

Report Number 25 A

Legal Issues in respect of Rights and Interests in and Uses of the Inherited Estate

Aviva's response to a report by the legal advisers of the policyholder advocate in connection with the reattribution of the inherited estates of CGNU Life and CULAC with-profits funds

Norwich Union rebranded as Aviva in the UK on 1 June 2009. Where an historical position or events prior to 1 June 2009 are described in this appendix, 'Aviva' and associated naming conventions have been used. Financial information has not been updated and remains as at the time of the report date.

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Appendix by: Aviva UK Life – June 2009

Aviva Life Services UK Limited. Registered in England No 2403746. 2 Rougier Street, York, YO90 1UU.

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Report Number 25 A

Contents

1.00	Context	3
2.00	Aviva Legal Opinion	4
3.00	How have the Opinions Influenced Aviva's Offer and the Negotiations?	12
4.00	Aviva's view of the Policyholder Advocate's Approach	15

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1.00 Context

As part of the reattribution process, the Policyholder Advocate, appointed under the Financial Services Authority (FSA) rules in the Conduct of Business Sourcebook (COBS), is required to negotiate with Norwich Union on behalf of the holders of Eligible Policies, the benefits to be offered to them in exchange for the rights and interests they will be asked to give up. (COBS 2.2.44)

The Office of the Policyholder Advocate therefore took legal advice:

- as to the respective rights and interests of policyholders and of the Commercial Union Life Assurance Company (CULAC) and CGNU Life, in respect of the CULAC and CGNU Life inherited estates
- as to the nature and extent of any legal constraints on the uses to which those estates may be put by the companies.

Aviva obtained its own legal advice in response to that obtained by the Policyholder Advocate.

The main elements of the Office of the Policyholder Advocate's advice are summarised in their appendix "Legal Issues in respect of Rights and Interests In and Uses of the Inherited Estate", whereas this appendix summarises the main elements of the advice obtained by Aviva. It should be made clear that Aviva does not necessarily agree with all aspects of the presentation of its legal advice in the appendix prepared by the Policyholder Advocate.

So far as the substance of the advice is concerned, there are some areas of agreement between the two sets of legal advice but there are also material respects in which the advice given to the Policyholder Advocate has differed significantly from that provided to Aviva, and indeed from current industry practice and the regulatory position.

This appendix concludes with an explanation of the role played by the legal advice in the reattribution negotiations.

2.00 Aviva Legal Opinion

2.01 Rights and Interests of policyholders

The essence of the legal advice to Aviva is that the rights and interests of policyholders should be analysed based on the terms of the relevant contract, other policyholder documents which may have influenced the policyholders' expectations, past practice, the regulatory environment and any relevant legal precedent. It can be summarised as set out in this section.

Aviva's legal team considers that any analysis of the rights of policyholders in connection with a proprietary insurer's inherited estate should start from two self-evident truths:

- First, assets allocated to the with-profits fund belong to the company, both legally and beneficially.
- Second, the relationship between the insurer and the policyholders is contractual.

The consequence of the legal and beneficial ownership by the company is that the policyholder has no proprietary rights to those assets. The with-profits fund is not a trust fund and it has no document establishing it as a separate legal organism. It does not have a purpose, as suggested by the advice obtained by the policyholder advocate, which is different from the purposes of the company.

In the event of a winding up of the company the assets of the with-profits fund are subject to the statutory scheme on winding up and available to meet in accordance with that scheme the claims of all long-term policyholders and not just with-profits policyholders.

The assets of an insurance company are managed and controlled by its directors who owe fiduciary duties to the company and the company alone. They do not by virtue of their position as directors owe fiduciary or other duties to the policyholders directly. It does not follow, however, that the freedom of action of the directors is free from all constraints in relation to the assets of a company's with-profits fund. It is not a "rule free" environment. The directors' control of the assets is circumscribed by the scope of their fiduciary duties to the company which require the directors to ensure that the company complies with its contractual engagements to policyholders and with relevant regulation, including the obligation to treat its customers fairly. The directors as approved persons are subject to regulatory obligations under the Financial Services and Markets Act (FSMA).

