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Contributions to the Inherited Estates

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

In considering policyholder potential interests in distributions from the inherited estate and how any reattribution incentive might be allocated to policyholders, it might be helpful to understand how the current generation of policyholders has contributed, if at all, to the inherited estate. Generally speaking, contributions from policyholders to the inherited estates can only occur when their policy ends. In considering whether policyholders have contributed, it is useful to look at the various sources where the inherited estate may have arisen in the operation of the fund.

The Financial Services Authority (FSA) describes¹ inherited estates as: "The 'inherited estate' is part of the with-profits fund. Generally, it is that part of the with-profits fund over and above the part required to meet realistic liabilities that the firm nevertheless retains for commercial reasons. For example, to ensure it has a strong capital base or to fund future growth plans. The inherited estate provides working capital for the with-profits fund in the longer term and supports its operation. In most with-profits firms, the inherited estate has built up over many years. It is usually made up of previous and current policyholders' premiums and investment returns, or past injections of capital from shareholders."

From both a legal and regulatory perspective the inherited estate is an asset of the company and represents its working capital. However, the size of the inherited estate is by no means fixed. It is perhaps best described as the difference between two very large amounts, namely the assets and liabilities of the with profit company, both of which are volatile and susceptible to external influences such as interest rates, equity movements and property markets.

In simple terms, the inherited estate is defined as the difference between two figures – realistic assets and realistic liabilities. The ability to measure and the accuracy of realistic liabilities have evolved considerably over time.

Although the early origins of the inherited estate are difficult to ascertain, Aviva recognises that significant emphasis is placed on the extent to which recent and current generations of policyholders may have contributed to, or benefited from, the inherited estate.

Analysis of the chronology of the CGNU Life and Commercial Union Life Assurance Company (CULAC) with-profits fund has led Aviva to conclude that:

- When the funds were originally set up and then again in 1945 and 1950 shareholders contributed to the funds²

¹ <http://www.fsa.gov.uk/pages/Doing/Regulated/newcob/faqs/estates.shtml>

² Based on informal documents by former Chief Actuaries it is known that contributions arose from pre-1926 General Life business where until 1963 the articles allowed 100% of the profit on non-profit business and 20% of the cost of bonus to be allocated to shareholders. In 1945 and 1950 full allowance for profit was not taken by shareholders. It is not possible for Aviva to quantify these amounts as many of the records were destroyed through flood damage in early 1970s.

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- The vast majority of the inherited estate arose prior to the introduction of asset share calculations in the 1980s. It is difficult to assess the position for each individual policyholder who has left the fund since that time, except to say that in aggregate there has been little, if any, contribution since then
- The special distribution, declared in February 2008, significantly reduces the size of the inherited estates and as a consequence also removes any doubt that the current generation of policyholders has contributed to the remaining inherited estate

Aviva has concluded that in aggregate the current generation of policyholders has not contributed to the inherited estates of CGNU Life or CULAC. Since Aviva's view is that the majority of the inherited estate has arisen through the running of the funds, it has not asked the Policyholder Advocate to take the known shareholder contributions to the funds into account in assessing the reattribution proposal.

For the avoidance of doubt, the reattribution proposals and negotiations have been conducted assuming that neither current policyholders nor shareholders have contributed to the inherited estate.

Aviva's analysis has been shared with the Policyholder Advocate.

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2.00 Asset Share

The principal measurement now used by the industry as a guide to identify each policy's "fair share" is asset share. This is used to determine actual payouts to maturing policies, with the funds targeting payouts of 100% of asset share across generations of policies.

