

Appendix 17 B

The Actuarial Function Holder's report

A report for 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 and Summary

1.01 Context

This appendix has been prepared by KPMG LLP for the policyholder advocate in response to the conclusions of the actuarial function holder's (AFH) report. Whilst we have done our best within this appendix to explain technical terms and concepts, it remains the case that this is a technical report intended for readers who have some familiarity with the concepts involved.

Deloitte, the tax advisers to the policyholder advocate, are dealing separately on any tax issues and these are not repeated here.

The policyholder advocate has commented in appendices 26 ("FSA guidance letters and responses") and 39 ("Impact of FSA guidance on policyholders") on the FSA rules as they stand at the time of writing this appendix, and the views as expressed by the policyholder advocate in these appendices have not been repeated here. The AFH is working within the FSA framework and our comments similarly take the current FSA rules as given. Our comments in this appendix do not therefore extend to any views held by the policyholder advocate in relation to the FSA rules. The rules are fundamental to the way in which the estate is used and who benefits from the estate, and therefore if the rules were different there may have been very different outcomes.

1.02 Background

With effect from 31 December 2004, it became a statutory requirement for a life insurance company transacting long-term business to have an AFH, and for a company transacting with-profits business to have also a with-profits actuary (WPA). The AFH's main responsibility is to advise the firm's management on the risks being run by the firm and the capital required to support the business. This includes advice on the methods and assumptions underpinning the firm's solvency calculations.

Under FSA guidance (SUP 18.2.58G), the affidavit evidence to the Court in relation to a transfer of business would normally include a report on the transfer by the AFH which

should be provided to the FSA at an early stage. We note that, and that the AFH report is not a mandatory requirement, but, as described below, it is effectively part of the Scheme in this case.

The role of the AFH is different from that of the WPA. The WPA is responsible for commenting on the application of discretion by the life company's management as it relates to the benefits of with-profits policyholders. In the context of the reattribution this involves looking at investment policy, bonus policy (including smoothing), risk appetite, and expense and tax apportionment. The WPA needs to consider whether the treatment of with-profits policyholders is fair between different groups of policyholders and between the shareholders and policyholders, and we cover this further in appendix 18 B ("The With Profits Actuary's report"). The AFH will need to consider the obligations to with-profits policyholders as well, but primarily from the point of view of the life assurer being able to meet the obligations to those policyholders now and in the future.

The Scheme refers to the AFH report for further details in a number of areas which we consider in section 4 below. We note that this makes the AFH report particularly important as it effectively becomes an appendix to the Scheme.

1.03 Requirements of GN40

Guidance Note 40 (GN40) is adopted by the Board for Actuarial Standards. It sets out guidelines for the role of the AFH, but does not specifically cover the role of the AFH in a transfer of business situation. GN40 will nevertheless be relevant to the post Scheme running of the business and is therefore relevant. As noted above, the AFH's main responsibility is to advise the firm's management on the risks being run by the firm and the capital required to support the business, and, in particular, the AFH is concerned with ensuring the firm has enough capital to cover its liabilities to policyholders in relation to the policyholders' benefits under their policies.

The following extract is from section 4.6 (***The firm's ability to meet liabilities to policyholders***) of GN40:

“When a material change is likely to take place in the firm’s business plans, practices or other circumstances, the actuarial function holder must take all reasonable steps to ensure that the firm appreciates the implications for fairness and the reasonable expectations of its policyholders. The actuarial function holder must also satisfy himself or herself that systems of control are in place intended to ensure that the firm’s policyholders are not misled as to their expectations. If the actuarial function holder believes that the systems of control may not be adequate, he or she must draw this to the attention of the firm, and must advise the governing body unless sufficient steps are otherwise taken to meet his or her concerns.”

The above guidance is clearly relevant to the transfer of business and reattribution, although it should be noted that the AFH role is an advisory one and that the main intent of the above is to ensure that the firm has sufficient capital available to meet policyholders’ reasonable expectations. In addition, the AFH should satisfy himself that the policyholders have not been misled about their expectations. The FSA rules require that excess capital in a with-profits fund is distributed to the policyholders of the fund. In a reattribution situation the judgements made around the potential amount of future excess surplus are important. This is also discussed further in appendix 18 B (“The With Profits Actuary's report”).

1.04 Purpose of this report

It is not a part of the policyholder advocate’s role to comment on the views expressed by the AFH. However, since the AFH report forms a key part of the Scheme and considers the benefit security of policyholders, the policyholder advocate has requested that KPMG consider the views expressed by the AFH in his report.

We have commented on the conclusions made by the AFH in his report, we also comment on other areas which are covered by the AFH report and which we consider relevant to policyholders’ benefits, finally we have considered all the areas where the Scheme relies on the AFH report for more detail, and we comment on the detail as set out in the AFH report.

1.05 The role of the AFH with regards to the re-attribution of the inherited estates of the CGNU Life and CULAC with-profits funds

Although in general, the role of the AFH is of an advisory nature, because the Scheme relies on the AFH report in a number of areas, it becomes a requirement for management to comply with certain statements made in the AFH report.

The primary role of the AFH is to consider whether the obligations to policyholders can be met now and in the future, whilst ensuring that the company appreciates the implications for fairness and the reasonable expectations of its policyholders.

1.06 Structure of this appendix

Section 1.07 sets out a summary of the key areas of the AFH report, and section 1.08 summarises any areas where we have specific comments on the AFH report. Section 2 gives KPMG's views on the conclusions made in the AFH report. In Section 3, we bring out other points which have not formed part of the AFH's conclusions, but on which we have views. Section 4 goes on to discuss areas where the AFH report effectively forms a part of the Scheme in that it provides further information on which the Scheme relies. The annex to this appendix sets out the references to the AFH report which appear in the Scheme.

1.07 Summary of the key areas of the AFH report on the Scheme

The AFH report is addressed to the Directors of CGNU Life, CULAC, AVLAP and NUL(RBS). A summary of the terms of the Scheme on which the report is based is given in Appendices 1 and 2 of the AFH report.

The AFH report (paragraph 1.5) states that the objective of the report is to consider the following:

- *“the effect of the Scheme’s proposals on the benefit security of policyholders of CGNU Life, CULAC, NUL(RBS) and [AVLAP];*

- *the effect of the Scheme on the fair treatment of non-profit policyholders of CGNU Life, CULAC and [AVLAP], including their reasonable benefit expectations;*
- *whether it is likely to be in the interests of holders of Eligible Policies to elect; and*
- *whether or not the holders of Non-Elected Policies are treated fairly in relation to their interests in future distributions from the Inherited Estates.”*

(holders of eligible policyholders are being asked to elect whether to accept the incentive payment. Non-Elected Policies are policies in respect of which the holder is offered an incentive payment but does not accept it.)

We agree with these objectives and note that the AFH’s conclusions, based on the financial position at 31 December 2008 and current FSA rules, set out in bold in the summary (Section 2 of the AFH report) are as follows:

- *“the effect of merging the CGNU Life and CULAC With-Profits Funds will be unlikely to have a material impact on the benefit security for policyholders in either fund;*
- *the benefit security for [AVLAP] policyholders will be increased as a consequence of the transfer;*
- *the transfers will not have any material adverse effect on the benefit security for the Transferred Policies or the with-profits policies of NUIL^[1];*
- *the reattribution proposals will not have a material adverse effect on the benefit security for the Transferred Policies, the with-profits policies of NUIL and the existing policies of [AVLAP];”*

¹ With-profits policies of NUIL are currently reassured to CGNU Life and CULAC. Following implementation of the Scheme such policies will be reassured to AVLAP.

- *“The initial allocation of the Inherited Estates under the reattribution is expected to preserve the collective contingent interest of holders of Non Elected Policies and the Old WPSF Proportion of Pipeline Policies in the Inherited Estate;*
- *it seems likely that in nearly all cases it will be in the financial interests of eligible policyholders to elect. Even in cases where the projected value of potential future distributions from the Inherited Estate of the Old WPSF exceeds the value of the PIP, an election will result in the certainty and immediacy of the PIP rather than the uncertainty of Inherited Estate distributions that might be made a number of years into the future to holders of with-profits policies then invested in the Old WPSF using an allocation basis to be decided at that time;*
- *based on the above conclusions, the respective Boards would be fully justified in making a recommendation to eligible policyholders that they elect to accept the PIP offered to them;*
- *the basis of allocation of a proportion of the combined Inherited Estates of CGNU Life and CULAC to the Old WPSF (after allowing for the effect, if any, of the VPDP Adjustment and the Effective Date BSF Test) is sufficient to ensure that in relation to their interests in potential future distributions from those Inherited Estates and their future benefit security, the holders of Non Elected Policies are treated fairly;”*

We note that in section 7.6.11 the AFH states *“that, taken collectively, the PIP offered to eligible policyholders substantially exceeds the contingent interest in future distributions from the inherited estate that they would be giving up by electing (based on the assumptions used in the projections) and that although the investment strategy for the inherited estate has changed since the original calculations were carried out (so that the EBR [equity backing ratio] is now less than that for assets backing the with-profits benefit reserves) and the policy data has not been updated since the initial*

negotiations took place, further testing has shown that the above conclusion would remain valid if the calculations were to be carried out at the present time.”

- *“it is likely to be many years before a merger of the New WPSF and the Old WPSF can take place under the terms of the Scheme, but that there is no reason why a merger should not take place once there are no longer any transferred policies left in force (other than Stakeholder Pension policies) invested in with-profits, or retaining the option to invest in with-profits. I [the AFH], also conclude that the security for policyholder benefits will continue to be adequately protected following such a merger;”*
- *“..the Scheme will have no material adverse impact on the expected benefits of holders of non-profit policies in the Transferor Companies and [AVLAP] and that the Scheme will have no impact on the fair treatment of such policyholders;”*
- *“..the proposed financing arrangements for the Policyholder Incentive Payments will have no material adverse impact on benefit security for the existing policyholders of [AVLAP] and the holders of Transferred Policies.”*

In the event that the Alternative Scheme is implemented:

- *“the effect of merging the CGNU Life and CULAC With-Profits Funds is unlikely to have a material impact on the benefit security for policyholders in either fund;*
- *the benefit security for [AVLAP] policyholders will be increased as a consequence of the transfer;*
- *the transfers will not have any material adverse effect on the benefit security for the Transferred Policies or the with-profits policies of NUIL;*
- *there will be no material adverse impact on the expected benefits of holders of non-profit policies in the Transferor Companies and [AVLAP]*

and that the Alternative Scheme will have no impact on the fair treatment of such policyholders.”

