

Report Number 18 A

## With-Profits Actuary's Report

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

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Appendix by: Aviva UK Life – June 2009

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## 1.00 Context

Aviva is proposing to make changes to three of its funds:

- CGNU Life with-profits fund
- Commercial Union Life Assurance Company (CULAC) with-profits fund
- NUL (RBS) Limited

These changes affect a large number of our policyholders.

Our proposed changes are a reorganisation: consisting of a reattribution and a fund transfer.

In accordance with SUP 18.2.58(G) and in compliance with SUP 4.3.17R(4) of the Financial Services Authority (FSA) Conduct of Business Sourcebook (COBS) rules, the With-Profits Actuary for CGNU Life, CULAC, Aviva Life and Pensions (AVLAP) and NUL(RBS) has produced a report to the Board of Directors for these companies. The objective of the report is to consider:

- The likely effect of the Scheme's proposals on the fair treatment of the with-profits policyholders of CGNU Life, CULAC, NUL(RBS) and AVLAP, including their reasonable benefit expectations;
- The fairness of the reattribution proposals; and
- Whether the governance arrangements are sufficient to ensure compliance with the detailed principles and practices following the implementation of the Scheme.

With that in mind, this paper shares some background information on the role of the With-Profits Actuary and provides a summary of his comments and conclusions in relation to the reorganisation proposals.

Copies of the full With-Profits Actuary's report have been made available to:

- The FSA
- The Independent Expert
- The Policyholder Advocate

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A copy of the full With-Profits Actuary's report will be presented to the Court so that it can be taken into consideration in the decision on whether or not to approve the transfer.

You will also find the Policyholder Advocate's and the Independent Expert's complete reports and the reports of the Actuarial Function Holder and the With-Profits Actuary on the website [www.aviva.co.uk/fundtransfer](http://www.aviva.co.uk/fundtransfer) as well as more information from the Policyholder Advocate on our website and her own. These reports and their appendices are very large documents, so in an effort to minimise the environmental impact of issuing printed copies of these publications they will only be available on-line or on request by writing to us at:

Aviva Fund Transfer Support Team, P.O. Box 3312, Surrey Street, Norwich, NR1 3FE.

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## 2.00 Introduction

### 2.01 What is a With-Profits Actuary?

The role of the With-Profits Actuary was introduced in 2005 following the FSA's With-Profits review. As part of its with-profits governance arrangements an insurer must appoint a With-Profits Actuary to perform the role set out in SUP4 and in particular SUP 4.3.13R (1)(b) of the FSA handbook.

The appointed With-Profits Actuary must have the required skills and experience to perform the role and be a Fellow of the Faculty of Actuaries or of the Institute of Actuaries.

Full details of the duties of the With-Profits Actuary are set out in SUP 4.3.16AR. In brief, the role of the With-Profits Actuary is to:

- Advise about the key aspects of discretion to be exercised in the management of the with-profits business,
- At least once a year, report on key aspects of the discretion exercised in the management of the with-profits business during the period, including application of the Principles and Practices of Financial Management (PPFM), and
- Each financial year, make a written report to with-profit policyholders to accompany the company's annual report.

### 2.02 Who is Aviva's With-Profits Actuary?

The With-Profits Actuary for CGNU Life, CULAC, AVLAP and NUL (RBS) is Richard Myers; he has held this role since 15<sup>th</sup> May 2008.

Richard is a Fellow of the Institute of Actuaries.

### 2.03 Structure of this Paper

Sections 3.00 to 7.00 of this paper have been extracted from the Summary section<sup>1</sup> of the With-Profits Actuary report to the directors of CGNU Life, CULAC, AVLAP and NUL (RBS) in connection with the proposed reorganisation of the CGNU Life and CULAC funds. As a result, the numbering sequence used in these sections corresponds with those used in the With-Profits Actuary's Report.

Section 8 of this paper provides Aviva's view of the Office of the Policyholder Advocate's commentary in relation to the With-Profits Actuary's report.