Generally speaking, an asset share is an accumulation of premiums less expenses and other costs, allowing for the actual investment return and any tax due. There are several different methods of carrying out the accumulation. The two methods relevant for eligible policies in the reattribution are:

- Historical accumulation using actual expenses
- Historical accumulation using policy charges

The items that would typically make up the calculation of the asset share under the two historical accumulation approaches are summarised in the table below:

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Asset share methodology		
	Historical Accumulation using Actual Expenses	Historical Accumulation using Policy Charges
	Premiums paid	Allocated premiums
Plus	Investment return	Investment return
Minus	Expenses	Policy charges
Minus	Commission	-
Plus / minus	Tax	Tax
Plus / minus	Mortality profits / losses	Mortality profits / losses
Plus / minus	Surrender profits / losses	Surrender profits / losses
Minus	Shareholder transfers	-
Plus	Non-profit business profits	Non-profit business profits
Plus / minus	Miscellaneous profits / losses	Miscellaneous profits / losses
Minus	-	Cost of rider benefits
Minus	Charges for capital, guarantees, smoothing, etc.	Charges for capital, guarantees, smoothing, etc.
Equals	Asset Share	Asset Share

In practice, actual payouts to maturing policies are based on asset share (subject to smoothing) in line with the applicable PPFM or, if higher, the guaranteed benefits under the policy. A smoothing account is maintained to monitor the operation of smoothing over time. Further details on smoothing can be found in the appendix "Investment Policy, Smoothing and Bonus Policy".

Over time, the net effect of smoothing will be zero because:

- Individual payouts of more than asset share reduce the balance of the smoothing account
- Individual payouts less than asset share increase the balance of the smoothing account
- The target is to pay out 100% of asset share on average in the long term

Aviva recognises the importance of the precise definition and accurate calculation of asset shares. As part of achieving this:

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- Details of the calculation basis for asset shares are disclosed in section 2 of the applicable PPFM
- Asset share calculations are subject to a rigorous control process
- Asset share assumptions and methodology are reviewed each year and any changes are subject to the approval of the With-Profits Actuary
- In recent years the asset share calculations have been subject to external audit

Our practice is to set bonus rates for the average of a policyholder group. Whilst the holistic outcome should achieve 100% asset share payouts over time, at an individual level payouts may be more than or less than 100% of asset share.

The relevant aspects of CGNU Life and CULAC's approach to the calculation of asset shares are described below.

2.02 Investment Return Credited to Asset Shares

The investment return credited to asset shares is that earned on the assets considered to be backing the with-profits policies. This is taken as the asset mix of the respective with-profits fund, after hypothecating appropriate assets to cover:

- The reserves for non-profit business
- The reserves for the guarantees on with-profits contracts
- In the case of CULAC, the reserves for with-profits Red Plan business
- Strategic investments

Actual asset mixes have been used for many years (since 1968 for CGNU Life and since 1985 for CULAC). Before this, estimates of the asset mix and returns were used due to a lack of data.

Since October 1998, the asset mix of the combined CGNU Life and CULAC with-profits funds has been used. The asset calculations also use actual annual returns (since 1983 for CGNU Life and since 1990 for CULAC). These returns are net of dealing costs.

2.03 Expense Charges

Deductions have been made from asset shares for expenses since the concept was introduced.

For conventional with-profits policies, deductions have been made for the distribution, administration and investment expenses incurred by the fund for that business

- Since 1st October 1998 administration expenses are based on the charges set out in the Management Services Agreement (MSA) between CGNU Life, CULAC and the administration company. Administration expenses prior to this date are based on actual expenses
- Investment expenses are based on the fee rates set out in the Investment Management Agreement (IMA) between CGNU Life, CULAC and the Investment Management company

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- Actual commission is used for each policy where this is available. If this is not available then average commission levels are used

Development expenses, distribution expenses in excess of the allowances in the profit testing basis and certain other expenses have not been charged to asset shares. Such expenses have been met by the inherited estate.

For most unitised with-profits policies written before 1st October 2001 asset shares are charged with the distribution, administration and investment expenses as described for conventional with-profits policies.

For CGNU Life's unitised with-profits policies written after 1st October 2001 actual policy charges are charged to the asset shares. These charges include:

- Initial charges
- Annual management charges
- Monthly fixed deductions that are made on certain products

Any difference between the policy charges and the expenses incurred (including the shareholder transfers) accrues to the inherited estate.

