

Appendix 21 B

Contributions to the inherited estates

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, and is a response to Aviva's paper on the same aspect of the proposals. 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.

1.02 Background

In considering policyholder potential interests in distributions from the CGNU Life and CULAC inherited estates, it is useful to consider what may have contributed to these inherited estates over time. Aviva's appendix 21 A ("Contributions to the inherited estates") addresses the issue of whether the current generation of policyholders has contributed to the inherited estates of CGNU Life and CULAC. This appendix responds to Aviva's conclusions on whether the current generation of policyholders has contributed to these inherited estates as well as covering, at a high level, the possible contributions to the CGNU Life and CULAC inherited estates over time.

The inherited estate is broadly defined as the difference between two figures – realistic assets and realistic liabilities. The calculations of both the realistic assets and liabilities are performed at least annually for regulatory solvency purposes and follow FSA rules.

In its Feedback Statement on the With-Profits Review (May 2002), the FSA stated that: "The inherited estate in most with-profits life offices is largely or entirely derived from that part of past with-profits policyholders' investments that has been retained and accumulated within the long-term business fund and not distributed. It may also reflect past injections of capital by shareholders or the reinvestment of shareholders' dividends." (para. 4.30).

One complication in the consideration of how the inherited estate has built up is smoothing. It is usual for with-profits companies to smooth payouts on with-profits contracts and any difference between the asset share and the payout due to smoothing may have an impact on the inherited estate. Aviva has been monitoring a "smoothing account" since 2004, which

effectively means that any identified smoothing profits or losses are added to this smoothing account, and the intention is to ensure that the smoothing is neutral over time and does not impact the inherited estate. The mechanics of the smoothing account are covered further in sections 2 and 3 below.

1.03 Structure of this Appendix

In section 2 we summarise Aviva's position without comment, and our views on that position are then described in section 3. Section 4 sets out KPMG's views on what may have contributed to the CGNU Life and CULAC inherited estates over time.

2.00 Aviva's View

2.01 Context

Aviva states that although the early origins of the CGNU Life and CULAC inherited estates may be difficult to ascertain, it 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.

Aviva comments that the FSA describes the term "inherited estate" and that in simple terms it is the difference between the realistic assets less the realistic liabilities. It also gives examples of the use of the inherited estate - to ensure a strong capital base, or to fund future growth plans - and it comments that the ability to measure the liabilities accurately has evolved over time.

Analysis of the chronology of the CGNU Life and CULAC with-profits fund has led Aviva to conclude that:

- when the funds were originally set up, shareholders contributed to the funds;
- the vast majority of the CGNU Life and CULAC inherited estates 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, overall net contribution since then;

- the special distribution, declared in February 2008, significantly reduces the size of the CGNU Life and CULAC inherited estates and as a consequence also removes any doubt that the current generation of policyholders has contributed to the remaining inherited estates of CGNU Life and CULAC.

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 fund into account in assessing the reattribution proposal.

Thus overall, the reattribution proposals and negotiations have been conducted assuming that neither current policyholders nor shareholders have contributed to the inherited estates of CGNU Life and CULAC, and the policyholder advocate is comfortable with the approach.

2.02 Asset Shares

Aviva states that the principal measurement used by the industry, (including Aviva), as a guide to identify each policy's full benefit entitlement at any point in time, or "fair share", is asset shares. Aviva uses asset shares to determine actual payouts to maturing policies, with the funds targeting payouts of 100% of asset shares across generations of policies.

Aviva has stated that, in practice, actual payouts to maturing policies are based on asset shares (subject to smoothing) in line with its Principles and Practice of Financial Management (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 appendix 29 B on "Investment policy, smoothing and bonus policy").

Aviva believes that, 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 payout 100% of asset share in the long term

The relevant aspects of CGNU Life's and CULAC's approach to the calculation of asset shares are described in the following sub-sections:

Investment return credited to asset shares

Aviva has stated that the investment return credited to asset shares is that earned on the assets considered to be backing the with-profits policies, with actual asset mixes being 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 net of dealing costs (since 1983 for CGNU Life and since 1990 for CULAC).

Expense Charges

Aviva has stated that it has deducted expense charges from asset shares since the concept was introduced.

Areas where actual expenses (or estimates thereof, including estimates of commission) are not charged to asset shares are set out below. Any difference between actual expenses and those charged to asset shares are met by the estate:

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.

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.

Certain other expenses (e.g. development costs which could be for the benefit of either new or existing policyholders) have not been charged to asset shares.