The main body of the AFH report provides background to the rationale for the proposed Scheme, along with a description of the current structure and operation of the Funds of the companies involved in the Scheme. The report also considers the proposed structure and operation of the Funds of AVLAP after the Scheme takes effect, as well as the impact on benefit security of merging the CGNU Life and CULAC With-Profits Funds and the effect of the Scheme on the benefit security for existing policyholders of AVLAP and the Transferring Policyholders. The report goes on to consider the management of the inherited estates and the prospects for future distributions from the inherited estates. The AFH report then considers whether the PIP offered to eligible policyholders should be considered to be attractive to them and whether the allocation of the transferred inherited estates is fair, as well as the financing arrangements for the PIP and any implications those arrangements may have for the security of guaranteed benefits. Consideration is also given to the fair treatment of holders of non-profit policies including their reasonable benefit expectations. The Alternative Scheme is also considered.

Importantly, the AFH report provides further detail on how the Scheme provisions will be implemented on the Effective Date (that is, the date when the reattribution takes effect) and the ongoing management of the transferred business after the Effective Date.

We note that further conclusions are made throughout the body of the report and these are detailed below:

Section 6.5.8:

“Given the currently acceptable financial position of the Non-Profit Sub-Funds on a realistic basis at 31 December 2008 as measured by the Pillar 2 assessment, the internal targets and ongoing monitoring carried out in connection with the capital planning and adverse scenario testing, I am satisfied that the risks to Transferring Policies arising from the business of the Non-Profit Sub-Funds are not significant.”

Section 6.5.16

“Given the current financial position of the fund at 31 December 2008, the review arrangements, the actions already taken by the [AVLAP] Board and their ongoing responsibilities under PRIN 2.1.1 (particularly Principle 3 (Management and Control) and Principle 4 (Financial Prudence)), I am satisfied that the risks to Transferring Policies arising from the business of the [AVLAP] WPSF are not significant.”

Sections 6.5.21 & 22

“Given the current financial position of the fund at 31 December 2008 and the capital resources that are available in the Non-Profit Sub-Funds and Shareholder Fund, I am satisfied that the risks to Transferring Policies arising from the business of the PM Sub-Fund are not significant.”

“Taking account of the risks arising from policies allocated to the Non-Profit Sub-Funds, the [AVLAP]WPSF and the PM Sub-Fund, I do not believe that the transfer of the long term business of the Transferor Companies into [AVLAP] will have any material adverse effect on the benefit security for the Transferred Policies. This conclusion applies also to the with-profits policies of NUIL whose benefits are currently wholly reinsured to CGNU Life and CULAC, and from the Effective Date will be wholly reinsured to the New WPSF and the Old WPSF.”

Section 6.6.10:

“Having regard to the constraints and governance provisions above, I am satisfied that the Remaining Assets of the New WPSF and of the Old WPSF will not be invested in a manner that will have a material adverse effect on their ability to provide benefit security to the Transferred Policies, the with-profits policies of NUIL and the existing policies of [AVLAP].”

Section 6.6.22:

“Having regard to the considerations above I am satisfied that the limitations on the exercise of management discretion will not have a material adverse effect on benefit security.”

Section 7.4.5

“The respective Boards made a commitment to distribute £2,363m from the combined Inherited Estates of CGNU Life and CULAC at 1 January 2008 by means of a Deferred Special Bonus to DSB Policyholders as described in Paragraph 5.14.97 above. A distribution at this level was consistent with the Risk Appetite Framework only after taking into account the de-risking strategy and it gave rise to a level of surplus that was around middle of the preferred range at 31 December 2007. The With-Profits Actuary confirmed that a distribution of this amount fell within a range that he considered to be reasonable and it was my view such a distribution, taken together with the agreed de-risking strategy, would not have a material adverse effect on benefit security.”

Section 7.7.12

“The requirements relating to future transfers of surplus from the Non-Profit Sub-Funds and future distributions from the New WPSF once there are no transferred policies (other than Stakeholder pension policies) invested in with-profits, or retaining the option to invest in with-profits, as described in Paragraph 7.7.9 above, are in my view appropriate for the normal operation of a With-Profits Sub-Fund and they should ensure that an adequate level of security is maintained for policyholder benefits.”

1.08 Summary of areas where KPMG has specific comments on the AFH report

Sections 2 and 3 of this appendix discuss key areas of the AFH report. This section lists any specific comments we have on or where we disagree with, conclusions made by the AFH, and details of our reasoning can be found in section 3:

- we note that the power to allocate some or all of future industry levies to asset shares has been introduced, and is solely for the Board to determine.

There is no power of veto from the WPC on the charging of these levies to asset shares. Although we have been told that the PPFM for the old with profit sub fund (Old WPSF) and the new with profit sub fund (New WPSF) and the Independent Expert's report will discuss how the WPC needs to be made aware of, and consulted on, such levies being charged to asset shares, and that the Board will properly consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies, we would have expected this important area of governance to be set out in the Scheme or the AFH report. Importantly, it would in our view be more appropriate for this power to be subject to the WPC approval process;

- strategic assets – we do not agree that the remaining assets of the Old WPSF should be invested in any form of strategic asset;
- the AVLAP Board will retain the right to change the basis of allocation of single premium increments and switches on eligible with-profits policyholders in the future so that they are allocated to the New WPSF with proportional reinsurance to the Old WPSF. We believe that the AFH should recommend that the With-Profits Committee (WPC) be required to approve such a decision; currently they are not.
- we believe that the timing and manner of the distribution of any potential “Old WPSF Bonus Amount” should be set out clearly in the Scheme, rather than being at the discretion of the AVLAP Board with the approval of the WPC.

2.00 KPMG's view of the AFH's Conclusions

In this section we comment on the conclusions and the basis for these conclusions of the AFH report set out in section 1.07 above.

As a general point, there are a number of times where the AFH report states that policyholders would not be “materially adversely affected”. We understand that it is not

always possible to be totally definitive, but nevertheless we would prefer the AFH give some indication of the degree of materiality he has in mind. We do however note that in a number of cases, the AFH has performed calculations under a number of scenarios to test the impact of the Scheme and bases his conclusions on the results of these outputs. In these cases it should be possible for the AFH to provide more clarity on the likelihood of there being any impact on policyholders.

Our reading of the AFH report, along with the Scheme, has led us to conclude that the AFH has carefully considered all aspects of benefit security for all policyholders, including the non-profit policyholders. He has done so for all situations, including for example, post merger of the New WPSF and the Old WPSF, and also in the situation that the Alternative Scheme is in place (that is, where the reattribution does not go ahead but the fund transfer and merger of the with-profits funds of CGNU and CULAC still takes place). Subject to the point referred to immediately below, we have no comments to make on his conclusions in these areas.

The AFH states that:

- *“the effect of merging the CGNU Life and CULAC With-Profits Funds will be unlikely to have a material impact on the benefit security for policyholders in either fund;*
- *the benefit security of the existing [AVLAP] policyholders will be increased as a consequence of the transfer;”*

In order for these statements to be simultaneously valid, the increase in the security of the AVLAP policyholders must be immaterial in the context of the CGNU Life and CULAC with-profits funds. The AFH has considered the benefit security of the funds by looking at the outputs of stochastic modelling, and to put this into context we have set out below the financial position of the With Profit Funds at 31 December 2008. The percentages at the bottom of the table show that, although there is some difference in the level of excess assets as defined by the realistic balance sheets (RBSs), the difference is not significant.

With-Profits Funds	CGNU Life	CULAC	AVLAP WPSF
Regulatory Peak	£m	£m	£m
Regulatory Assets (A)	13,675	13,076	22,405
Regulatory Liabilities (B)	12,312	11,541	19,646
Long Term Insurance and Resilience Capital Requirements (C)	585	417	675
Regulatory Excess Capital (C=A-B-C)	778	1,118	2,084
Realistic Peak	£m	£m	£m
Realistic Assets (D)	14,229	13,609	22,549
Realistic Liabilities (E)	13,464	12,845	21,382
Inherited Estate (Working Capital) (F=D-E)	765	764	1,167
Risk Capital Margin (G)	393	377	635
Realistic Excess Capital (H=F-G)	372	387	532
Cover for RCM (=F/G)	195%	203%	184%

Source Table 2 of appendix 3 to the AFH report

We have not had access to the results of further stress tests on the funds, but understand that the AVLAP WPSF is the weakest financially of the three funds under such stresses as at 31 December 2008. The Independent Expert has considered this issue in detail and has had access to results the further stress testing. The Independent Expert has not raised any concerns in this area. We have not repeated this work.

Analysis carried out by the policyholder advocate agrees with the AFH conclusion that, given the current FSA rules, for a significant majority it will be in the financial interests of eligible policyholders to elect to receive their offered incentive payment (see appendix 45 “Formulation of guidance to policyholders”). However, we would add that there will be cases where the estimated value of potential future special distributions which might arise in the absence of the reattribution is greater than the value of the offered PIP (see appendix 43 “Allocation of the aggregate PIP between policyholders”), although it is not possible to advise policyholders at such an individual level, the policyholder advocate has considered policyholders at a group level. This is not a comment on the actual degree of fairness of the PIP offer which would not only take into account a comparison with

policyholder's potential benefits forgone, but would also take account of any potential gain made by shareholders. The FSA is to comment on fairness to the High Court.

The AFH concludes, based on the results from projections carried out as at 31 December 2006, that in most cases the value of potential distributions to holders of with-profit policies is considerably less than the offered PIP. In other words the PIP substantially exceeds the value placed on potential future distributions from the inherited estate by Aviva. We have not reviewed these Aviva calculations, but confirm that, based on the policyholder advocate's base case with Aviva new business assumptions, the policyholder advocate's calculations in this respect are consistent with this conclusion. We note that the calculations and assumptions will be out of date by the time the Effective Date is reached. The impact of this has been considered by the AFH in his report and he concludes that there is no material impact on the results from these calculations being out of date. The policyholder advocate has requested that the data and assumptions used to generate the model output provided to the policyholder advocate are updated before the court hearing to assess whether her advice to policyholder is affected.

The AFH concludes that the basis of allocation of a proportion of the combined inherited estates of CGNU Life and CULAC to the Old WPSF (after allowing for the effect of any adjustment required to ensure that the value of potential special distributions to holders of Old WPSF with-profits policies is broadly preserved² and any adjustment required as a result of applying the Effective Date Benefit Security Factor (BSF) Test³) is sufficient to ensure that, in relation to their interests in potential future distributions from those inherited estates and their future benefit security, the holders of with-profits policies allocated (or reassured, to the extent that such policies are reassured) to the Old WPSF on the Effective Date are treated fairly. Broadly, consideration of "fairness" in this respect is determined by considering both the benefit security of policyholders and how the value of potential future special distributions to holders of Old WPSF with-profits policies compares immediately pre and post reattribution, making various assumptions with

² Which may result in a transfer of assets from the RIEESA to the Old WPSF.