2.01.01 The With-Profits Contract

The contractual relationship between the company and the with-profits policyholder is therefore central to the legal analysis of the policyholders' rights and interests in the with-profits fund. The with-profits contract is the mechanism by which the policyholder gains access to the with-profits fund of the company. A with-profits contract, as opposed to a unit-linked insurance contract or an investment in other types of collective investment scheme, has certain distinctive features. The most significant from a policyholder's standpoint is that in return for transfer of ownership of his premiums and the assets represented thereby the policyholder will be paid certain guaranteed amounts and (if greater) bonus allocations representing a share in the profits of the fund which the directors determine to distribute to with-profits policyholders by way of a bonus. Such bonuses are in the case of CGNU Life and CULAC

Report Number 25 A

to be allocated 90:10 as between policyholders in the aggregate and the company's shareholders' fund, as provided in the constitutional documents of the companies and as referred to in some of the policyholder documentation.

2.01.02 Advantages of with-profits policies

The main reasons that access to a with-profits fund is commercially attractive to a policyholder are threefold. First, there is the advantage of contractual rights in relation to a larger pool of money than the policyholders' own fortune, thereby spreading risk and increasing security. Second, there is access to the fund management skills of the operator of the fund, thereby moving from the policyholder the burden of making investment decisions. Third, there is the ability to obtain a smoothed return on his investment and, in most cases, a minimum guaranteed return, thereby protecting him from asset price volatility (in contrast to many other equity-based investments where the customer bears the entire investment risk).

2.01.03 Choice of insurer - financial strength

Whilst an investor's choice of insurer may well be derived in part from a perception of its general financial strength, Aviva's legal advisers consider that it is unrealistic to suppose, at least until more recently, that many potential policyholders specifically consider the implications of the existence of an inherited estate of any particular size or antecedents in relation to the likelihood of receiving any distributions from it. More likely the strength of a company is relevant in choice of insurer because of the security of benefits and investment freedom that strength allows. Further it is this aspect of financial strength that Aviva has used in the marketing of its funds. The policyholder documentation in the case of CGNU Life and CULAC does not represent to policyholders that a particular feature of the products is the possibility of enhanced bonuses due to the presence of the inherited estate or the overall strength of the fund.

Aviva's legal team consider that the investor expects that the above three factors will translate into a return represented by the payment of any guaranteed benefits and the participation in such bonus declarations as may be made by the directors during the life of the policy. It is plain from the contractual arrangements with the investor and the related policyholder literature firstly that all bonus declarations are a matter of discretion and secondly that not all the profit and/or surplus capital in a with-profits fund is to be allocated to bonus declarations. That discretion derives from the Articles of Association of each company. Typically, however, the contractual documents comprising the with-profits policy do not set out in detail the basis of calculation of bonuses or any contractual constraints on the determination by the directors of the appropriate level of bonuses. The older policies tend to contain no guidance on the approach to bonuses at all.

More recently reference may be made to the concept of asset shares and the calculation of bonuses on this basis in the policy or other documents incorporated into or referred to in the policy or at the time of sale (for example a key features document or the firm's Principles and Practices of Financial Management (PPFM)).

It is now generally accepted within the industry that smoothed asset share is the concept upon which the declaration of bonuses is based and COBS 20 reflects this. This concept is employed in the illustrations provided by CGNU Life and CULAC to potential policyholders. The concept is also encapsulated in the literature made available to policyholders in the PPFM and Customer Friendly PPFM (CFPPFM). Aviva's legal team considers these to be highly important documents and a central plank of the FSA's approach to regulation of the management of with-profits policies. At the time of original preparation they record past principles and practices adopted by CGNU Life and CULAC in

Report Number 25 A

the management of their funds and they dictate such principles and practices going forward. They are available to policyholders. Since April 2005 the CFPPFM have had to be sent to all with-profits policyholders. The CFPPFM contain clear references both to the concept of asset share and uses of the inherited estate. They also inform policyholders of the existence of the PPFM and how to get copies of them. As regards the PPFM an annual certificate of compliance is required and any departure from them must be notified to policyholders.

