted to the fact that further changes are proposed for the provisions in Schedule 2 with respect to the inter-play between the BSF adjustment and the OWPSF Bonus Amount (OBA). We found these changes rather puzzling, because it seemed to us that there would be no BSF adjustment at all if there had also been a VPDP adjustment (otherwise the prohibition on any BSF adjustment that reduces VPDP would be breached); and that since the OBA provisions should only be triggered if there has been a VPDP top up of the OWPSF from the RIEESA, there could never be the inter-reaction between BSF adjustment and OBA that the new arrangements envisaged.

However, Aviva's response on this has been to say that the OBA adjustment is NOT limited to situations where there has been a VPDP top up. So if an unexpected pattern of elections occurs and



this leaves the Old fund above AAA (after any BSF adjustment) they can defer the distribution of this by setting aside an OBA. This is certainly a new idea for us, as the OBA concept was always part of the VPDP adjustment proposals, and it had never occurred to us that Aviva thought otherwise (indeed the language explaining the approach to be taken on distribution of the OBA seems to make the linkage between OBA and VPDP adjustment clear)

Your team was, I know, influential in Aviva's decision to offer the VPDP adjustment as a means of ensuring so far as practicable that policyholders who chose not to accept the PIP were so far as practicable unaffected by the reattribution proposal. I would imagine that, like my team, you saw the OBA adjustment as a proportionate response to an unintended and arguably distorting impact of the VPDP top-up. I should be interested to know whether you consider that an OBA adjustment should be permitted absent a VPDP top up.

There are a few other outstanding issues that I think are agreed but where we wait to see revised drafting in the Scheme or the AFH report. These relate to (a) allocation of non-policy specific expenses that are incurred post effective date; (b) allocation of carried forward capital losses; and (c) ensuring that the formulas in schedule 3 are adjusted to ensure that they do indeed deliver an aggregate sum that is the agreed aggregate minimum PIP. We are comfortable that the adjustment formula works provided the minimum PIP allocation actually distributes the full £500 million

I would be very happy to discuss any of these issues further with you. I think that most of them have been around for some time now, but I thought it right that FSA should have a final look at them before we finalise our comments.

Yours sincerely,



Clare Spottiswoode CBE

From: Catherine Beech [mailto:Catherine.Beech@fsa.gov.uk]  
Sent: 25 March 2009 10:20  
To: eileen Marshall; Clare Spottiswoode; Philip Salter; FSA Supervision - Aviva Group  
Cc: Mandy Homer; Team Secretary; philip.richards@freshfields.com; Jenny Khosla  
Subject: RE: 090323\_newversion41\_reorder.pdf

Eileen,

We have looked at Clare's letter of 13<sup>th</sup>. We did not think there was anything in the letter which would cause us to change our view of the scheme, and we will pick up the points in her letter as necessary as we review the detailed documentation. We had understood that Clare did not require a response in order to complete her response to the offer – could you let me know if that is not the case?

Regards

Catherine Beech  
Major Retail Groups Division

020 7066 1602  
catherine.beech@fsa.gov.uk