³ Which may result in a contingent loan of assets from the Old WPSF to the RIEESA.

respect to future economic outcomes and new business. Given that any transfer of funds from the Old WPSF to the RIEESA as a result of applying the Effective Date Benefit Security Factor Test will be restricted to the extent that it would otherwise reduce the value of potential future special distributions to holders of Old WPSF policies determined on the Effective Date as specified in the Scheme, and will be in the form of a contingent loan (see below) to be repaid, we see no reason to disagree with his conclusions. In addition, the AFH concludes that the initial allocation of the inherited estates under the reattribution is expected to preserve the collective contingent interest of holders of Non Elected Policies and the Old WPSF Proportion of Pipeline Policies in the inherited estate. Given the work that has been done to assess whether any additional assets should be transferred to maintain the interest in the inherited estate, we agree with this conclusion.

We note that the calculation to determine the security of the Old WPSF and New WPSF assumes capital support would be available from the RIEESA to the Old WPSF in accordance with the Scheme. The result of this is that it is only possible for funds to be required to be transferred from the Old WPSF to the RIEESA, as a result of applying the Effective Date Benefit Security Test, and not from the RIEESA to the Old WPSF. Due to this being a one way test, Aviva has decided that any funds transferred would be in the form of a loan which must be repaid back to the Old WPSF in full, subject to the New WPSF being sufficiently capitalised and in any case before any distribution of the RIEESA to shareholders is permitted. We are comfortable with this approach.

The AFH has considered the governance around the writing of new non-profit business in the Non-Profit Sub-Funds and has concluded that the risks to Transferring Policies arising from the business of the Non-Profit Sub-Funds will not be significant. We believe that the AFH has considered this issue fully and have no reason to disagree with his conclusions.

The AFH report explains how under the Scheme two new sub-funds of its long term fund, the Old WPSF and the New WPSF, will be created in AVLAP. This means that policyholders of CGNU and CULAC will be in the same overall long term business fund as existing policyholders of AVLAP. The AFH concludes that the risks to Transferring

Policies arising from the existing business of AVLAP are not significant and vice versa, and he has considered this under a number of extreme scenarios. We see no reason to disagree with his conclusions that the risks are not significant nor with his conclusions around the benefit security of all policyholders involved. The AFH has reviewed his conclusions in the light of the current economic situation. The AFH report notes that stress tests carried out at 31 December 2008 allowing for a further substantial fall in investment markets show that the AVLAP WPSF can meet its Pillar 1 capital requirements in such a scenario, but this was not the case for its Pillar 2 capital requirements. Given the current economic climate, we are not surprised by this result and note that, following these investigations management actions have been taken which have improved the ability of the AVLAP WPSF to continue to satisfy its Pillar 1 and Pillar 2 capital requirements in the event of a further substantial worsening of financial conditions after 31 December 2008, Aviva has told us that these management actions involve better matching of assets to liabilities.

The AFH considers that the declaration of a Deferred Special Distribution from the inherited estates of CGNU Life and CULAC as at 1 January 2008 did not have a material adverse impact on benefit security, when taken together with the de-risking that took place in the funds. Given that the level of capital left in the funds was still significantly higher than that required to meet the Pillar 2 capital requirements, we agree with this conclusion

We believe that the AFH has considered the investment of the remaining assets of the New WPSF (including the assets of the RIEESA) and of the Old WPSF in some depth and have no reason to disagree with his conclusions regarding such investments. However, our preference for the Old WPSF is to have no investments in strategic assets at all in this fund (see section 3.01 below).

We have considered the constraints placed on management actions. We believe there is a fine balance between allowing sufficient flexibility to maintain security of guaranteed benefits and ensuring that benefit expectations are maintained. From the perspective of

benefit security the most significant restrictions on management actions introduced by the Scheme are:

- the lower limit to the Benchmark equity backing ratio (EBR) for the Return Assets;
- the removal of the power to introduce charges to the asset shares of transferred policies for guarantees after the Effective Date; and
- the removal of the Affordability Condition in relation to the application of the Mortgage Endowment Promise provided by CGNU Life and CULAC.

The limitations on management discretion as set out above have been put in place in order to reduce the potential conflict of interest between policyholders and shareholders and we agree these limitations are required. We have no reason to disagree with the AFH's conclusions around the limitations on the exercise of management discretion and we believe that the AFH has considered this area in detail. Further the AFH has performed sensitivity testing to inform his decision.

It is currently proposed that the whole of the cash payments will be financed through a capital contribution into Norwich Union Life Holdings Limited (NULH) the immediate parent company of AVLAP. It is also proposed that the whole of the Additional Benefits Amount will be met from the existing surplus in the AVLAP Non-Profit Sub-Funds, provided that AVLAP would then still have sufficient surplus assets to meet its capital requirements. This constraint coupled with the fact that only a minority of PIP is payable via additional benefits leads us to conclude that we have no reason to disagree with the AFH's conclusions around the impact of the proposed financing arrangements for the PIP on the benefit security for the existing policyholders of AVLAP and the holders of Transferred Policies.

3.00 Comments on the AFH report: issues which are not part of the AFH's conclusions

This section sets out those areas covered by the AFH on which we have a view and which are not covered in sections 2 or 4 of this appendix.

3.01 Strategic Assets

Strategic Assets means strategic investments as defined in the strategic investment policy of AVLAP as at the date of the Scheme - for example, investments in joint venture partners. Details of the rules around investing in strategic assets are covered in the Scheme and the AFH report. The AFH considers the potential impact of such investments on the security of the fund and we note he has considered this aspect. The Scheme provides for any existing strategic assets held by CGNU Life or CULAC to be allocated between the Old WPSF and the RIEESA on the Effective Date. We note, also, that it appears to be the intention to transfer the Old WPSF's interest in such assets from the Old WPSF to the RIEESA provided that an appropriate price can be agreed with the with-profits committee (WPC), but this has not been formalised. We believe that investing in strategic assets is potentially more risky in nature than investment in comparable investments which are not considered to be strategic, and since the facility will exist via the RIEESA for all strategic investments to be held for ultimate shareholder benefit, we believe that transferring strategic assets should be allocated solely to the RIEESA. We would prefer this to be more formally documented. We do however note that as at the end of 2008, very few strategic assets (██████)⁴ remained; the majority of such assets having been sold at a loss over the year.

Apart from the comments made above, we agree with the AFH's conclusions with regard to the constraints and governance provisions surrounding the future investment strategy of the Remaining Assets of the New WPSF (including the RIEESA) and of the Old WPSF.

⁴ The amount of strategic assets held has been redacted (i.e. blanked out). This has been a requirement of Aviva, in order to prevent the public disclosure of information which Aviva believes is commercially sensitive. The policyholder advocate does not agree that this information is commercially sensitive and believes that the redaction is inappropriate and unnecessary.

The constraints and governance provisions are extensive and include both defined restrictions and approval of the WPC for any new loan that is provided to a Group company or any changes to the strategic investment policy as it applies to the with-profits funds or the RIEESA. In addition, the Scheme requires that the investment of the Remaining Assets of the New WPSF (including the assets of the RIEESA) in non-profit business, strategic assets and Group companies should not give rise to an unacceptable risk of a failure to meet the statutory capital requirements of the New WPSF, the Old WPSF and the non-profit business of the RIEESA.

3.02 New Business written by AVLAP after the Effective Date

The only comments we have on the allocation of new business are in respect of single premium increments and switches to with-profits investment on any Transferred Policies. These will be allocated to the AVLAP Sub-Fund to which the policy is allocated - we agree with this allocation. However, the AVLAP Board will retain the right to change the basis of allocation of single premium increments and switches on eligible with-profits policyholders in the future so that they are allocated to the New WPSF with proportional reinsurance to the Old WPSF. It is envisaged by the AFH that the AVLAP Board would exercise this right if it were necessary to do so in order to maintain a broad equilibrium between the respective financial strengths of the New WPSF and the Old WPSF. We believe that the AFH should recommend that the WPC should be involved in such a decision.

3.03 Old WPSF Bonus Amount

Section 5.5.1 of the AFH report sets out the calculations for the Old WPSF Bonus Amount (OBA) which would be set up to avoid any immediate distribution of surplus from the inherited estate of the Old WPSF which might otherwise result from the election outcome. An extract from paragraph 5.5.6 of the AFH report is as follows:

“...no distributions will be made from the OBA for at least 3 years after the Effective Date and any distributions that are made after that date will be consistent with the Risk Appetite Framework from time to time (the current Risk Appetite Framework is described

in Paragraphs 7.3.6 to 7.3.9 below). The interests of shorter term policyholders are preserved as such policyholders could not have reasonably expected to benefit from further Inherited Estate distributions in the short term in the absence of the Scheme.”

Given the current economic climate, it appears unlikely that a non-zero Old WPSF Bonus Amount will be determined. However, in the event there is, we agree that the Old WPSF Bonus Amount should be kept as a separate account, but we feel that the AFH report should be more specific in terms of when the Old WPSF Bonus Amount will be distributed to ensure, as far as is possible, that policyholders are in the same position they would have been absent the reattribution. Clearly, the OBA would not arise in the absence of the reattribution, but there is an estimated pattern of distributions which could be used to estimate when the funds backing the OBA might have been distributed. Aviva’s view on this is that there is little potential for conflicts of interest between policyholders and shareholders, and it sees no need to be specific about when the Old WPSF Bonus Amount will be distributed, particularly since the Scheme requires the WPC to consider on an annual basis whether a distribution should be made, and any such distributions will only be made to holders of with-profits policies allocated (or reassured) to the Old WPSF on the Effective Date which remain in force and invested in with-profits at the date of the distribution. We agree that there is little potential for conflicts of interest between policyholders and shareholders, but nevertheless we believe that at the very least, the expected pattern of distribution of the Old WPSF Bonus Amount should be made available to the WPC so that it can understand when the funds backing the Old WPSF Bonus Amount might have been distributed (under a set of best estimate assumptions) in the absence of the reattribution. Setting aside that the OBA would not arise in the absence of the reattribution, we assume that distribution pattern could be determined if the WPC were to request it in the future.

Further, the original reason for the policyholder advocate arguing for the Old WPSF Bonus Amount to be a part of the reattribution Scheme was as a direct result of the requirement therein to transfer assets from the RIEESA to the Old WPSF (“the VPDP Adjustment”) if, as a result of the election outcome, the value of potential distributions to

holders of Old WPSF with-profits policies (determined in accordance with the Scheme) would not be at least maintained. Aviva's view was that it would not be appropriate for the Scheme to trigger an immediate special distribution from the inherited estate of the Old WPSF. However, the Old WPSF Bonus Amount will be determined whether or not a VPDP Adjustment is made, and it is this that we disagree with. Although we believe that the likelihood of a non-zero Old WPSF Bonus Amount arising is extremely unlikely given the current surplus in the funds, as the markets would need to recover to well above the levels they were at as at the end of 2007 and the estate would have to be invested in these high performing assets. We believe that the Old WPSF Bonus Amount should not be triggered in the absence of a VPDP Adjustment. If a VPDP Adjustment is not required to be made then we see no reason for the resulting deferral of special distributions which might arise from the requirement to set up an Old WPSF Bonus Amount if the surplus of the Old WPSF exceeds 100% of the AAA Capital Threshold on the Effective Date.