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<sup>1</sup> Section 2 of the With-Profits Actuary's Report dated 30/04/2009

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### 3.00 The Scheme (Section 2.1)

2.1.1 In summary the transfer and financial reorganisation being proposed under the Scheme comprises:

- (a) A merger of the businesses of CGNU Life and CULAC
- (b) The establishment of two new With-Profits Sub-Funds in AVLAP (the New WPSF and the Old WPSF)
- (c) A transfer of the policies of CGNU Life, CULAC and NUL (RBS) and the associated assets and liabilities into the New WPSF and the Old WPSF
- (d) An election by eligible with-profits policyholders to accept the reattribution proposals (as described below) and be transferred into the New WPSF, or not to elect to accept the reattribution proposals and be transferred into the Old WPSF
- (e) The transfer of ineligible with-profits policies and non-profit policies (including the unit-linked part of hybrid linked policies) partly to the New WPSF and partly to the Old WPSF based on the outcome of the election
- (f) The apportionment of the transferred Inherited Estates of the CGNU Life and CULAC With-Profits Funds between the Non-Profit Sub-Funds of AVLAP (the Reattributed Inherited Estate External Support Account or RIEESA) and the Old WPSF based on the outcome of the election
- (g) Ancillary provisions governing:
  - The investment and bonus policy for the transferred business
  - Requirements relating to the RIEESA concerning its investment, its use to provide capital support to the New WPSF and the Old WPSF and its future release to shareholders
  - The efficiency of the investment process including the pooling of assets
  - Future new business arrangements
  - Other changes aimed at providing greater clarity on the exercise of management discretion following the reattribution
  - Governance arrangements, appropriate to the changed circumstances following the reattribution, designed to ensure compliance with the Principles of the Scheme

## 4.00 The Reattribution Proposals (Section 2.2)

### 4.01 Overview

2.2.1 Under the reattribution proposals, eligible with-profits policyholders of CGNU Life, CULAC (including for this purpose the with-profits policyholders of Aviva Life International Limited whose benefits are wholly reinsured to CGNU Life and CULAC) and NUL (RBS) will be offered a choice. They can elect to accept certain reattribution benefits (Policyholder Incentive Payments (PIPs)) and if their policy remains in force on the Effective Date, have their policy transferred to (or reassured to in the case of Aviva Life International Limited) a newly established sub-fund of AVLAP (the New WPSF). Such policies will no longer be eligible to participate in any future Inherited Estate distributions. Eligible with-profits policyholders who do not so elect (including those who fail to respond) will, if their policy remains in force on the Effective Date, have their policies transferred (or reassured) to another newly established sub-fund of AVLAP (the Old WPSF). Such policies will be eligible to participate in any future Inherited Estate distributions from that fund whilst they remain in force and invested in with-profits. It is intended that the reattribution proposals will not be implemented unless a minimum proportion of eligible policyholders elect to accept the proposals (Election Threshold). The AVLAP Board does have the ability to waive this condition although the Election Threshold has been set at a very low level as described in Section 21 of Appendix 1.

2.2.2 Eligible with-profits policyholders whose policies terminate before the Effective Date as a result of the occurrence of an insured event such as death, maturity or normal retirement, will receive a PIP (unless they have elected not to accept the reattribution benefits). With-profits policyholders whose policies terminate before the Effective Date as a result of voluntary actions (such as surrender, transfer or early retirement) will not be eligible to receive a PIP.

2.2.3 Where the with-profits investment of an Elected Policy is voluntarily reduced between the Qualifying Date and the Effective Date, the AVLAP Board may proportionately reduce the PIP. No such reduction will be applied in respect of the continuation of automatic partial withdrawals that were being made on the Qualifying Date or, for pension policies, from the 'lifestyling' option of automatic switches out of with-profits as the normal retirement date in the contract approaches. Furthermore, no such reductions will be applied in respect of any reduction in the with-profits investment which took place prior to 24<sup>th</sup> April 2009.