2.01.04 Implied terms

The with-profits contract will contain express terms and may contain implied terms. Such implied terms may arise as a result of a rule of law (which is not relevant in this case) or be based on the actual or imputed intentions of the contracting parties, construing their express agreement as a whole in its commercial setting. However as stated by Lord Steyn in *Equitable Life Assurance Society v Hyman* such a principle is to be "sparingly and cautiously used and may never be employed to imply a term in conflict with the express terms of the text. The legal test for the implication of such a term is a standard of strict necessity".

Thus if terms are to be implied into the policy as suggested by the policyholder advocate's legal advice, the view of the legal advisers to Aviva is that it must be strictly necessary to imply such terms in order to properly construe the contract. The legal advisers to Aviva do not believe that this standard is met in the case of the five principles proposed by the policyholder advocate's legal advisers.

If it is not strictly necessary to imply terms in order to properly construe a contract, the court will look at the presumed intention of both parties. As Lord Wilberforce notes in *Liverpool CC v Irwin* where there is, on the face of it, a complete bilateral contract, the courts are sometimes willing to imply terms, but in such instances the courts must be "spelling out what both parties know and would, if asked, unhesitatingly agree to be part of the bargain".

Whilst both parties agree that there are restrictions of the exercise of discretions which in the view of Aviva's legal advisers may be partly derived from the presumed understanding and expectation of the parties to a with-profits contract, the parties differ on what that agreed understanding and expectation may be. Given the current custom and practice in the market and the case law such as it is, Aviva's legal advisers do not consider that both parties' intentions, and particularly not the insurer's intentions, could be presumed to encompass the five principles.

Marketing material, including with-profits guides and PPFM, do not have contractual effect unless expressly incorporated into the policy, although such documents will have relevance in shaping policyholders' reasonable expectations and in any analysis of whether customers are being treated fairly. Whilst certain of the Aviva policy literature refers customers to the with-profits guides and PPFM for further information the with-profits guides/PPFM are not expressly incorporated as terms of the contract.

2.01.05 Policyholder Reasonable Expectations

The expression "policyholders' reasonable expectations" (PRE) has not been defined by statute but was considered both in the first instance decision in *Equitable Life v Hyman* and in the AXA decision. Both judgments concluded that PRE is shaped by the terms of the contract, promotional material, the provisions of the Articles of Association, past practice of the insurer (in particular its bonus policy) and the current practice of the industry. In both *Equitable Life v Hyman* at first instance and in the Warren Opinion provided to *Equitable Life* [policyholders] in the context of its scheme of arrangement, PRE is

Report Number 25 A

said to include an expectation that the life insurance company will behave fairly and reasonably in exercising the discretion available to it.

As stated in paragraph 12 of Mr Justice Evans-Lombe's judgment in the AXA case, the starting point for assessing PRE for a with-profits policy is the asset share, i.e. a calculation of the value of the investments to be found in the insurance company's long term fund acquired from the accumulated premiums paid by the policyholder together with the accumulated profits arising from those investments. This should be adjusted by an appropriate share of profits arising on other operations financed by the long term fund and an appropriate deduction for tax, contributions to expenses and working capital.

The purpose of COBS 20 is to secure an appropriate degree of protection for actual and potential with-profits policyholders and to promote confidence among them. The Rules in COBS 20 are intended to supplement Principle 6 (the requirement to pay due regard to the interests of customers and treat them fairly) Principle 7 (communications with clients) and Principle 8 (conflicts of interest). This background is relevant to the construction of the individual sections of COBS 20 which can, in the view of Aviva's legal team, also be seen as a logical progression of the judicial analysis of PRE. This view of COBS 20 is supported by the FSA's statements in the consultation papers on COBS and its predecessor COB 6.12.

Aviva's legal team consider that it is clear from the nature of with-profits business, the descriptions given in the policyholder literature of bonus policy and of the uses to which the inherited estate is put in the management of the with-profits business, that there cannot be an expectation on the part of the policyholders at the time at which they take out their policies that the inherited estate will be distributed to them rather than applied for other purposes, where those purposes are clearly stated in the policyholder literature. It is important to approach the policyholder literature without preconceptions. For example, if a statement is made as to the use to which the inherited estate is or may be put, Aviva's legal advisers consider that it should be taken at face value unless there is some reason in settled law or regulation not to do so. Aviva's legal advisers consider that this is the approach a reasonable policyholder would take. Even if policyholder literature is silent, Aviva's legal advisers do not believe that there is any justification to import principles to restrict the exercise of the insurer's discretion unless they are strictly necessary to give effect to the contractual bargain between the parties or are supportive of legal or regulatory requirements applicable to the contract.