For CGNU Life's unitised with-profits policies written after 1st October 2001 actual policy charges are charged to the asset shares. 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 from asset shares, and the balance of the shareholder transfer has been met by the inherited estate.

Risk Costs

Aviva states that it generally credits/charges mortality profits/losses on conventional business and unitised with profits life business to asset shares based on actual experience. There are small exceptions to this which Aviva believes to be immaterial.

Tax Costs

Aviva has set out its approach to calculating the tax charges on asset shares and has stated that any difference between the tax liability of the fund and these aggregate tax allowances is attributable to the inherited estate. (Note that this is in regard to policyholder tax as opposed to shareholder tax).

It has also stated that tax associated with shareholder transfers is met from the inherited estate.

Surrender Profits and Losses

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

In the main, Aviva credits/charges any surrender profits or losses to the asset shares of remaining in-force policies. Aviva's view is that surrendering policies do not contribute significantly to the inherited estate or the smoothing account.

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 inherited estates of CGNU Life and CULAC.

The special bonus declared in February 2008 allocated the excess surplus in the CGNU Life and CULAC inherited estates to the current generation of policyholders. This sizeable distribution significantly reduces the size of the inherited estates of CGNU Life and CULAC and as a consequence, contrary to contributing to these inherited estates, 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.

3.00 KPMG's Comments on Aviva's View

3.01 Context

We agree with the description of "inherited estate" since this is set out in the glossary to the FSA Handbook. We note that the source of Aviva's comments as to the potential uses of the inherited estate is derived from some introductory comments regarding the reattribution process found on the FSA website, and we acknowledge that these are common uses. We agree that the ability to measure liabilities has evolved over time, but would note that this is now a well developed area.

We note that the PA objects to the uses of the inherited estate as set out in Aviva's paper since these uses, in her view, transfer estate value to shareholders beyond their 10% allocation and reduces the amount that policyholders can receive from the estate. This is discussed further in

appendix 25 B “Legal issues arising in respect of right & interests in & uses of the inherited estates”.

It is the policyholder advocate’s view that the Aviva offer to buy out policyholders’ rights to future special distributions from the inherited estate is a forward looking offer. In order to make an offer to policyholders, Aviva has to assess the cost of the offer against the flow of additional income it will receive as a result of owning 100% of the reattributed inherited estate. The investment decision is therefore based solely on future income flows, and any past income flows are not relevant to the decision to make an offer to policyholders.

This means that although KPMG could have looked at the value of all the uses which have benefitted shareholders over the past, this would not have had any impact on what shareholders were prepared to offer policyholders for the value of their rights going forward. KPMG has therefore not done this exercise.

3.02 Asset Shares

We have not performed a review of Aviva’s asset shares or the value of the assets. These values are reported in the FSA returns at the year end and are subject to external independent audit.

Aviva has stated that there are various areas where asset shares are deliberately not charged with the actual experience of the fund. These include expenses for UWP contracts, some risk charges, and some fund tax costs. Aviva believes these to be small. We have not validated this assertion, but, from our understanding of these items, the approach taken by Aviva is in line with many companies in the industry, and we would not expect them to be material.

One other area to note is that, in the past, some business was sold on more beneficial terms to the policyholders than the more usual 90:10 policyholder/shareholder distributions. However, prior to 2008, Aviva has effectively allocated a full 10% of the distributions to shareholders by taking the excess over what is charged to the asset shares from the inherited estates of CGNU Life and CULAC. We note that at least one other major with-profits company has sold

business on a similar basis to this in terms of charging the excess to the inherited estate. Any 10% shareholder deductions which, together with the more beneficial terms to policyholders, add to more than 100% of distributions will erode the value of the estate. Our understanding is that the FSA no longer permits business to be written so that the estate can be eroded in such a manner, and therefore such business should no longer be being written.

Aviva also states that with-profits surrender profits and losses are charged through to asset shares and do not impact the CGNU Life and CULAC inherited estates. Our view is that it is unlikely that surrender profits can be allocated to asset shares with complete accuracy. We would therefore expect there to be some impact on these inherited estates due to policies surrendering and receiving more or less than their asset shares. We have no means of quantifying the impact of surrenders on the CGNU Life and CULAC inherited estates, but we do note that, since Aviva estimates surrender profits/losses and credits/charges these to asset shares, any impact from surrenders on these inherited estates would be limited to the difference between the actual profits and losses and the estimated figures made by Aviva.