### 4.02 Determination of the PIPs

2.2.4 The PIPs offered to Eligible Policyholders (calculated as described in Section 23 of Appendix 1) will be based on an assumed value of the combined Inherited Estates of CGNU Life and CULAC of £1,200m and in this event an aggregate PIP of £500m (the Minimum Aggregate Policyholder Incentive Payment) will be made if all Eligible Policyholders elect to accept the proposals. The actual value of the combined Inherited Estates will however be established as at the Effective Date (the Estate Value as described in Paragraph 2.2.5 below) and the aggregate PIP will be enhanced in the event that the

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Estate Value exceeds £1,200m. The enhanced value (Final Aggregate Policyholder Incentive Payment) will then be apportioned between those policyholders who remain Eligible Policyholders one month and one day prior to the Effective Date. This will be achieved by enhancing the PIPs offered to the remaining Eligible Policyholders by a uniform percentage (after allowing for any proportionate reduction in the payments to be made in the circumstances described in Paragraph 2.2.3 above). Through this mechanism, the payments made to holders of Elected Policies will reflect an allowance for the PIPs which would have been paid to potentially Eligible Policyholders who have voluntarily terminated their policy prior to the date one month and one day before the Effective Date (and reflect any reduction in payments in the circumstances described in Paragraph 2.2.3 above). In the event that the Estate Value would be less than £1,200m (before the application of the £1,200m minimum value) the AVLAP Board and the Aviva Board will consider whether or not to waive the Estate Condition and if not, the Scheme will not proceed.

2.2.5 The Scheme requires that the Estate Value used for the purpose of calculating the Final Aggregate Policyholder Incentive Payment will be calculated using the average of three values of the combined Inherited Estates of CGNU Life and CULAC. For this purpose the values will be determined at the three consecutive month ends 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. The average value so obtained will be increased to allow for two months interest at an appropriate risk free rate. The approach to the Estate Value calculation has been chosen so as to protect both policyholders and shareholders from sharp market movements on any particular day whilst enabling the PIP payments to be made as quickly as possible after the Effective Date. The approach adopted is the same as that used to produce half-year results for Aviva plc. This relies on the use of market indices and economic sensitivities to project the most recently calculated balance sheet position forward and it makes no allowance for non-economic movements during the projection period. The calculation of the Estate Value is described in Appendix 6 of the Actuarial Function Holder's Report.

#### **4.03 Financing arrangements for the PIPs**

2.2.6 Electing policyholders and those eligible with-profits policyholders whose policies terminate before the Effective Date who are deemed to have elected, will receive a PIP which in most cases will take the form of a cash payment. For certain categories of contract however the PIP will take the form of an additional benefit. The AVLAP Board will determine whether any part of the PIP that takes the form of an additional benefit should be financed from the surplus assets in NPSF1 and NPSF2 (prior to the transfers, but after allowing for any expenses arising in respect of the transfers which are to be charged to these sub-funds). The balance of the cost of such PIPs together with the whole of the cost of any PIP that takes the form of a cash payment will be financed by Aviva from resources outside the long term business funds but may take the form of a contingent loan to AVLAP which is subordinated to policyholder liabilities (although at the date of this report this option is not being proposed).

#### **4.04 The transferred Inherited Estates**

2.2.7 The proportion of the Inherited Estates of CGNU Life and CULAC on the Effective Date which is deemed to relate to policyholders who have received a PIP (the New WPSF Proportion as described in Paragraph 3.4 of Appendix 1) will be transferred to the Non-Profit Sub-Funds of AVLAP. The balance of the Inherited Estates of CGNU Life and CULAC will be transferred to the Old WPSF.

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2.2.8 That part of the Inherited Estates of CGNU Life and CULAC which is transferred to the Non-Profit Sub-Funds of AVLAP (the RIEESA) will not be immediately available for distribution to shareholders. The RIEESA will instead be 'locked-in' until it is no longer needed to provide support for the transferring with-profits policies, so that in this respect the security for policyholder benefits and the freedom to manage the business of the transferring funds is not diminished by the Scheme. The RIEESA will, subject to the limitations specified in the Scheme, be available to write non-profit new business for the benefit of shareholders and to provide capital to support with-profits new business.