The lack of expectation of distributions of the inherited estate beyond the amount necessary to achieve the guaranteed benefits or, if greater, asset share was recognised in the AXA case, *the Equitable Life case* and in the report by Lord Penrose into the Equitable Life Assurance Society ("*the Penrose Report*").

Since AXA there has been the promulgation of COBS 20.2.21 which ensures that if an excess surplus exists and to retain it would breach Principle 6, i.e. Treating Customers Fairly (TCF), a firm should either make a distribution or carry out a reattribution, two patently different things. It follows, according to Aviva's legal advisers, that it remains within the directors' discretion to determine whether or not an excess surplus exists and if so whether to carry out a reattribution or distribution or to retain such surplus because to do so is not, on the facts, in breach of Principle 6.

On the basis of precedent case law, FSA regulation and the facts in relation to CGNU Life and CULAC, Aviva's legal advisers do not consider that it is inherently unfair for the company to retain rather than distribute assets which have been specifically stated in the companies' PPFM to have a use as working capital of the fund (a use which inherently precludes a distribution) being assets from which use those current policyholders have already benefited; over which they do not have, and never

Report Number 25 A

have had ownership rights of any kind and from which (in Aviva's legal advisers' view) they have no reasonable expectation of a distribution based on the policyholder documentation and past practice (as recorded in the PPFM).

2.01.06 Role of Regulation

In the area of the exercise by directors of their discretions to declare bonuses, regulation has had a highly significant role to play. Under the FSA's Principles for Businesses an insurer must pay due regard to the interests of the customers and treat them fairly (TCF or Principle 6). This principle has fulfilled the function previously carried out by the more actuarially based concept of a policyholder's reasonable expectations, although Aviva's advisers do not consider that concept to be redundant, and the FSA has indicated that the emphasis on TCF is not intended to significantly change the expectations of policyholders or the terms of the contract between insurer and policyholder.

Two of the most significant aspects of TCF are:

1. the obligation to comply with public statements and guides which have been promulgated (whether or not seen by the policyholder concerned) and which have indicated how any discretion is likely to be exercised
2. to indicate transparently for policyholders how discretions are to be exercised and the fund is to be managed.

Aviva's legal advisers do not consider that there is any legal authority for a proposition that the insurer's discretion as regards bonuses is required to be used only for the purposes of the fund as described in the policyholder advocate's legal adviser's five principles. On the contrary, Lord Woolf MR in the Court of Appeal judgment in *Equitable Life* stated that "the powers are entrusted to the Board to be used equitably for the benefit of existing and future policyholders having regard to the terms of their respective policies and the interests and needs of the Society as a whole".

This statement is in Aviva's legal team's view consistent with the origin of the directors' discretion being contained in the Articles of Association of the company, the purpose of which is to establish the parameters of the directors' powers in managing the company in accordance with all of their duties and responsibilities as directors. They also consider it to be consistent with other judicial descriptions of PRE, the FSA's interpretation of PRE and TCF in the Consultation Papers pre-dating COBS and its predecessor provisions in COB Chapter 6 and in COBS itself.

Importantly, Lord Woolf MR concludes that in considering whether the directors have acted inequitably or have otherwise gone outside their powers the terms of the policy are of critical importance. This suggests that the foundation of the decision in *Equitable Life* is that it is appropriate to prohibit the exercise of discretion in a way which is inconsistent with the contractual position rather than that there is a positive duty on the directors of a life company to exercise their discretion regarding the use of the estate or the distribution of surplus at all times for the benefit of current policyholders. The *Equitable* decision does not, in the views of Aviva's legal advisers, go beyond establishing the principle that discretion should be exercised in good faith, consistently with the purpose for which it was given and should not interfere with contractual rights.

Aviva's legal advisers consider that the judgment in the AXA case is also of particular relevance to the analysis of the policyholders' rights and interests in the inherited estate because it is the only case that relates to a reattribution of inherited estate.