The establishment of the smoothing account in 2004 should in theory mean that the CGNU Life and CULAC inherited estates have been, and will continue to be, protected from smoothing profits and losses. Our understanding of the smoothing approach (based on discussions with Aviva actuaries) can be illustrated by a simple example. If an overpayment of 1000 were made on maturities due to smoothing (as opposed to being due to guarantees), then the assets would reduce by 1000, but the smoothing account would also reduce by 1000. This in turn would drive a reduction in liabilities since the projected payouts used in determining the smoothing liabilities shown in the FSA returns are set so that the smoothing account is recouped/paid out over time. Hence, since the inherited estate is the difference between the assets and the liabilities, the net effect should be neutral. We have seen evidence to show that, although not exactly the same, the smoothing account and the cost of smoothing liabilities as reported in the FSA returns are not materially different.

We cover our views on Aviva's smoothing approach more fully in appendix 29 A ("Investment policy, smoothing and bonus policy"), but note here that Aviva's assertion that "the net effect of smoothing will be zero" may overstate the case since it is not certain that in

all situations it would be possible to ensure that smoothing is neutral. However, we acknowledge that the approach taken by Aviva is an appropriate approach which should ensure smoothing is neutral in most situations, and we believe that Aviva's approach is particularly appropriate if the reattribution takes place since identifying and measuring smoothing in a separate account will be key to maintaining a fair level of policyholder assets.

We have had discussions with Aviva actuaries around how the various components of the build up of the smoothing account have been measured and Aviva has informed us that the historic measurements have not been precise and that there may be some element of guarantee costs included in the smoothing account which should otherwise have been charged to the inherited estates of CGNU Life and CULAC. We are told by Aviva that this is due to the complex nature of the calculation and lack of data as opposed to being a deliberate feature. Aviva has informed us that they would not expect this to be a material figure, but we have not been able to validate this assertion.

3.03 Our Conclusions

KPMG's views on Aviva's conclusions are set out below:

We have seen no evidence of shareholders having contributed to the CGNU Life and CULAC inherited estates, but we confirm the approach advised by Aviva i.e. that shareholders contributions have not been taken into account in the negotiations. The Aviva offer to buy out policyholders' rights to future special distributions from the inherited estate is a forward looking offer. In order to make an offer to policyholders Aviva has to assess the cost of the offer against the flow of additional income it will receive as a result of owning 100% of the reattributed estate. The investment decision is therefore based solely on future income flows, and any past income flows are not relevant to the decision to make an offer to policyholders.

We have not seen any evidence to suggest that in aggregate there has been any contribution by policyholders to the CGNU Life and CULAC inherited estates since the introduction of asset shares by Aviva in the 1980s.

Throughout the negotiations it has thus been assumed that neither current policyholders nor shareholders have contributed to the CGNU life and CULAC inherited estates, and the policyholder advocate is comfortable with this approach.

The setting up of the smoothing account in 2004 should ensure that these inherited estates have not been built up significantly since then. In addition, the introduction of asset share calculations in the 1980s means that Aviva will have been managing its business taking asset shares into account.

By definition, for policyholders of UWP contracts whose policies were sold based on being charged annual management charges as opposed to actual expenses, any differences between charges and expenses (including shareholder transfers) for example will impact the inherited estate. Under normal circumstances, for other types of contract, contributions from policyholders to the inherited estate can only occur when their policy ends; therefore the current policyholders who still hold policies are unlikely to have made any material contributions to the inherited estate. Circumstances where the current generation of policyholders could have contributed to the inherited estate would be where their asset shares were not being allocated in line with actual experience in relation to returns, tax, miscellaneous profits and expenses etc. We have considered Aviva's view and conclude that there is no reason to suspect this to be the case, and concur that it is very unlikely that the current generation of policyholders has contributed materially to the inherited estates of CGNU Life and CULAC.

4.00 KPMG's View of the Possible Contributions to the inherited estates

The inherited estate could result from a number of causes. We consider these below in both general terms and also in terms of whether these could be possible contributors to the CGNU Life and CULAC inherited estates:

Historic payouts being less in aggregate than the contributions made to the fund

It is almost certain that most of the CGNU Life and CULAC inherited estates will have been built up for this reason. The setting up of the smoothing account in 2004 should ensure that these inherited estates have not been built up significantly since then. However there are still questions around the approach taken to the measurement of the smoothing account and, as explained above, we understand that some guarantee costs could well have been allocated to the smoothing account. However, we would not expect the approximations used in the smoothing account to have a material impact on the CGNU Life and CULAC inherited estates.