4.00 Summary of the key areas where the Scheme relies on the AFH report

This section considers all the areas (as set out in Annex 1 below), where the Scheme depends on the AFH report for further detail, and we give comments on these areas. On our reading of the Scheme we found it difficult in many places to understand the intention behind the language, and we note that the AFH report provides some clarity to the Scheme with regards to the actuarial issues.

4.01 Determination of specifically allocated assets (Scheme 4.7.8)

The AFH report states that Specifically Allocated Assets will consist of those assets, other than Linked Fund Assets, that are specifically allocated to a particular sub-fund or sub-funds and separately managed for those sub-fund(s), or which consist of rights under third party reinsurance contracts. Linked Fund Assets consist of assets held by the unit-linked funds of CGNU Life or CULAC. Section 5.3.8 of the AFH report details which transferring assets are to be designed as specifically allocated assets.

We have reviewed section 5.3.8 of the AFH report, and agree with Aviva's approach because the specified assets are broadly used to match certain liabilities within the particular sub-fund and so it is appropriate to allocate these assets in the first instance to match the allocation of those liabilities.

4.02 Adjustment to the allocation of transferred assets (Scheme 4.9.1(b))

Section 5.4 of the AFH report sets out the process for calculating the benefit security factor (BSF) and adjusting the transferred assets accordingly if the security of the Old WPSF differs from that of the New WPSF (considered together with the RIEESA) by more than 0.5% (in each case security being determined as specified in the Scheme).

The AFH report acknowledges that, due to the fact that the RIEESA can be used to support the Old WPSF, the security of the New WPSF at the Effective Date cannot exceed that of the Old WPSF. This means that the only asset transfer that can be made as a result of the comparison of security is a transfer of assets from the Old WPSF to the RIEESA by way of a contingent loan. The one-way nature of the asset transfer reflects the asymmetric nature of the capital support arrangements between the RIEESA and the Old WPSF (i.e. the RIEESA is required to provide capital support to the Old WPSF if necessary, whereas the Old WPSF is not required to provide capital support to the RIEESA or to the New WPSF).

The approach to calculating the security of the funds uses a stochastic approach to test on a no new business basis how likely it is that the funds will cover the realistic liabilities over the expected remaining lifetime of transferring policies taking no account of potential distributions of the inherited estate of the Old WPSF or releases from the RIEESA. The assumptions are to be realistic and the results will be subject to review by Aviva's external auditors.

The methodology and assumptions used for the two funds are to be consistent except that the investment strategy for the Remaining Assets of the Old WPSF may differ from the investment strategy for the New WPSF so as to allow for differences in the nature and term of

policies allocated under the Scheme to the Old WPSF and the New WPSF on the Effective Date. (The calculations make no specific assumptions as to investments in strategic assets since this would be too detailed for the purpose of this modelling.) The assumed management actions allowed for in the calculation of the funds' security levels at the Effective Date will otherwise be based on those used in the most recent RBS submission to the FSA except to the extent that that submission did not take account of the full range of potential management actions available to the Boards of CGNU Life and CULAC on a dynamic (i.e. depending on the circumstances at the time) basis and the WPC has approved any additional management actions modelled.

We have reviewed the methodology proposed for the testing the security of the funds at the Effective Date, and have no issues with the approach proposed. We agree that if there is to be any transfer of assets from the Old WPSF to the RIEESA, it should be by way of a contingent loan because it is likely to be repaid except under very adverse scenarios.

4.03 Augmentation of the asset shares of Elected Policies in certain circumstances (Scheme 5.2.5)

Because a significant part of the negotiations depended on the assumptions for new business, Aviva has agreed to augment the asset shares of Elected Policies using assets of the RIEESA in certain circumstances where new with-profits business written after the Effective Date is very low relative to the volumes assumed for 2009 to 2013 by Aviva for the purpose of its VPDP calculation, or Aviva ceases to allocate new with-profits policies to the Old WPSF and the New WPSF before 2014.

Section 5.10.7 of the AFH report states that such a transfer and augmentation will only be required to the extent that the New WPSF (including the RIEESA) would retain sufficient surplus (after deducting the realistic value of the obligation to repay any outstanding amount of contingent loan from the Old WPSF to the RIEESA) to cover its capital requirements under FSA Rules after the transfer and augmentation of asset shares has been made.

We have no issues with section 5.10.7, because we would expect the fund to maintain sufficient capital under the FSA rules, although we note that the interpretation of these rules could result in prudent assumptions being used in order to increase those capital requirements. However we believe that this issue is academic since section 5.10.9 of the AFH report, which states:

“The asset transfers referred to in Paragraph 5.10.6 above will not be required if the [AVLAP] Board with the agreement of the WPC considers that the reduction in new business volumes is either appropriate or unavoidable, provided that the FSA has been notified of the view of the [AVLAP] Board and has not disagreed within 14 days of the notification being given. The circumstances in which such a reduction might be appropriate or unavoidable include (but are not necessarily limited to):

- *The need to protect the solvency of the New WPSF;*
- *The need to treat customers fairly; and*
- *Changes in the wider market which lead to an unavoidable reduction in new business”,*

This leaves shareholders enough judgement for the transfer to be extremely unlikely even in the event of very low new with-profits business volumes, or such business ceases to be written by the Old WPSF and the New WPSF, before 2014.

4.04 Areas where the AFH report states changes to Policy and Methodologies must be approved by the WPC (Scheme 5.7.3)

We have reviewed the areas where the AFH report states that approval of the WPC is required, and agree that this is appropriate in all cases, and only have comments in the following areas:

Section 5.10.2 states that “*changes in the allocation of future new business to the with-profits sub-funds will be reviewed by the WPC.*” The WPC is required to approve any reduction in the proportion of new with-profits of the New WPSF reassured to the Old WPSF below the Old WPSF Proportion. We believe that the WPC should monitor the

situation proactively and continuously and should proactively consider whether changes are necessary. We believe this for a number of reasons, including the fact that new business can reduce the security of the fund, and because, under current FSA rules, new business reduces potential future special distributions to current policyholders (which will only be relevant to the Old WPSF).

Section 5.11.11 of the AFH report states that *“if the [AVLAP] Board considers that the basis of apportionment of expenses is inconsistent with the fair treatment of policyholders allocated to the New WPSF and the Old WPSF, it will amend the basis of apportionment so as to ensure that such policyholders are treated fairly, having regard to actuarial advice and subject to the approval of the WPC.”* Our view is that the WPC should review the allocation in light of any changes in the relative sizes of the Old WPSF estate and the RIEESA and determine itself whether any changes should be made.

Section 5.14.45 of the AFH report states that *“after the Effective Date the [AVLAP] Board will consider whether it is appropriate to transfer the existing strategic asset holdings and investments in Group companies of the Old WPSF to the RIEESA in exchange for assets of equivalent value. Such a transfer will only be made if the proportion of eligible policyholders who elect is not significantly lower than anticipated by the [AVLAP] Board [ie so long as there are enough funds in the New WPSF], and if agreement can be reached with the WPC on a fair value for the strategic assets to be so transferred. Following the sale of most of the strategic asset holdings during 2008, the value of the remaining strategic assets is not material in the context of the size of the Funds.”*

Our view is that the WPC should be involved in deciding whether the assets should be transferred and, as mentioned above, we believe that these assets should be transferred.

4.05 Allocation of expenses and tax to the AVLAP sub-funds

Section 5.11 of the AFH report sets out how future expenses and tax will be allocated. We have not reviewed the tax allocations as this is being performed by Deloitte, the policyholder advocate’s tax advisers.

Overall, we welcome the clarity that the AFH report gives in the area of the apportionment of expenses.

The AFH report firstly considers how the expenses allocated to policies are split between the AVLAP WPSF, PM Sub-Fund, Belgian Sub-Fund, NPSF1 and NPSF2 and states that these will be determined in the same manner as those which applied prior to the Effective Date.

In general, the AFH report sets out that expenses will, as far as practicable be apportioned in line with how the expenses are incurred.

Areas where we believe that there could have been a number of plausible approaches and where Aviva has used judgement are set out below:

- the Management Services Agreement charges for administration consist of per-policy fees for new business, per-policy fees for existing business and an annual flat fee which is independent of the number of policies administered. For allocation purposes the flat fee will be included within the per-policy fees by way of a uniform percentage enhancement to those fees. The total administration charges will then be allocated between the New WPSF and the Old WPSF and the RIEESA by multiplying the enhanced per-policy fees by the relevant numbers of policies allocated to each sub-fund (with due allowance being made for the internal reinsurance arrangements);
- mis-selling expenses in respect of business that was allocated to the New WPSF and/or the Old WPSF on the Effective Date will be allocated to the New WPSF and the Old WPSF in the New WPSF Proportion and the Old WPSF Proportion respectively;
- other expenses for example project/development costs, staff pension scheme deficit funding costs, regulatory fees, audit fees and industry levies which need to be apportioned between the AVLAP sub-funds, (which for

this purpose the New WPSF (including the RIEESA) and the Old WPSF are considered as one sub-fund) will, where it is not possible to allocate according to the underlying cause and there is no other clearly fair method of allocation, be allocated in proportion to the respective RBS liabilities at the time unless the WPA advises a more appropriate approach;

- audit fees which are not to be charged to asset shares will be apportioned between Transferred Business and business allocated to each of the New WPSF (net of reinsurance), Old WPSF and RIEESA pro rata to the mathematical reserves for the business concerned,
- regulatory fees, audit fees and industry levies and any other expenses which are not to be charged to asset shares which have been apportioned to Transferred Business will be allocated to the New WPSF and the Old WPSF in the New WPSF Proportion and the Old WPSF Proportion respectively.
- regulatory fees, audit fees and industry levies (other than those which are to be charged to asset shares) and any other expenses which have been apportioned to business written since the Effective Date will be allocated to the New WPSF, Old WPSF and RIEESA in line with the business to which they relate;
- expenses which relate to any non-profit business written as an investment of the RIEESA after the Effective Date will be allocated to the RIEESA (or to the New WPSF or the Old WPSF in the event that such business is subsequently transferred to those sub-funds under the capital support arrangements);
- expenses which relate to any non-profit business written as an investment of asset shares after the Effective Date will be allocated to the New WPSF and the Old WPSF in proportion to their respective with-profits benefit reserves for the relevant policies.