#### 4.05 Associated changes

2.2.9 A distribution of part of the Inherited Estates of the CGNU Life and CULAC With-Profits Funds is being made to certain with-profits policyholders whose policies are invested in those funds (including NUL(RBS) policyholders and Aviva Life International Limited policyholders who are invested in with-profits). This distribution (being the Special Bonus which is described in Paragraph 4.4.1 below) is being made to all with-profits policies of CGNU Life, CULAC, NUL (RBS) and Aviva Life International Limited (other than Stakeholder Pension Policies) that were in force and invested in with-profits on 1 January 2008. Part of the Special Bonus distribution was made in 2008 and the remainder will be distributed by way of further distributions in 2009 and 2010 to the same policyholders, provided that their policies remain in force and invested in with-profits at the relevant time. The Special Bonus, including the element which is deferred, has been facilitated by the strategy of hedging some of the investment risks to which the Inherited Estates are exposed ('de-risking' – as described in Paragraph 7.4.3 of the AFH Report) and it has been taken into account as part of the negotiations with the Policyholder Advocate who has been appointed in connection with the reattribution proposals (see Paragraph 2.4.3 below). Such a distribution demonstrates Aviva's commitment to treating its customers fairly and it means that the likelihood of a further sizeable distribution from the Inherited Estate of the Old WPSF in the short to medium term is low.

2.2.10 As part of the reattribution, and conditional upon it taking effect, the Affordability Condition in relation to the application of the Mortgage Endowment Promise provided by CGNU Life and CULAC will be removed (although the other conditions applying to the Promise will continue to apply). The removal of this condition (whereby top-up payments can be reduced or withdrawn in certain adverse circumstances) will provide greater clarity on the application of shareholder discretion in the post reattribution environment and will, in certain circumstances, be of direct financial benefit to some policyholders. The greater clarity is considered desirable in view of the increased potential for conflicts of interest between policyholders and shareholders generated by the reattribution. The removal of the Affordability Condition would apply to all relevant policyholders in CGNU Life and CULAC who benefit from the Mortgage Endowment Promise irrespective of whether or not they elect to receive a PIP. There will be no change to the terms of the Mortgage Endowment Promise in relation to policies allocated to the existing sub-funds of AVLAP.

2.2.11 As a further part of the reattribution proposals and in order to provide greater clarity to policyholders on the application of discretion in the post reattribution environment:

- The ability of the AVLAP Board to make charges to the asset shares of Transferred Policies for guarantees will be restricted after the Effective Date. Such charges will only be made in respect of transferring policies where an explicit charge was being applied under the terms of the policy prior to the Effective Date. Furthermore, no additional charges will be made for guarantees in the period prior to the Effective Date unless the application of such charges is

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explicitly specified in the product terms and conditions. Charges for guarantees may be made to new policies effected after the Effective Date provided such charges are clearly permitted under the terms of the policy

- Prior to the Effective Date a final assessment will be made of the profits that are expected to arise under certain classes of non-profit business where it has been the practice of CGNU Life and CULAC to allocate such profits to asset shares. The non-profit business concerned is that described in Paragraph 4.5.1 of the AFH Report. The purpose of that assessment will be to establish whether the previous allocations to asset shares in respect of such profits should be adjusted in the light of any differences between the future experience (in relation to mortality and policy lapses for example) which was anticipated when those allocations were made and the subsequent experience up to the date of the assessment. Our current expectation is that the previous allocations to asset shares will exceed the profits that are expected to arise under those classes of non-profit business and in these circumstances no further adjustments will be made to asset shares. After the Effective Date no further adjustments will be made to asset shares in respect of the profits or losses on non-profit business written prior to the Effective Date (except to correct any factual errors as described in Paragraph 5.14.104(d) of the AFH Report).

2.2.12 Stakeholder Pension policyholders with investments in the Stakeholder With-Profits Fund will not be affected by the reattribution proposals. They will as currently only be entitled to participate in distributions from a Stakeholder With-Profits Fund which, after transfer, will be the AVLAP Stakeholder WPSF.