Overall, we consider that any underpayments over and above the usual smoothing rules are likely to have occurred before the introduction of the smoothing account.

Current asset shares not reflecting the actual experience of the fund and so in aggregate being less than the contributions made to the fund

Aviva has highlighted potential areas where this could be the case and, aside from the charges versus expenses on UWP business (where the present value of any excess of charges over expenses forms part of the value of in-force business on this business), we agree it is unlikely to be a material factor. We note that MSA and IMA fees are treated as an expense to the fund and either charged through to asset shares where relevant and so in this respect they only have an impact on the inherited estate to the extent that UWP charges differ from these expenses.

We would also note that the asset shares are subject to external independent audit and as such we would expect the assumptions used in their derivation to reflect the expected experience where relevant.

Deliberate deductions from asset shares to increase the inherited estate

We are not aware that such deductions have been made.

Profits being made on non-profit business or with-profits surrenders which are not fed back to with-profits asset shares

Aviva has said it has already enhanced current asset shares for past and future profits on non-profit business, and that it has allocated with-profits surrender profits to asset shares. We

have not validated this statement. There could be differences between what has been allocated and what the actual experience has been, but this is not easily quantifiable. We would expect that any difference would be due to approximations being used as opposed to any deliberate enhancements to the inherited estate. For example, it is unlikely that the surrender basis will equate perfectly to asset shares.

Shareholders' contributions

Any shareholder contributions which may have occurred in the past have not been taken into account in the negotiations, and we have seen no evidence of these contributions.

Pension Scheme Deficit

As the issue of pension scheme deficits and how these interact with with-profits funds is often one of significance, we have set out below the situation as we understand it in this case.

We have been informed by Aviva that in general the pension scheme deficit relates to defined benefit pensions of employees who worked for the with-profit companies prior to the introduction of the respective Management Services Agreements (MSAs) in 1998. Using the April 2005 pension scheme valuation, the Scheme Actuary apportioned the overall deficit as pre-MSA and post-MSA service.

Prior to the MSAs, expenses incurred in running the business were charged directly to the relevant life fund within the life company. This included all pension scheme costs. As a result (and in line with the stated uses in the PPFM of the funds) it was deemed reasonable for the CGNU Life and CULAC with-profit funds' inherited estates to meet a proportion of the pre-MSA deficit (since these related to the pensions of those employees who had previously worked for these funds). This was calculated as 12% of the pre-MSA deficit amount.

The inherited estates of CGNU Life and CULAC were charged a proportionate share of the deficit. These charges could have been made to asset shares.

We are also informed that the Board considered whether it would be more appropriate to charge this to asset shares but deemed that approach to be unfair (as the cost should ideally be allocated to those policies that benefited from the service. Many of these had gone off the

books and therefore the remaining policies would meet a disproportionate cost). The Board decided the fairest thing to do was charge it to the inherited estates of CGNU Life and CULAC in the circumstances.

Aviva has also informed us that its current operating procedure is to use a separate service company, Aviva Life Services (NULS), and to have MSAs between the life companies and NULS which define the services to be provided and the basis for charging expenses to the life funds in respect of the costs incurred in carrying out those services. Pension scheme contributions are defined as being part of these costs. We note that, in line with the PPFM, no pension scheme deficit costs (or pension scheme surpluses) can be charged to asset shares.

Clearly, the pension scheme deficit has had some impact on the CGNU Life and CULAC inherited estates, and this has thus had a positive impact on the asset shares of previous generations of policyholders who might otherwise have had these costs allocated to their asset shares (had the costs been known at the time).

Uses of the inherited estate to which the policyholder advocate objects

Over time Aviva will have applied the CGNU Life and CULAC inherited estates to meet the costs for various items not discussed above such as:

- mis-selling costs both in terms of administration expenses and compensation costs;
- tax on shareholder transfers from the with profit funds;
- investments in strategic assets;
- new business subsidies which could present themselves in a number of ways, for example, by not charging for the cost of guarantees, or not charging the full shareholder transfers to asset shares.

These will all have reduced the value of the estate. The policyholder advocate can see no justification for this. Her legal advice on the subject can be found in appendix 25 B (“Legal issues arising in respect of right & interests in & uses of the inherited estates”). The uses of



the estate for shareholder benefit are discussed in appendix 27 (“House of Commons Treasury Committee report: inherited estates”), the impact of FSA guidance on policyholders.