We had extensive discussions with Aviva around the allocation of expenses, where a range of possible allocation methods exists. We are comfortable that the final position with regard to how the expenses are allocated between the AVLAP sub-funds is fair. However, we note that the power to allocate some or all of future industry levies to asset shares has been introduced, and is solely for the Board to determine. There is no right of veto from the WPC on the charging of such levies to asset shares. We comment further on this issue in appendix 18 B (“The With Profits Actuary’s report”).

The draft PPFM for the Old WPSF and the New WPSF states that the Board will consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies. We also note that the Independent Expert covers this aspect as well in his report; a relevant extract from the Independent Expert’s report is set out below:

“8.9.12 Through the operation of the RIEESA, the [AVLAP] shareholder will meet any industry levies which are to be charged to the New WPSF but not deducted from the asset shares of with-profits policies of the New WPSF. It is possible that implementation of the Main Scheme could lead to circumstances where industry levies referable to transferring with-profits policies will be charged to the asset shares of those policies, where in the absence of the reattribution they would have been charged to the inherited estates of the CGNU Life WPSF and the CULAC WPSF. The Main Scheme does not introduce any specific constraints to manage this potential conflict between the interests of holders of transferring with-profits policies allocated to the New WPSF and the [AVLAP] shareholder. However, the Actuarial Function Holder has informed me that the [AVLAP] Board has undertaken to consult with the With-Profits Committee and properly consider the views of the Committee before reaching a decision on whether to introduce any charges to asset shares in respect of industry levies. This undertaking will be reflected in the PPFM for the New WPSF and the Old WPSF following the Effective Date. In forming its views, I would expect the With-Profits Committee to give particular consideration to the likelihood that corresponding charges would have been applied in the absence of the Main Scheme.”

Given the importance of this issue, and the fact that the AFH report effectively forms an addendum to the Scheme, we would have expected this area of governance to be set out either in the Scheme, or in the AFH report.

In its appendix 17 A on the “The Actuarial Function Holder's report“, Aviva states *“that the power to allocate some or all of the future industry levies to asset share is not intended to be utilised in the normal course of events, but is intended to deal with a situation where, due to the current financial crisis and government bailouts, there is either a large levy or a number of levies adding up to a high amount, on insurers.”* Aviva does not want to be in the position of not being able to make any charge to asset shares in respect of such levies, particularly if the rest of the industry is able to do so. The power to make such a charge will be subject to the terms of the policy and to treating customers fairly. Aviva goes on to state that a large levy on AVLAP could have implications for its financial security, and so it does not think it is appropriate for the WPC to have a veto. The WPC will of course have whistle-blowing rights if they consider the allocation of such charges, or the manner in which the charges are allocated between policyholders, is unfair.

We note the above, but remain of the view that it would be more appropriate for this power to be subject to the WPC approval process. The Scheme does not limit this power to periods where such a levy on AVLAP would otherwise have implications for its financial security. In addition, we would not expect the WPC to veto such a decision if the security of the company were at stake and so we do not agree with Aviva’s reasoning for not making this power subject to WPC approval.

We also note the potential for inconsistent treatment between the various classes of with-profits policyholders within AVLAP post transfer, ie between former CGNU Life and CULAC policyholders and policyholders in the existing AVLAP with-profits funds. We are told by Aviva that statements regarding the possibility that some or all of future industry levies could be charged to asset shares will be included in the PPFMs for the existing AVLAP with-profit funds as soon as is practicable.

4.06 Description of Return Assets and the investment return thereon (Scheme 5.15.4(b)(iii) and the definition of “Return Assets” in Schedule 1)

The AFH report states that Return Assets consist of those assets which are used to determine the investment return to be credited to the asset shares of with-profit policies that are allocated to the New WPSF and the Old WPSF (or reflected in the benefits under those with-profits policies where asset shares are not used). The overall investment objective in managing the Return Assets is to maximise the long term returns within an acceptable level of risk. In this connection the most important factor influencing future returns is the EBR for the Return Assets (being the percentage invested in equities and property). We cover the derivation of the EBR later in this section. The investment managers are provided with a Benchmark EBR for the Return Assets against which their performance will be assessed. They are however free to invest with an EBR which differs from the Benchmark EBR within specified limits (tactical limits) with the objective of outperforming the benchmark.

There is a conflict of interest introduced by the reattribution, namely that the shareholders could mitigate the risk of the RIEESA being required to cover guarantees in the New WPSF, if it were to invest the asset shares in more secure assets offering lower potential future returns than equities and properties. The AFH has considered the potential conflict of interest. The AFH report sets out how there are detailed rules around the setting of the equity backing ratio with significant oversight by the WPC. Due to the detailed rules around the setting of the EBR, which are specifically laid out in the AFH report, we are comfortable that policyholders are protected from the conflict of interest.

4.07 Definitions of “Realistic Liabilities” (Schedule 2 part 2(4))

The allocation of transferring long term business assets and liabilities between the Old WPSF, the New WPSF and the RIEESA under the Scheme relies *inter alia* on the AFH report for a definition of the “Realistic Liabilities”. We have not found a definitive description in the AFH report (aside from some detail on tax), but the Scheme states that

the same methodology and assumptions adopted for determining realistic liabilities for the purposes of preparing the RBSs of CGNU Life and CULAC immediately preceding the Effective Date with the economic assumptions and in-force policy data being updated (if the Effective Date is not immediately following that balance sheet date) to reflect that the calculation is being performed at the Effective Date will be used. This approach is as we would expect.

Section 5.3 of the AFH report describes how the liabilities and assets will be allocated between the various funds, and we believe it is this area of the AFH report which the Scheme is actually referring to. We have reviewed the allocation of the liabilities of transferred policies between the Old WPSF and the New WPSF. Broadly, the liabilities will be allocated in line with the allocation of policies where this is logical to do so, and any transferred liabilities relating to transferred assets will be allocated in line with those assets. Liabilities in respect of the tranches of the Special Bonus which have not been declared prior to the Effective Date will be allocated in line with the allocation between the Old WPSF and the New WPSF of those policies which qualify to participate in those declarations. Other transferring long term liabilities are to be allocated in line with the aggregate amount of the PIP between Elected Policies and Non-Elected Policies. We find the approach taken to be appropriate.

4.08 Assumptions used in the calculation of the VPDP Adjustment (Schedule 2 part 2A(2))

The Scheme requires a transfer of assets from the RIEESA to the Old WPSF (not exceeding £100 million) if the value of potential future special distributions to holders of Old WPSF with-profits policies would otherwise be lower than the value of potential future special distributions to the holders of such policies in the absence of the Scheme (in each case those values are to be determined as specified by the Scheme).

Section 5.3.13 of the AFH report sets out the calculation of the value of potential future distributions to holders of Old WPSF with-profits for this purpose.

A summary of the key assumptions and methodologies to be used is as follows:

- the value of potential distributions to holders of Old WPSF with-profits policies will be calculated from the average of stochastic projections of the possible future development of the relevant funds⁵ over a period of 25 years;
- the investment mix assumed for the inherited estates will initially be the same as that applying at the Effective Date; in favourable scenarios, the model will assume the mix will gradually change so that it is the same as the asset mix assumed for asset shares;
- the parameters used in the Economic Scenario Generator used to generate the stochastic projections of the possible future development of the fund will be those appropriate to a real world projection (as referred to in the AFH report) on the Effective Date;
- the demographic assumptions will be those used in Aviva's most recently published market consistent embedded value;
- allowance will be made for future new business after the Effective Date, based on the average amounts written in the three year period immediately preceding the Effective Date (separately for each category of policy that is modelled). New business will be assumed to decline at the rate of 10% per annum after the first year;
- distributions from the inherited estate will be assumed to be made when the AAA CT (Capital Threshold) Coverage exceeds 105%, and allocated in proportion to asset shares. In this event the amount assumed to be distributed will be such as to bring the AAA CT Coverage down to 105%;
- the investment strategy assumed for the Remaining Assets of the Old WPSF may differ from the investment strategy assumed in respect of the corresponding assets of CGNU Life and CULAC so as to allow for

⁵ The CGNU Life WPSF and the CULAC WPSF for the calculation assuming the Scheme is not implemented, and the Old WPSF assuming the Scheme is effected.

differences in the nature and term of policies allocated under the Scheme to the Old WPSF relative to the mix of the combined business of the with-profits sub-funds of CGNU Life and CULAC;

- the calculations will otherwise be carried out using the methodology and assumptions specified for the determination of the AAA CT (capital threshold) of the Old WPSF and the New WPSF;

The AFH states (paragraph 5.3.13) that an external audit opinion will be obtained that the procedure described above has been correctly implemented and that the assumptions used are determined as required by the Scheme.

The policyholder advocate was involved in discussions on the determination of the pre and post reattribution value of potential distributions to holders of Old WPSF with-profits policies for the purpose of the VPDP Adjustment. Although there are a number of assumptions that could be made, in particular over future levels of new business, we believe the above approach to determining the value of potential distributions to holders of Old WPSF with-profits policies is appropriate since it does assume a reduction in current levels of new business of 10% a year after the first year (which would serve to increase the value relative to Aviva's corresponding assumption of an increase of 5% a year from 2011 for the purposes of its VPDP calculation), and the other assumptions are Aviva's best estimates. This means that the value of the estate which is transferred to the Old WPSF on the Effective Date (and which will thereafter form its inherited estate) should be more than adequate to put non-electing policyholders (considered together) in the same position in relation to potential future distributions from the former inherited estates of CGNU Life and CULAC that they would have been without a reattribution under most circumstances.

We would add that we believe that Aviva has engaged very positively in this particular aspect of the Scheme to ensure that, as far as possible, the non-electors are in no worse position than they would have been, absent the reattribution (see appendix 44 "The position of non-electing policyholders").

4.09 Calculation of Effective Date inherited estates (Schedule 3 part 3(4))

Appendix 5 of the AFH report describes how the inherited estates of CGNU Life and CULAC will be calculated for the purposes of determining the aggregate amount of the PIP. Since the PIP offer is determined by Aviva as a percentage of the inherited estate, it is important that the calculation is as accurate as possible. The policyholder advocate was involved in discussions around whether the PIP should be based on one estate value, or an average of the estates. We agree that Aviva's decision to use an average of the inherited estates over three months is appropriate as it smoothes out possible one off shocks which can occur in any one month.

In summary, the AFH report sets out the following process:

- The three values will be derived from the most recent full valuation based on the in force policy data, accounting data and asset values on the date of such a valuation. Full valuations are undertaken as at 31 May, 30 September and 31 December in each calendar year;
- The valuation assumptions adopted for the full valuation will be consistent with the principles required to be used in Form 19 (the RBS) of the most recently prepared FSA Returns and using economic assumptions based on financial conditions on the date of the full valuation;
- The three valuations of the combined inherited estates will be obtained from the immediately preceding full valuation using a roll-forward approach which accumulates assets and asset shares using the investment returns obtained from assuming investment in representative published indices over the period between the date of the full valuation and the relevant monthly valuation date. The guarantee costs are to be revalued so as to allow for these updated asset shares and the risk free rates and volatility assumptions at the relevant monthly valuation date, and the non-

economic assumptions used will be the same as those used for the purpose of the full valuation;

- the review by external auditors, will be more rigorous than the normal review performed for half year interim reporting purposes, and is described in the AFH report.