With the exception of CGNU Life's unitised with-profits policies written after 1st October 2001, deductions have been made from asset shares in respect of the shareholder transfers associated with past bonus declarations. For some contracts, less than the full amounts of the transfers have been deducted and the balance has been met by the inherited estate.

2.04 Risk Costs

Mortality profits and losses arise when the death benefits paid out differ from the asset share. Generally, mortality profits/losses on conventional business and Unitised With-Profits (UWP) business are credited to / charged to asset shares based on actual experience. There are some exceptions to this:

- For UWP pensions business written by CGNU Life and CULAC, differences accrue to the estate. Mortality profits for this business are unlikely to be material
- Payments in respect of with-profits immediate annuities (WPA), where mortality rates are based on the premium basis

The volume of WPA business is very small, in CGNU Life only, and generally pensioner mortality has been getting lighter (though the volume of business is too small to conclude that it would necessarily follow industry trends). On this basis, payouts for this class of business will have been supported by the inherited estate as a result of policyholders living longer than originally anticipated.

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2.05 Tax Costs

Appropriate allowance for income and capital gains tax is made in the investment returns for Life business. Allowance is made for tax relief on expenses for Life business. The prevailing rate of policyholder tax is applied to the gross expenses with allowance for any deferral of relief.

For income, the prevailing rate of policyholder tax is applied to the gross income yield.

For capital gains, the indexed gains are taxed at a policyholder tax rate, reduced for deferral of realisation based on expected asset turnover rates.

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

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

2.06 Surrender Profits and Losses

Surrender profits and losses arise when surrender payouts differ from the asset share. This is as a result of surrender smoothing.

In the main, any surrender profits or losses accrue to the asset shares of the remaining in force policies. Hence policies surrendering do not contribute by and large to the inherited estate or the smoothing account.

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3.00 Aviva's Analysis and Conclusions

3.01 Asset Share and Payouts

In general terms, any difference between asset share and payouts (except when policy guarantees are more than asset share) is credited to the smoothing account not the inherited estate.

Further details can be found in the appendix "Investment Policy, Smoothing and Bonus Policy".

3.02 Analysis Conclusions

Aviva is satisfied that asset shares capture all the cashflows to policyholders. The inherited estate is the excess after allowing for realistic assets and realistic liabilities and through the analysis undertaken, the Board can confidently conclude that the current generation of policyholders has not contributed to the estate of CGNU Life and CULAC.

The special bonus declared in February 2008 allocated the excess surplus in the CGNU Life and CULAC inherited estate to the current generation of policyholders. This sizeable distribution significantly reduces the size of the inherited estate and as a consequence contrary to contributing to the inherited estate, current policyholders who qualify for the special bonus have benefited from the inherited estate.

Aviva has concluded that in aggregate the current generation of policyholders has not contributed to the inherited estates of CGNU Life or CULAC. Since Aviva's view is that the majority of the inherited estate has arisen through the running of the funds, it has not asked the Policyholder Advocate to take the known shareholder contributions to the funds into account in assessing the reattribution proposal.

Aviva has shared its analysis and conclusion on the origins of the inherited estate with the Policyholder Advocate.

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4.00 Aviva's view of the Policyholder Advocate's Approach

In their paper on this subject, the Office of the Policyholder Advocate has made clear that under normal circumstances, contributions from policyholders to the inherited estates can only occur when their policy ends.

They have gone on to say that there is no reason to suspect that asset shares for current policyholders have not been allocated in accordance with actual experience in terms of investment returns, expenses etc., and as a result concur with Aviva that it is unlikely that the current generation of policyholders has contributed materially to the inherited estates of CGNU Life and CULAC.

As a result the negotiated reattribution offer assumes that neither current policyholders nor shareholders have contributed to the inherited estate of CGNU Life and CULAC.

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5.00 References

- Investment Policy, Smoothing and Bonus Policy
- Principles and Practices of Financial Management (PPFM) for CGNU Life Assurance Limited & Commercial Union Life Assurance Limited (CGNU/CULAC)