Mr Justice Evans-Lombe summarised the approach of the Court in deciding whether or not to approve the AXA Scheme as determining the contractual rights and reasonable expectations of policyholders

Report Number 25 A

before the Scheme and then comparing them with the likely effect on such rights and expectations if the Scheme is approved. The starting position for assessing PRE was stated to be asset share. The judge went on to state that the Inherited Estate represents accumulated surplus in excess of the sum of asset shares and then identified potential sources of inherited estate. It was acknowledged by the parties in AXA that the inherited estate represents a significant resource for an insurance company which could be used for purposes including to enable smoothing, greater investment flexibility, provide extra policyholder security and to finance the writing of new business. It was agreed in the AXA case that the AXA inherited estate had not been used to systematically enhance bonuses or benefits. Aviva's legal team consider there to be clear parallels between the uses of its estate by AXA and the uses by CULAC and CGNU Life of their estates.

The judge in AXA concluded that policyholders would reasonably expect the inherited estate to be used for the above purposes but not that the inherited estate would be distributed to current policyholders as a bonus or other benefit during the currency of their policies.

Paragraph 33 of the judgment contrasts the position of policyholders in a mutual who could themselves decide on and put into effect a closure of the fund and a proprietary company. In the latter case the decision whether to close the fund (and thereby distribute the inherited estate) is one for the directors. Save in circumstances where the company had got into difficulties, the judge considered that it would be highly unlikely that directors would decide to close the fund thereby precluding taking on new business. In the case of a strong company such as AXA the judge considered that there would be no question of the directors closing the fund. The judge therefore concluded that the policyholders had no reasonable expectation that the fund might be closed to new business and the inherited estate therefore be distributed to the current generation of policyholders.

Aviva's legal advisers do not believe that his conclusions would have been fundamentally different had COBS 20.2 been in place at that time since COBS 20.2 preserves the principle that it is for the directors to decide whether or not to close a fund. COBS 20.2 simply provides a framework to ensure that the decision is made by the directors on a reasonable and transparent basis and to ensure that the directors deal fairly with the inherited estate if they make such a decision. As was the case for AXA, the CULAC and CGNU Life with-profits funds are both strong funds. It is clear from internal CULAC and CGNU Life papers and from their public statements that they intend to continue to operate the funds as strong funds with a relatively high equity backing ratio and to promote growth in new with-profits business.

With respect to the exercise of discretion by the board, there was no suggestion in the AXA judgment that the discretion to determine how much surplus to distribute at any time should be exercised for the benefit of current policyholders and that as a result the policyholder's reasonable expectations were that the inherited estate would be distributed to them rather than applied for other purposes. Paragraph 18 of the judgment refers to the Articles of Association of AXA (which are in similar form to CGNU Life and CULAC's articles) and which give the directors absolute discretion as to how the long term funds should be disposed of, including "to allow such sums as they think fit to be carried forward". The judge did not feel constrained (as a result of the Equitable Life decision or otherwise) to suggest that such discretion should be exercised in a particular way so as to benefit current policyholders. In fact, on the contrary, he considered that it would not be a reasonable expectation of a policyholder to consider that the directors would promote a scheme of reorganisation which involved a distribution of inherited estate for policyholders' benefit. Aviva's legal advisers do not consider that COBS 20.2.21 fundamentally changes this analysis. Instead it provides a framework within which the directors decide firstly whether any surplus is available for distribution to policyholders or is required for other

Report Number 25 A

purposes, secondly whether it would be unfair in all the circumstances to retain such surplus and thirdly whether such surplus should be distributed or reattributed.

The TCF principle and the requirement to publish PPFM have clarified the operation of with-profits funds and created greater transparency for policyholders, but Aviva's legal advisers do not consider that such changes in regulation have fundamentally changed the contractual rights of with-profits policyholders under their policies or their reasonable expectations regarding benefits. The principal purpose of COB 20 is to create more transparent parameters within which the directors' discretion in managing with-profits funds is exercised rather than to change the reasonable expectations of policyholders under their policies. This view is supported by several statements to this effect in the relevant FSA consultation papers.