We have reviewed the proposed roll forward and our views on the implementation and assumptions used are detailed in our supplementary appendix to the “Size of the inherited estates” appendix (appendix 35 B).

4.10 Principles of allocation of the Deferred Special Bonus (DSB) (Definition of “DSB Assets” (Schedule 1))

The Deferred Special Bonus Assets is the amount of assets available to meet the tranches of the pre reattribution distribution announced by Aviva in February 2008 which have not been declared on or prior to the Effective Date. Sections 5.14.97 to 5.14.102 describe how the Deferred Special Bonus Assets will be applied to meet the costs of the Deferred Special Bonus liability. We have reviewed the approach and believe the approach is appropriate and in line with treating customers fairly.

4.11 Differing investment policies for the Remaining Assets in the New WPSF compared to the Old WPSF (Schedule 4 part 3(3))

The relevant Scheme provision (see Annex 1) is difficult to follow, but in respect of the reference to the AFH report, our understanding is that approval of the WPC is only required to adopt different investment mixes for the Remaining Assets of the Old WPSF and for the Remaining Assets of the New WPSF (including those of the RIEESA) in respect of non-profit business, strategic assets or Aviva Group companies if the proposed approach is not as set out in Section 5 of the AFH report.

The AFH report in section 5.14 states that the investment strategy for the Remaining Assets of the New WPSF may be set independently from that of the Remaining Assets of

the Old WPSF. It goes on to set out a number of constraints on the investment of such assets, for example, changes in the planned use of the New WPSF and the RIEESA to write new non-profit business, to invest in new strategic assets or to invest in Group companies will not be made if to do so would increase the risk of a failure to meet the statutory capital requirements of the New WPSF, the Old WPSF or the non-profit business of the RIEESA to an unacceptable level.

In general we have no issues with there being differences in the approaches to these investments. We understand that there could be a number of valid reasons why there is a need for different investment policies (for example, we do not believe that the Old WPSF should be invested in strategic assets). We note there are a number of safeguards which are designed to protect both policyholders' security, and the EBRs used for the asset shares and so we do not see there is any reason for there to be a conflict of interest in terms of the investments of these assets.

We do however note that this particular part of the Scheme is effectively a non-clause since the reference to the approval of the WPC is irrelevant since the AFH report itself sets out that (subject to certain constraints) the remaining assets in the New WPSF may be invested in non-profit business, in strategic assets or in other Group Companies without investing the remaining assets in the Old WPSF in such assets. We recommend the reference to approval of the WPC is deleted.

4.12 Assessment of the risk of failure to meet capital requirements (Schedule 4 part 3(5), Schedule 4 part 3(8) and Schedule 4 part 3(9))

Sections 5.14.29 to 5.14.45 of the AFH report sets out how an appropriate investment strategy for the Remaining Assets is to be determined. This is to be done by ensuring that the investment strategy adopted does not lead to an unacceptable level of risk of not meeting capital requirements. The AFH report discusses how EBRs are set allowing for stochastic modelling. We have reviewed the approach taken and believe that the safeguards, which include testing the solvency to a high level of security (by ensuring that

the Old WPSF, the New WPSF and the RIEESA would be expected to cover their statutory capital requirements after a particular adverse economic shock) and ensuring that the risk appetite framework (RAF) is prudent, are sufficient to ensure that the risks are considered adequately.

4.13 4.15 Roles of the With-Profits Committee (Schedule 4 part 4(4(c)) and Schedule 4 part 4(5))

Paragraph 5 of part 4 of Schedule 4 to the Scheme reads as follows:

“For the avoidance of doubt, notwithstanding any requirement in the Scheme, the Actuarial Function Holder’s Report, the With-Profits Actuary’s Report or the [AVLAP] PPFM for the review, confirmation or approval of the With-Profits Committee to any aspect of the management of the Old WPSF or the New WPSF, 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 With-Profits Committee except for any renewal, replacement or amendment thereof unless the basis for such renewal, replacement or amendment is specified in the contract or arrangement.”

We have asked Aviva what it intended by this statement. We have been informed that the provision is intended to provide continuity for existing contracts or arrangements so that there is no need to seek WPC approval where any options under those contracts or arrangements are subsequently exercised. The same applies to new contracts or arrangements which have been approved by the WPC after the Effective Date. We agree the approach since the alternative would clearly be impractical.

4.14 Description of the Theoretical EBR (Referenced in “Moderated AAA CT of the Old WPSF”, Schedule 8 part 2)

We cover the description of the methodology for determining the Theoretical EBR used for asset shares in appendix 29 B (“Investment policy, bonus and smoothing policy”). It

is our view that the Scheme, together with relevant statements in the AFH report, will put in place safeguards to protect the policyholders from any potential conflicts of interest, and the methodology used to determine the Theoretical EBR is appropriate.

4.15 Derivation of the required probability of ruin for risk appetite purposes (Definition of “Required Probability”, Schedule 8, part 2)

Paragraph 5.14.79 of the AFH report sets out how the default rates are to be derived from Moody’s data for the purpose of the AAA Capital Threshold Tests (which will form the basis of the determination of whether distributions are required from the inherited estate of the Old WPSF and whether releases from the RIEESA to the AVLAP shareholder are permitted). We have commented separately on Aviva’s risk appetite in appendix 28 B (“Policyholders’ future security and risk appetite”) and do not repeat our comments on this specific area in this appendix. However as this is an important area because it is a key determinant of the amount of capital which may be released, we have summarised below how the default probabilities are derived:

The AAA CT is the lowest level of Estate Assets (assets equivalent in value to the inherited estate) that will ensure that the fund concerned has sufficient assets at the end of each year during the next 25 years to cover its realistic liabilities with a probability that is at least equal to a certain percentage. This percentage is to be calculated as 1 minus the cumulative rate of historic bond default for the period concerned.

For this purpose the cumulative rate of historic bond default is that obtained from the “Moody’s 1920 – current” AAA investigation.

Where the cumulative default rates obtained from the Moody’s investigation for particular periods are zero or trivial, those rates will be replaced by rates determined from the annualised default rate that is equivalent to the first non-trivial cumulative default rate in that investigation. For this purpose, a trivial default rate is one that generates default rates in earlier years that are less than 0.005% per annum. Similarly an experienced default rate

of less than 0.005% in year 1 of the investigation would be regarded as trivial. The annualised default rate so determined will be compounded so as to obtain the replacement cumulative default rates for those years.

Currently the Moody's investigation only covers default rates for periods of up to twenty years. For the purpose of the AAA CT calculation it will be assumed that the default rate for any subsequent year is equal to the annualised default rate that, when compounded, is equivalent to the cumulative default rate for a period of twenty years.

We have commented on the use of the Moody's data to set default assumptions for these purposes in appendix 28 B ("Policyholders' future security and risk appetite"). We note here that there is very little data which can be used and the approach taken is not out of line with the industry, and in particular the approach taken to making allowances for trivial data is reasonable. We note that although this methodology is becoming more common, there is no standard accepted practice in the industry for the determination of these forms of thresholds and the associated probabilities.

4.16 Definitions of the maximum permitted coverage (MPC) and capital release point (CRP) (Schedule 8 part 3 (3(a) and 3(d)), Schedule 8 part 3(4(b)) and Schedule 8, part 6(4(e)))

The capital release point and maximum permitted coverage are covered in sections 5 and 7 of the AFH report. The AFH report goes into detail as to how the levels were set and how they will be managed in the future.

The maximum permitted coverage represents the level at which any assets held by the Old WPSF representing AAA CT Coverage in excess of this level must be distributed to with-profits policyholders of the Old WPSF and the AVLAP shareholder according to the '90:10' profit sharing arrangement applying to the sub-fund. The maximum permitted coverage has been set at 120%. For these purposes, the AAA CT is the minimum value of Estate Assets which will ensure that the realistic liabilities of the fund are covered at the end of each of the following 25 years with specified probabilities.

The capital release point represents the minimum level of security that is considered by the AVLAP Board to provide a high level of security. The capital release point has been set at 110%. Surplus held by the New WPSF and RIEESA in excess of 110% of the AAA CT is potentially available for release to the AVLAP shareholder. However, the Scheme does not permit a release from the RIEESA which would reduce the financial strength of the New WPSF (considered together with the RIEESA) below that of the Old WPSF (determined after allowing for any proposed coincident special distribution), those financial strengths being determined as specified in the Scheme.

We have already stated elsewhere (appendix 28 B “Policyholders' future security and risk appetite”), that using AAA as a capital standard is in our view prudent. The effect of the above two thresholds means that the capital level above which surplus of the Old WPSF has to be released is 120% of this value, and the level at which surplus of the New WPSF and the RIEESA will be considered for release is 110% of this value. Our view is that, although the levels do give a high level of security to policyholders, they do not take into account the potential benefits to existing policyholders of lowering the capital thresholds. Whilst ensuring they remain at levels that will maintain adequate policyholders' benefit security, a less prudent approach would potentially give rise to earlier distributions of excess capital if the experience is favourable, with less being passed on for potential distribution to new policyholders.

Aviva's view is that the 120% AAA CT is a backstop measure. The funds are managed in accordance with the RAF and distributions (or other actions) would be probable before reaching this level. The funds have never been managed with the objective of maximising the value of potential distributions to holders of WP Policies of the current generation of policyholders. We understand this viewpoint and note that for calculating potential benefits forgone, the policyholder advocate has assumed any surplus in excess of 100% of AAA CT would be distributed and Aviva has assumed any surplus in excess of 105% of AAA would be distributed. We are comfortable with these levels as the level at which distributions would be probable.

Annex 1: Areas where the Scheme relies on the AFH report

The sections below are direct extracts from the Scheme (final)

Scheme 4.7.8

Subject to the requirements of paragraphs 4.7.2 to 4.7.7 and save as set out in paragraph 4.7.9, the [AVLAP] Board shall determine as set out in Section 5.3 (Initial allocation of Transferred Liabilities and Assets to the [AVLAP] Sub-Funds and the [AVLAP] Shareholder Fund) of the Actuarial Function Holder's Report or as otherwise approved by the With-Profits Committee, which Transferred Assets are to be specifically allocated to each [AVLAP] Sub-Fund on the Effective Date so as to constitute Specifically Allocated Assets of such [AVLAP] Sub-Fund.