## 5.00 Implications for Policyholders (Section 2.3)

2.3.1 From a with-profits policyholder perspective, the terms of the reattribution under the Scheme are designed to:

- Ensure that the security of policyholder benefits for all with-profits policyholders will not be materially adversely affected
- Ensure that, as far as possible, policy benefits will be no different from those that would have been provided in the absence of the Scheme (disregarding for this purpose the benefits that might have been paid to electing policyholders and non eligible policyholders in the event of further distributions from the Inherited Estates and the additional benefits that will be provided to certain categories of policyholder under the incentive arrangements in lieu of a cash payment)
- Ensure that the implementation of the Scheme will not lead to a change in the investment policy for assets backing the asset shares
- Provide eligible policyholders the opportunity to access the value (through the payment of a PIP) of their contingent eligibility to participate in any future distributions from the Inherited Estates should any be made. Following the allocation of the Special Bonus, the likelihood of further sizeable additional distributions in the short to medium term is relatively low. Consequently, for many policyholders who are currently entitled to participate in such distributions should they be made, this eligibility would more than likely be given up to future generations of policyholders on exit and generate no significant value to them
- Provide clarity for eligible policyholders who choose to elect, as to the ownership of the Inherited Estates, their entitlements under their policies and the responsibilities of shareholders and management
- Give eligible policyholders who choose not to elect the option to retain their eligibility to participate in future distributions from the Inherited Estate if they so wish, whilst maintaining the value at the Effective Date of their collective interests in future distributions from the Inherited Estate
- Provide greater clarity in the operation of management discretion (as outlined in Paragraphs 2.2.10, 2.2.11 and 2.3.2)

2.3.2 The exercise of Board discretion in the management of with-profits business could give rise to a potential for conflicts between the interests of policyholders and shareholders. This potential conflict is already recognised in the existing governance arrangements for the with-profits funds. These include the publication of detailed Principles and Practices of Financial Management (PPFM), the role of the With-Profits Actuary (as described in Paragraph 10.4 below) and the With-Profits Committee (WPC) (as described in Paragraph 10.2 below) in advising the Board and reporting on the exercise of discretion and compliance with the PPFM. The reattribution would however give rise to a greater potential for conflicts between the interests of policyholders and shareholders and this has been

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recognised in designing the proposals. In particular, the Scheme specifies detailed principles of financial management which will be supplemented by additional practices set out in the report of the Actuarial Function Holder (AFH Report), in this report, and recorded in the PPFM for the New WPSF and Old WPSF. These principles and practices (which include those described in Paragraph 2.2.10 and 2.2.11 above) will impose limitations on the exercise of discretion by the Board and management of the company. There will be a further strengthening of the governance arrangements in respect of compliance with, and future changes to, these principles and practices which will provide an appropriate level of protection for the interests of policyholders after the Scheme takes effect. In particular, internal governance and guidance documentation provides greater codification of these principles and practices and whereas future changes to principles and practices will continue to be subject to review by the WPC, any material changes will require its prior confirmation or approval.

## 6.00 Fund Transfer and Reattribution Process (Section 2.4)

2.4.1 The Scheme is subject to the provisions of Part VII of the Financial Services and Markets Act 2000 and regulations made under it. It is also subject to the detailed guidance regarding transfers of insurance business as laid out in SUP 18.2. In addition, the process for reattribution of the Inherited Estates is subject to the rules and guidance laid out in the New Conduct of Business Sourcebook (COBS) in COBS 20.2.42 to 20.2.52 inclusive.

2.4.2 The Scheme, this report and the AFH Report will be reviewed by the Independent Expert appointed (with the approval of the FSA) in connection with the Scheme. The Independent Expert has in addition carried out an extensive due diligence exercise and will provide a report on the Scheme to the Court. His report covers (amongst other things):

- The likely effects of the Scheme on long-term policyholders including, but not limited to, their security and benefit expectations
- The approach applied to determining the allocation of PIP between relevant policyholders
- The effect of the Alternative Scheme where the transfer becomes effective without the reattribution proposals being implemented

2.4.3 The reattribution proposals have been considered by a Policyholder Advocate who has been appointed in accordance with the provisions of COBS 20.2.42 to 20.2.46 inclusive. The role of the Policyholder Advocate is (inter alia):

- Negotiating with the firm the benefits to be offered to policyholders (i.e. the policyholder incentive payments) in exchange for the rights and interests that they would be giving up
- No explain to eligible with-profits policyholders the rights and interests that they would be giving up in exchange for the incentive payment
- To comment to with-profits policyholders on:
  - The methodology used in allocating the policyholder incentive payments amongst the eligible with-profits policyholders, or groups of such policyholders, and the form of those payments
  - The criteria used for determining the eligibility of with-profits policyholders to elect
  - The terms and conditions of the proposals
  - The views expressed by the With-Profits Actuary and the Independent Expert on the allocation of the policyholder incentive payments amongst the eligible with-profits policyholders
- To advise with-profits policyholders or each group of with-profits policyholders, with reasons, whether in her view the proposals are in their interests.