The FSA, in its "Feedback Statement on the With-Profits Review" made the point that the pooled assets within a with-profits fund belong to the insurer not the policyholders. Whilst the policyholder has a contractual right to benefits stipulated in the contract and may have other rights to be treated fairly, he does not own the fund from which those entitlements and expectations are to be met. This was followed by CP 207 which stated that:

"Questions have been raised about who actually owns an inherited estate. This appears to stem from confusion over whether the policyholders have rights in relation to the whole estate or distributions made from the estate. In fact, it is an entitlement to a share of the money that is distributed. However, there is no doubt that the estate, like the whole of the with-profits fund, belongs to the firm".

CP 207 also discussed the legal framework surrounding the reattribution of inherited estates. The FSA states that "the first important factor to understand is that a process of this kind has to operate within a statutory framework that already exists and which it is not appropriate for [the FSA] to interfere with". The FSA acknowledged that it is dealing with issues that are generally within the jurisdiction of the Court and it is not open to them to interfere with its powers and discretion. Aviva's legal advisers consider that the principles behind the AXA decision should therefore continue to be valid notwithstanding the introduction of COB 6.12 and subsequently COBS 20.

2.02 Uses of the Inherited Estate

In considering the uses to which an inherited estate can be put, Aviva's legal advisers conclude that the directors are entitled to have regard to the interests of the company as the proprietor of the with-profits business, although the requirement to comply with contractual obligations and TCF must also be observed. In every circumstance any possibility that security, guaranteed benefits and benefits targeted on smoothed asset share might be compromised will preclude giving any decisive weight to any other factors if TCF is to be complied with. Once these factors have been complied with, however, Aviva's legal advisers consider that other considerations can be given some weight, including in particular the fact that it is in the interests of the company to continue to operate its business in accordance with sound business practices and with a view to making a profit over the longer term.

Fundamentally, TCF will always require directors to be satisfied that there is no prejudice to policyholders (both with-profits and other policyholders). Fairness to with-profits policyholders therefore does not, in Aviva's legal advisers' view, have to comprise the provision of any additional benefit which is not part of their contractual rights or reasonable expectations. They consider that it is adequate for TCF that policyholders receive their expected benefits and are suitably protected from detriment.

Report Number 25 A

The permitted uses of the estate need to be consistent with the contractual rights of the policyholders and with their expectations based on what they have been told about the management of the fund. They must also be consistent with any regulatory requirements both specific and more generic such as treating customers fairly. The legal advisers to Aviva were satisfied that the four uses questioned by policyholder advocate's advisers were in each case in practice consistent with:

- (i) the contractual provisions of the with-profits policies
- (ii) the legally recognised concept of PRE
- (iii) statements in the PPFM and
- (iv) the FSA's requirements for TCF for with-profits policies as evidenced by COBS 20, and permitted under COBS 20.

Given that the uses were compatible with the rights and interests of policyholders under current regulation, there appeared to Aviva's legal advisers to be no basis upon which to discount any such uses in the context of valuing the benefit to shareholders of proceeding with a reattribution.

It was, however, recognised that this analysis would inevitably turn on the facts of a particular case and that it might be the case that such uses in other scenarios might not be consistent either with policyholders' interests in the estate or with TCF. For example, using the estate to make a significant investment in new business even though anticipated to be profitable in the future if that had an adverse effect on the estate available to support the existing with-profits business. However, assessing the impact of uses of the estate on with-profits policyholders, Aviva's legal advisers did not find any reason in the policyholder literature, current regulatory environment or case law to test the appropriateness of such use by reference to its impact on the amount of excess surplus which might otherwise be available to make distributions to with-profits policyholders.

2.03 Implication for terms of Reattribution

The legal advisers to Aviva conclude that given the contingent and uncertain nature of any individual policyholder's interest in the estate it would be inappropriate to base the calculation of the payment to be made for policyholders giving up such interest solely on the valuation of that interest.

It is accepted that for current policyholders in aggregate their expectation of a distribution over the lifetime of their policies is not zero since policyholders in aggregate have an expectation that if an excess surplus does arise during the currency of their policies, which the board considers it unfair to retain, then they will share in a distribution of that surplus, usually on a 90:10 basis. However, there is no single accurate method to value that expectation since it is dependent on a number of uncertain factors in the future of the funds over which the insurer has little or no control.