Scheme 4.9.1 (b)

as soon as practicable following the completion of such calculations, and in any event by no later than 215 days after the Effective Date, such initial allocations will be adjusted as necessary (taking into account the application of any adjustments required pursuant to paragraph 4.8 and for these purposes valuing any assets to be transferred to make any necessary adjustment, as at the Effective Date adjusted by the investment rates of return (net of investment management expenses but before any adjustment for Tax) credited to Asset Shares of WP Policies allocated to the Old WPSF and the New WPSF (other than Stakeholder Policies) as at the Effective Date (and calculated as set out in section 5.4 of the Actuarial Function Holder's Report (Adjustment to the Allocation of Transferred Assets on the Effective Date)), in respect of the period from the Effective Date to the date of adjustment), to reflect the final calculation as if such final allocations had been made on the Effective Date. Any adjustments in respect of the investment return and investment management expenses will be taken into account in the next following Tax calculations to be performed after the Effective Date for the Old WPSF, the New WPSF and RIEESA as also described in section 5.4 of the Actuarial Function Holder's Report.

Scheme 5.2.5

If the [AVLAP] Board significantly reduces (as specified in Section 5.10.7 (New business written by [AVLAP] after the Effective Date) of the Actuarial Function Holder's Report), or resolves to cease, the allocation of any New WP Policies to the Old WPSF and the New WPSF (including by way of reinsurance from the New WPSF to the Old WPSF or to such Sub-Funds from any other [AVLAP] Sub-Fund) on or before 31 December 2013 then (subject to paragraphs 5.2.8 and 5.2.9 below) the [AVLAP] Board shall be obliged within 12 months of the end of the calendar year in which such significant reduction occurred or within 12 months of the resolution to cease such allocation of new business, to transfer the amount ("A") set out in paragraph 5.2.7 below from the RIEESA and apply such sum to augment the Asset Shares of WP Policies which are Elected Policies in force and allocated (or reassured) to the New WPSF as at the date of such augmentation.

Scheme 5.7.3

The [AVLAP] Board appointed the With-Profits Committee with effect from 1 July 2007. The With-Profits Committee shall exercise the powers and oversight in relation to the Old WPSF, the New WPSF and the RIEESA as set out in Part 4 of Schedule 4 and elsewhere in the Scheme, the Actuarial Function Holder's Report, the With-Profits Actuary's Report and the relevant PPFM and such other powers and duties in relation to the other with-profits Sub-Funds as are set out in the Scheme or as the [AVLAP] Board may determine from time to time.

Scheme 5.14.5 (a)

Liabilities relating to or arising from the conduct of insurance business that has been internally reassured from the New WPSF (or the RIEESA) to the Old WPSF, or internally co-insured among the New WPSF (or the RIEESA) and the Old WPSF, shall be allocated to the New WPSF (or the RIEESA) and the Old WPSF pro rata to the allocation, reinsurance or co-insurance of the relevant New Policies comprised in the insurance business as further described in Section 5.11 (Allocation of Expenses and Tax to the [AVLAP] Sub-Funds) of the Actuarial Function Holder's Report; and

Scheme 5.15.4 (b) (iii)

the rate of investment return credited to Asset Shares (gross of investment management expenses but before any adjustment for Tax) of WP Policies allocated or reassured to the New WPSF applied to the opening balance on the Core Assets Account (less the Market Value of any Identified Assets if paragraph 5.15.9 applies) such rate adjusted from time to time as described in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report for the amounts and timing of those cashflows arising during the period and for which there is a corresponding addition or subtraction to the Core Assets Account less a tax charge calculated using a methodology consistent with the basis for allocating tax on investment returns to Asset Shares of WP Policies allocated or reassured to the New WPSF and allowing for the tax relief on expenses. The calculation of such tax charges and tax reliefs are further described in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report.

Scheme 5.15.9 & 10

The [AVLAP] Board may, for the purposes of the calculation in paragraph 5.15.4, on or prior to the first date of the relevant calculation period identify as a separate account, a pool of assets within the New WPSF which the [AVLAP] Board estimates to have a Market Value equal to or less than the excess (if any) of the balance of the Core Assets Account over the adjusted value of the with-profits benefit reserve at the start of the relevant period (the "Identified Assets"). If such separate account is identified, the Identified Assets shall be excluded, for the purposes of the calculations set out in paragraph 5.15.4 but the Market Value of the Identified Assets shall be deducted from the balance of the Core Assets Account at the start of the relevant calculation period and the Market Value of such Identified Assets at the end of the relevant period (after taking into account actual investment return, expenses, Tax and other charges on the Identified Assets calculated as further described in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report) added to the balance of the Core Assets Account at the end of the relevant period after the calculation in paragraph 5.15.4 to form part of the final balance on the Core Assets Account before any adjustment under paragraph 5.15.5.

For the purposes of this paragraph 5.15.9, the adjusted value of the with-profits benefit reserve means (i) the aggregate value of the with-profits benefit reserve; plus (ii) the amounts referred to in paragraphs 3(b) and 3(d)(i) of Part 3 of Schedule 2; minus (iii) the amount referred to in paragraph 3(d)(ii) of Part 3 of Schedule 2; in respect of all Relevant WP Policies as at the first date of the calculation period as estimated by the [AVLAP] Board. Where the amount referred to in paragraph 3(c) of Part 3 of Schedule 2 is positive (i.e. B-C is > 0) then this amount shall also be deducted in order to determine the aggregate value of the with-profits benefit reserve for these purposes.

Identified Assets of the New WPSF may be sold or otherwise disposed of from time to time and invested in further Identified Assets or the proceeds (net of Tax and dealing costs calculated as set out in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report) may remain credited to the Core Assets Account and may be applied for the acquisition of further investments provided that:

- (a) such acquisitions and disposals shall be made in accordance with an investment policy determined by the [AVLAP] Board in compliance with Schedule 4;*
- (b) all proceeds of any such disposals (net of Tax and dealing costs calculated as set out in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report) and any such further investments shall be allocated to the Core Assets Account; and*
- (c) no Identified Assets may be transferred out of the New WPSF to any other [AVLAP] Sub-Fund other than on arm's length commercial terms approved by the [AVLAP] Board and with the agreement of the With-Profits Committee.*

Schedule 1

"DSB Assets" means that amount of assets remaining, after allocation of the first tranche of the DSB and any other amounts which have been declared and allocated prior to the

Effective Date, to be applied towards meeting the costs (to comprise for any tranche the project cost and the cost of the bonus plus associated shareholder transfer and shareholder tax thereon) of any further amounts of the DSB for which the bonus declaration has not yet been made, increased from time to time by an assumed investment return on that amount as if assets representing that amount were invested in the same way as Return Assets, as more particularly described in Sections 5.14.97 to 5.14.102 (Deferred Special Bonus) of the Actuarial Function Holder's Report it being the intention that all the DSB Assets shall be applied in meeting the costs (as aforesaid) of such further amounts;

"Return Assets" means the assets invested in accordance with Schedule 4, the investment return on which is used to determine the investment return to be credited to Asset Shares or the benefits under WP Policies where Asset Shares are not used to determine such benefits each as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report;

Schedule 2 part 2 (4)

The value of the Realistic Liabilities attributable to the Transferred Policies and other Transferred Liabilities to be allocated to each of the Old WPSF (the "Old WPSF Realistic Liabilities"), the New WPSF and the RIEESA (the "New WPSF Realistic Liabilities") in each case net of any internal reinsurance arrangements shall be calculated as at the Effective Date and aggregated (the "Aggregated Liabilities"). Such Realistic Liabilities shall be calculated as described in Section 5.3 (Initial Allocation of Transferred Liabilities and Assets to the [AVLAP] Sub-Funds and the [AVLAP] Shareholder Fund) of the Actuarial Function Holder's report and using methodology and assumptions adopted for determining the realistic balance sheets of CGNU Life and CULAC immediately preceding the Effective Date with the economic assumptions and in-force policy data being updated (if the Effective Date is not immediately following that balance sheet date) to reflect that the calculation is being performed at the Effective Date. The Realistic Liabilities shall be calculated prior to the allocation of Additional Benefits and shall be

adjusted to reflect the provisions of paragraph 9.5 [of the Scheme] in respect of the Promise.

Schedule 2 part 2A (2)

The [AVLAP] Board shall calculate the value of the VPDP for the purposes of paragraph 1 above using the average level of projected distributions from stochastic projections of the development of the relevant business over a period of 25 years by reference to a number of assumptions as to the level of claims, level of new business, investment returns and other matters as further described in Section 5.3 (Initial Allocation of Transferred Liabilities and Assets to the [AVLAP] Sub-Funds and the [AVLAP] Shareholder Fund) of the Actuarial Function Holder's Report.

Schedule 2 part 2A (5(a))

Where, at any time after the Effective Date and after completing the calculations required by paragraph 4.9.1(b) of the Scheme any Policies are identified which have been inaccurately classified and allocated as any of Electing Policies, Non-Electing Policies or ineligible Policies then:

- (a) such Policies shall be re-classified as appropriate and re-allocated to the correct Sub-Fund in accordance with the provisions of Chapter 4 together with associated liabilities in respect of such Policies and appropriate assets equal to such associated liabilities in each case taking into account the asset allocation principles in paragraphs 4, 10 and 11 in Part 2 of this Schedule 2 (including, for the avoidance of doubt, any share of the estate attributable to such Policies) as described in Section 5.4 (Adjustment to the Allocation of Transferred Assets on the Effective Date) of the Actuarial Function Holder's Report; and

Schedule 2 part 3 ((2)(f))

The calculation of the Minimum Asset Requirement for the New WPSF on the Effective Date shall take into account (among other liabilities) the following liabilities: ...

- (f) *any capital gains tax liabilities properly attributable to the New WPSF which will be allocated based on the methodology described in Section 5.3 (Allocation of the Transferred Liabilities and Transferred Assets to the [AVLAP] Sub-Funds and the [AVLAP] Shareholder Fund on the Effective Date) of the Actuarial Function Holder's Report; and*

Schedule 2 part 3 ((3)(c)ii(d))

...There shall be deducted from the amount calculated under paragraph 3(b) of this Part 3, an amount ("A") (calculated in a manner consistent with the FSA Rules) where $A = B$ minus C and for these purposes: ...

- (ii) *C equals an amount representing the expected value of: ...*
- (d) *future tax arising in relation to investment income and gains on Return Assets in relation to the Relevant WP Policies calculated using a methodology consistent with the basis for allocating tax on investment returns to Asset Shares of WP Policies and allowing for tax relief on expenses as further described in Section 5.9 (The Core Assets Account) of the Actuarial Function Holder's Report; plus*

Schedule 3 part 3 (4)

The inherited estates of CULAC and CGNU Life will be valued as at the Effective Date by (i) determining the arithmetic mean of the three values of the inherited estates calculated as at the dates which are three calendar months, two calendar months and one calendar month prior to the day which is one day prior to the Effective Date (or if any of the three such dates is not a working day in the UK, the latest preceding working day); and (ii) applying to such calculated average two calendar months notional interest at an annualised rate corresponding to the two month LIBOR rate on the date which is one calendar month prior to the day which is one day prior to the Effective Date or, if this date is not a working day, the latest preceding working day. The method of determination of the inherited estate values is specified in Appendix 6 (Calculations of the Estate Value) of the Actuarial Function Holder's Report.