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2.4.4 Aviva's website will be updated to include this report and the full reports of the Actuarial Function Holder, the Independent Expert and the Policyholder Advocate (subject to the removal of any price sensitive information). Aviva's website will also include summaries of the Scheme and the Independent Expert's report together with the executive summary of the Policyholder Advocate's report and her Guide. Paper copies of these reports, the summary of the Scheme (and the full Scheme) will be sent to policyholders free of charge upon request. Policyholders will have the right to raise questions, concerns or objections to the proposals. The Court will be informed of the number of such questions or complaints and any substantive questions or complaints will be notified to the Court.

## 7.00 Outline of the Report (Section 2.5)

2.5.1 Section 3 of this report provides an outline of the current position concerning the fair treatment of with-profits policyholders including their reasonable benefit expectations. This section covers in particular the current rights and expectations of with-profits policyholders in relation to distributions from the Inherited Estates of CGNU Life and CULAC and I comment on the likelihood of such distribution in the future. I also consider whether the current generation of with-profits policyholders has contributed to the build up of the Inherited Estate.

I conclude that with-profits policyholders as a whole have a right to receive a proportion (at least 90%) of the relevant Inherited Estate to the extent that it is distributed, but not otherwise and that individual policyholders have very little specific rights to participate in a future distribution from the Inherited Estate. I also conclude that there is no reason to believe that the current generation of with-profits policyholders has in aggregate contributed to the build up of the Inherited Estates.

2.5.2 In Section 4 I review the effect of the Scheme on the fair treatment of the with-profits policyholders of CGNU Life, CULAC and NUL (RBS) including their reasonable benefit expectations.

I conclude that the Scheme is consistent with the fair treatment of the transferring with-profits policyholders of CGNU Life, CULAC and NUL (RBS) and that there will be no material adverse effect on their reasonable benefit expectations.

2.5.3 In Section 5 I review the effect of the Scheme on the fair treatment of the with-profits policyholders of the AVLAP With-Profits Sub-Fund including their reasonable benefit expectations.

I conclude that the Scheme is consistent with the fair treatment of the existing with-profits policyholders of the AVLAP WPSF and that there will be no material adverse effect on their reasonable benefit expectations.

2.5.4 In Section 6 I review the effect of the Scheme on the fair treatment of the with-profits policyholders of the Provident Mutual Sub-Fund of AVLAP including their reasonable benefit expectations.

I conclude that the Scheme is consistent with the fair treatment of the existing with-profits policyholders of the PM Sub-Fund and that there will be no material adverse effect on their reasonable benefit expectations.

2.5.5 In Section 7 I review the effect of the Scheme on the fair treatment of the with-profits policyholders of the Belgian Sub-Fund of AVLAP including their reasonable benefit expectations.

I conclude that the Scheme is consistent with the fair treatment of the existing with-profits policyholders of the Belgian Sub-Fund and that there will be no adverse effect on their reasonable benefit expectations.

2.5.6 In Section 8 I comment on the fairness of the reattribution process.

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I conclude that:

- The reattribution process has been undertaken in line with regulatory requirements and provides eligible customers with a choice:
  - (a) To accept the terms of the reattribution and receive a PIP
  - (b) Not to accept the terms of the reattribution and continue to be eligible to participate in any future Inherited Estate distributions
- The negotiation process with the Policyholder Advocate has been robust with open access to information. Accordingly the Policyholder Advocate and the FSA have been able to properly assess, present and agree their respective positions and the Policyholder Advocate has been able to recommend the reattribution for the majority of eligible customers
- Consequently, policyholders have been treated fairly in the reattribution process

2.5.7 In Section 9 I review the impact on the fair treatment of with-profits policyholders transferring to AVLAP and existing with-profits policyholders of AVLAP, including their reasonable benefit expectations, in the event that the Alternative Scheme is implemented.

I conclude that:

- The Alternative Scheme is consistent with the fair treatment of the transferring with-profits policyholders of CGNU Life, CULAC and NUL (RBS) and that there will be no material adverse effect on their reasonable benefit expectations
- The Alternative Scheme is consistent with the fair treatment of the existing with-profits policyholders of the AVLAP WPSF, the PM Sub-Fund and the Belgian Sub-Fund and that there will be no material adverse effect on their reasonable benefit expectations.