Schedule 4 part 2 A (12)

The policies for the management of with-profits business adopted by CGNU Life and CULAC have developed over a number of years and it is expected that such policies will continue to develop in the future within [AVLAP] as set out in the [AVLAP] PPFM (as amended from time to time). Notwithstanding the principles set out in this Schedule 4 [AVLAP] may make appropriate changes to its policies and methodology in future provided that (i) any such changes in policy or methodology (including with regard to the payment of bonuses) are reasonably justified by reference to changes in economic conditions or the financial circumstances of [AVLAP], (ii) are compliant with FSA Rules and (iii) where required by the Scheme, Actuarial Function Holder's Report, With-Profits Actuary's Report or PPFM, are approved by the With-Profits Committee.

Schedule 4 part 2 B (3)

For the purpose of determining investment returns to be credited to the Asset Shares of WP Policies the asset mix used will be based on the combined mix of the Return Assets in respect of all WP Policies (or, if appropriate, any category of equivalent WP Policies) in the Old WPSF and New WPSF in aggregate. Such Return Assets will be invested in accordance with the investment policy in respect of the relevant WP Policies as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report and set out in the [AVLAP] PPFM.

Schedule 4 part 2 B (5a)

As at 31 December 2009 and 31 December 2010, in respect of each further tranche of the DSB:

- (a) the total aggregate costs (including the costs of shareholder transfers and tax thereon) of that tranche of the DSB and the allocation of bonus as between the DSB Policies in force as at 1 January of the relevant calendar year, shall be determined by the [AVLAP] Board in accordance with the principles set out in Sections 5.14.97 to 5.14.102 (The Deferred Special*

Bonus) of the Actuarial Function Holder's Report, having taken appropriate actuarial advice and taking into account its duty to treat policyholders fairly with the intention of applying all of the DSB Assets to meet the costs (as defined above) of the further tranches of the DSB;

Schedule 4 part 3 (3)

The [AVLAP] Board may, in accordance with paragraphs 6 and 7 of this Part 3 of Schedule 4, invest the Remaining Assets in the New WPSF in Non-Profit Business, in Strategic Assets or in other Aviva Group Companies without necessarily investing the Remaining Assets in the Old WPSF in such assets provided that where the [AVLAP] Board wishes to apply such a different investment policy in relation to Non-Profit Business, Strategic Assets or investments in other Aviva Group Companies (other than where such different investment policy results from any differences in expected liabilities and claims experience of the two funds, referred to in paragraph 1 of this Part 3 or is otherwise as set out in Section 5 (The Proposed Structure and Operation of the Funds of [AVLAP]) of the Actuarial Function Holder's Report and specified in the [AVLAP] PPFM) it shall firstly obtain the approval of the With-Profits Committee.

Schedule 4 part 3 (5)

The investment policy for the Remaining Assets shall be reviewed at least annually and from time to time following any significant change in experience in relation to the Old WPSF or the New WPSF to assess whether in the opinion of the [AVLAP] Board having taken appropriate actuarial advice any such change has led to an unacceptable risk (in the absence of making significant changes to the current principles and practices of financial management including in relation to management actions) of a failure to meet the Capital Requirements applicable to the New WPSF, the Old WPSF and any Non-Profit Business in which the RIEESA is invested to the extent that such Capital Requirements are required to be met, or are determined by the [AVLAP] Board to be met, from assets within the relevant sub-fund. Such assessment shall be carried out based on the methodology set out in Sections 5.14.29 to 5.14.45 (Investment Strategy for assets other than the Return Assets (Remaining Assets)) of the Actuarial Function Holder's

Report. If such assessment indicates that the risk of a failure to meet such Capital Requirements is too high, the [AVLAP] Board, having taken appropriate actuarial advice, shall take such action in respect of the investment policy for the Remaining Assets as may be appropriate to reduce such risk of failure to meet Capital Requirements to an acceptable level.

Schedule 4 part 3 (8)

The investment of Remaining Assets relating to the New WPSF under paragraphs 6 and 7 of this Part 3 of Schedule 4 shall be restricted so as to ensure that such investment does not result in an unacceptable risk of failure to meet the Capital Requirements of the New WPSF, the Old WPSF including any Non-Profit Business in which the Remaining Assets of the New WPSF or the RIEESA are invested to the extent that such Capital Requirements are required to be met, or are determined by the [AVLAP] Board to be met from assets within the relevant sub-fund. Sections 5.14.29 to 5.14.45 (Investment Strategy for assets other than the Return Assets (Remaining Assets)) of the Actuarial Function Holder's Report sets out the principles for a methodology to identify a sufficient level of assets within the RIEESA to cover such risk, which assets will not comprise Strategic Assets, investments in Aviva Group Companies or in Non-Profit Business. To the extent that there are Remaining Assets relating to the New WPSF in excess of the identified assets at the relevant time those assets may be applied as provided in paragraphs 6 and 7 of Part 3 of this Schedule 4 without infringing the restriction in this paragraph 8 save that Non-Profit Business written by [AVLAP] or any other member of the Aviva Group prior to the Effective Date may only be transferred or reassured to the RIEESA or as part of the Remaining Assets in the Old WPSF or the New WPSF for the purposes of simplifying or improving the administration of the business of [AVLAP] to be so transferred or reassured and that of corresponding policies in the new Sub-Fund to which the business is being transferred or reassured. Such Non-Profit Business may only be so transferred or reassured up to a cumulative strain (as defined below) of £10m per annum in aggregate for the Old WPSF, New WPSF and the RIEESA and with the approval of the With-Profits Committee. For the purpose of this paragraph 8, "cumulative strain" shall be determined

at the point of transfer or reinsurance and shall mean the technical reserves held by [AVLAP] in respect of such Non-Profit Business less the price paid for the transfer or reinsurance as agreed by the With-Profits Committee. Any unused cumulative strain may be carried forward and used in future years but the maximum investment in any one year from this accumulation shall be £25m.

Schedule 4 part 3 (9)

The calculations made for the purposes of paragraphs 5 and 8 will be reviewed by the With-Profits Committee who may only object if such calculations are inconsistent with the provisions of paragraphs 5 and 8 of this Part 3. The [AVLAP] Board may, having taken appropriate actuarial advice, propose changes in the methodology applied for the purposes of paragraphs 5 and 8 as set out in Sections 5.14.29 to 5.14.45 (Investment Strategy for assets other than the Return Assets (Remaining Assets)) of the Actuarial Function Holder's Report to reflect, inter alia, improvements in stochastic modelling capability or changes in the basis for calculating Capital Requirements for the New WPSF. Any such proposals to change the model being used, the methodology or the basis used for selecting assumptions (including in respect of new business and Capital Requirements) shall be subject to the approval of the With-Profits Committee (having taken appropriate actuarial advice).

Schedule 4 part 4 (4(c))

In respect of the business allocated to the Old WPSF and the New WPSF and the RIEESA, the role of the With-Profits Committee is to: ...

- (c) consider those aspects of the management of the New WPSF (including the RIEESA) and the Old WPSF (including changes in policy, process or methodology) which require the With-Profits Committee's review, confirmation or approval as specified in the Scheme, the Actuarial Function Holder's Report, the With-Profits Actuary's Report or the [AVLAP] PPFM and, if it considers appropriate (taking into account the governance objectives of the Scheme set out in paragraph 9 of this Part 4*

of Schedule 4), provide the [AVLAP] Board with the relevant confirmations or approvals;

Schedule 4 part 4 (5)

For the avoidance of doubt, notwithstanding any requirement in the Scheme, the Actuarial Function Holder's Report, the With-Profits Actuary's Report or the [AVLAP] PPFM for the review, confirmation or approval of the With-Profits Committee to any aspect of the management of the Old WPSF or the New WPSF, 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 With-Profits Committee except for any renewal, replacement or amendment thereof unless the basis for such renewal, replacement or amendment is specified in the contract or arrangement.

Schedule 8 part 2

"Moderated AAA CT of the Old WPSF" means the AAA CT for the Old WPSF Sub-Fund calculated in the same way as the AAA CT of that Sub-Fund but assuming that the Remaining Assets (other than the NP Assets and Guarantee Assets) are invested in accordance with the Theoretical EBR (as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report) for the aggregate Return Assets in the Old WPSF and the New WPSF in respect of WP Policies allocated to such Sub-Funds.

"Required Probability" means, for each of the periods from the investigation date to the end of each of the following 25 years, a probability which results in a risk level consistent with the historic observed default rate published by Moody's in respect of Aaa corporate bonds, and derived as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report with such changes and modifications from time to time as are agreed with the With-Profits Committee.

Schedule 8 part 3 (3(a) and 3(d))

For the purposes of the calculations of the AAA CT Coverage in paragraph 1 of this Part 3, the AAA CT shall be determined on the following assumptions:

- (a) assets backing the with-profits benefit reserve are invested in accordance with the Theoretical EBR (as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report) then applicable to the Sub-Fund (or such other benchmark as may be agreed by the [AVLAP] Board with the With-Profits Committee for the purposes of determining and monitoring the investment mix of assets backing the with-profits benefits reserve);*

...

- (d) any assets held in excess of (a), (b) and (c) above shall be assumed to be held in the same proportions as the actual assets held in excess of that level as at the investigation date and managed in accordance with the investment policy applicable to those assets for the purposes of the projections only, as [described] in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report; and*

Schedule 8 part 3 (4(b))

Any changes after the Effective Date to the assessment of the Required Probability, the stochastic model, ESG1, or other aspects of the methodology used for the annual investigations described in this Schedule 8 (including in respect of new business and capital requirements) will be subject to the prior approval of the With-Profits Committee. Any changes must comply with the following principles: ...

- (b) the margin between the implied risk associated with the MPC and the CRP (as described in Section 5.14 (Ongoing Financial Management of the New*

WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report) should be preserved.

Schedule 8 part 6 (4(e))

In calculating the Moderated AAA CT of the New WPSF and the Old WPSF for the purposes of paragraph 3 above: ...

- e) *The Moderated AAA CT of the New WPSF shall be calculated in the same way as the AAA CT of that Sub-Fund but assuming that the Remaining Assets (other than the Guarantee Assets and the Allowed NP Assets of the New WPSF) are invested in accordance with the Theoretical EBR (as described in Section 5.14 (Ongoing Financial Management of the New WPSF and the Old WPSF after the Effective Date) of the Actuarial Function Holder's Report) for the aggregate Return Assets in the Old WPSF and the New WPSF in respect of WP Policies allocated to such Sub-Funds;*