2.5.8 In Section 10 I review the governance arrangements that will apply after the Effective Date of the Scheme, including the role of the WPC and the annual certification requirements.

I conclude that the governance arrangements are appropriate and sufficient to facilitate compliance with the detailed principles and practices that apply to the management of the funds under the Scheme after the Effective Date.

2.5.9 Information on the background of the companies involved in the Scheme and the rationale for the Scheme is provided in Section 3 of the AFH Report. Details of the current structure and operation of the transferring funds and AVLAP are provided in Section 4 of that report with details of the proposed structure and operation of the funds of AVLAP after the Scheme takes effect being provided in Section 5 of that report. In my report I make reference to these sections and to other sections within that report. My report should therefore be read in conjunction with the AFH Report.

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## **8.00 Aviva's view of the Policyholder Advocate's Approach**

### **8.01 Materiality**

The Office of the Policyholder Advocate has suggested that it would have been helpful if the WPA could have given some indication of the degree of materiality he has in mind. As the Office of the Policyholder Advocate acknowledges, it is difficult to provide a precise definition of this term.

The use of such terminology in the context of a Part VII Fund Transfer (and reattribution) is commonplace and represents a professional and expert opinion of the effects of the proposals without being able to provide absolute assurances due to the uncertain nature of future events.

### **8.02 Prospect of Future Distributions**

The comments made by the Office of the Policyholder Advocate in relation to the prospect of future distributions cause Aviva concern since they could mislead policyholders into believing that there is a definite entitlement to distributions of the inherited estate (that doesn't exist) and more certainty over the prospect of future distributions than it is possible to give.

Aviva's view is that as a group, policyholders (including future policyholders) have some expectation of potential future special distributions from the inherited estate – this is however an uncertain event as the potential for future special distributions is dependent, amongst other things, on the economic situation, investment returns, levels of new business etc.

A combination of the announced special bonus, the recent significant market falls and prolonged market volatility has taken the fund strength outside of the preferred range of surplus but comfortably within the acceptable range of surplus. Our aim is to remain within the range of AA to AAA because this is not only prudent in fluctuating economic conditions but is also consistent with the basis upon which the funds were sold to our customers.

At this point, the Board (in consultation with the With-Profits Committee) considers that further special distributions from the CGNU Life and CULAC inherited estates are unlikely in the short to medium term. It therefore seems to us that it is appropriate for the With-Profits Actuary to comment on this conclusion in his report, and he does so, indicating that "I conclude that the Inherited Estate is needed to provide security and investment freedom and the other purpose described in Paragraph 3.5.2 and that, only to the extent that it is considered by the Board to be excessive, is there any expectation of a direct benefit from the Inherited Estate to policyholders". Clearly, if the inherited estate were at much increased levels such as significantly above the preferred range and accordingly some or part of it was not needed, this conclusion might be very different.

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### **8.03 Fair Treatment of With-Profits Policyholders**

It is not clear to us why, in assessing the fair treatment of policyholders, the Office of the Policyholder Advocate is suggesting that “the WPA would need to have satisfied himself that the PIP is in the interests of policyholders under a plausible range of scenarios” or that he should specifically comment on the new business forecasts used by Aviva in assessing whether the offer was fair to eligible policyholders.

In making the offer to policyholders, Aviva has endeavoured to ensure that the proposals have been developed, considered and challenged through a rigorous process, which in line with regulatory requirements includes negotiations with an independent Policyholder Advocate representing all affected CGNU and CULAC customers.

In making his report to the Board of Directors, the WPA has focused on the fairness of the reattribution process. In making her report, the PHA has focused on the benefits of this deal for the policyholders she represents. The Actuarial Function Holder has represented Aviva and, in making his report, in addition has satisfied himself that the PIP offer is fair to policyholders taking into account a range of future scenarios and concluded that “in nearly all cases it will be in the financial interests of eligible policyholders to elect. In making these comments, it is important to note that the range of future scenarios considered by these representatives for each party involved in the negotiations, including specifically the plans and prospects for new business, are key to the negotiations and impact the assessment of the PIP directly. Hence, there has been proper representation for this deal of both seller and buyer, all eligible customers have an individual choice whether to elect to take their PIP (and give up any rights) or not, and in the latter case the WPA has additionally concluded that there will be no material adverse effect on affected customers reasonable benefit expectations.”

From Aviva’s perspective, the combination of internal and external scrutiny of both the process and proposals has ensured the fair treatment of with-profits policyholders using a pragmatic division of accountabilities which, when looked at as a whole, provide clear evidence that customers have been treated fairly.

### **8.04 Uses of the Estate**

We acknowledge that the Policyholder Advocate has strongly held views on the appropriateness of the uses of the inherited estates allowed under the COBS rules. The relevant PPFM for these funds sets out what the CGNU Life and CULAC inherited estates can be used for.

Section 3.5 of the With-Profits Actuary report to the Board of Directors assesses the permitted uses of the inherited estates and whilst the Office of the Policyholder Advocate has suggested that his consideration of these uses should have gone further, we disagree.

### **8.05 Risk Appetite Framework**

The development of the Risk Appetite Framework (RAF), and the concept of the preferred range of surplus, essentially represents a formalisation of the approach that has been followed by the Board in the running of the funds for many years. The establishment of the formal framework took account of actions taken in the past in response to changes in economic circumstances. It also reflected the

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long-running practice of maintaining very strong funds with relatively high equity backing ratios, using the Estate to support new business growth and to cover, for example, guarantee and smoothing costs.

In articulating its RAF in a way that customers can understand, Aviva has:

- Undertaken analysis of how the funds were run in the past
- Modelled the impacts of market fluctuations and shocks
- Ensured that the RAF concepts are embedded in the with-profits governance framework and that they treat customers fairly
- Liaised closely with FSA to ensure that the RAF is appropriate from their perspective

Under these circumstances we are not sure why the Office of the Policyholder Advocate is suggesting that they would have expected the With-Profits Actuary to consider the balance between a high level of security and the potential for future distributions of the inherited estate, and to draw out the advantages and disadvantages in his report as this aspect of the management of the funds is not being considered for change as part of the reattribution or fund transfer proposals.

The Office of the Policyholder Advocate goes on to suggest in their paper that they “believe that policyholders may prefer the fund to be managed in a less prudent way” – we are not aware of any factual evidence to support this claim and would counter this suggestion by noting that one of the factors that have attracted investment in the CGNU Life and CULAC funds is their long-term financial strength.

The risk appetite framework formalises the approach that has been followed by the Board in the running of the funds for many years. Indeed, if the Board were to increase the risk in the funds following the reattribution they would arguably not be treating customers fairly (by not keeping their promises) and fall foul of one of the key outcomes used by the FSA to judge the appropriateness of reattribution transactions – “Ignoring the scope for future distributions, policyholders’ benefit expectations are no worse under the proposals than if the reattribution does not take place”<sup>2</sup>. Given the current economic volatility (and the failure of a large number of financial institutions) we can see no justification for the suggestion that the level at which mandatory distributions should be made should be weakened.

## 8.06 Industry levies

Aviva notes that the Office of the Policyholder Advocate has commented on the provisions in the scheme which address the facility to charge industry levies and the governance of those provisions. From Aviva’s perspective, the inclusion of the facility to charge industry levies is a response to regulatory change and is not a consequence of either the reattribution or fund transfer. Transferring policyholders will benefit from restrictions, which are introduced in the scheme, on certain new charges to asset share, and it was therefore necessary to document an exception (noted in paragraph 1 (c) of

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<sup>2</sup> House of Commons Treasury Committee. Inherited Estates: Financial Services Authority and Office of Fair Trading Responses to the Committee’s Twelfth Report of Session 2007-08

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Part 2C of Schedule 4 of the scheme) to deal with industry levies as a contingency measure against potential financial security issues.

The facility to allocate 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 there is either a large levy or number of levies imposed on insurers. Any ability to make such a charge will be subject to the terms of the policy and to TCF. The Principles and Practices of Financial Management (PPFM) make it clear that in considering whether or not to make such a charge the AVLAP Board will have regard to appropriate actuarial advice and the views of the With-Profits Committee. Aviva has considered the policyholder advocate's comments and remains satisfied that an appropriate combination of governance controls has been put in place to deal with this potential financial security issue.