Therefore, in determining how to value the PIP a further important component of value to assess is the value of the reattribution to shareholders. This itself involves a comparison of the value currently derived by shareholders from the estate and the increased value available to shareholders following the reattribution, taking into account the cost to shareholders of realising the value, the restrictions applying to the reattributed inherited estate after reattribution compared with those applicable pre reattribution and any additional risks taken on by the shareholders as a result of the reattribution.

Report Number 25 A

3.00 How have the Opinions Influenced Aviva's Offer and the Negotiations?

3.01 General

Whilst Aviva does not accept the legal view of with-profits put forward by the PHA's advisers, which is untested by the Courts and inconsistent with industry precedent, the legal differences have not been definitive in the negotiations. Even were the position set out in the PHA's legal advice ever to be adopted by the Courts, it would not provide clear answers to many of the issues which have been important in the negotiations.

In conducting the negotiations, Aviva has primarily been concerned to reach an agreed offer which fairly divides the unlocked value of the inherited estates between policyholders and shareholders.

For more details on the approach please refer to the Aviva appendices - "Valuing the Reattributed Estate" and "The Aviva Offer".

The negotiations have been conducted against the current regulatory background but Aviva has, as set out below, agreed some adjustments to its view of the value of the estate in the context of the negotiations to accommodate some of the PHA's views and enable an acceptable and demonstrably fair offer to be agreed.

3.02 Rights and Interests

Whilst Aviva believes that estimating what would have been the value of future distributions from the estate to policyholders in the absence of a reattribution is inherently uncertain and impossible to accurately predict, for the purposes of the negotiations Aviva developed a methodology to attempt to assess the potential value of future distributions to policyholders in aggregate.

This methodology produces what is described by Norwich Union as the Value of Potential Distributions to Policyholders (VPDP). As future distributions depend upon a range of factors that are beyond the control of the insurer, that interact with each other and that are difficult to predict, the methodology can only be a very rough guide and cannot be viewed as the definitive answer. As a result, VPDP has been viewed as giving an estimate of the amount which groups of customers might potentially receive as future special bonus, calculated using assumptions as to the future development of the inherited estates which Norwich Union consider to be reasonable assessments of what might happen over the next 25 years. These factors include, for example, market performance, new business volumes, management actions, and policyholder death and lapse rates.

However, a major principle followed by Norwich Union was that the PIP offered to policyholders should be based on a fair sharing of the unlocked value in the inherited estates rather than compensating policyholders for distributions foregone, since the value of the VPDP is so uncertain.

Aviva agrees with the statement in paragraph 20 of the policyholder advocate's appendix that it would be wrong to look at the reattribution bargain by reference only to the narrow question of policyholders'

Report Number 25 A

expectation of a future distribution. As can be seen from the Aviva legal advice it is agreed that an important component of value to assess is the value of the reattribution to shareholders. However the position is not as stark as portrayed by the Policyholder Advocate in that shareholders do not purely gain a 100 per cent interest in distributions as against their current contingent 10 per cent interest in the estate. The 100 per cent interest is also contingent, perhaps even more so in that the shareholders take on greater risk in relation to the funds and are subject to a number of restrictions as to the use of the reattributed inherited estate which remains available to support policyholders' benefits for so long as it is needed to provide security, investment flexibility and financial strength.

It is not appropriate in the view of Aviva that any negotiation as to the value of benefits given up by policyholders and gains to the shareholder should be conducted on the basis of the five principles suggested by the Policyholder Advocate. Where practices inconsistent with the five principles are justified under current regulation and in the view of Aviva, taking into account policyholders' reasonable expectations and past practice, these practices may be assumed to continue in the absence of a reattribution.

A large part of the value considered in the negotiations was that part of the estate which results from intergenerational transfer between policyholders and is an important feature of with-profits, i.e. the inherited estate capital supports the new business of subsequent generations of policyholders and although the current generation has not contributed to the estate which is there during the currency of its policies, it will have benefited in its turn when the business was originally written.

Whilst this capital belongs to the company and both teams acknowledge that neither FSA regulation nor legal precedent provide clear guidance on how to divide the interest in this capital between shareholders and policyholders, both the Policyholder Advocate and Aviva agreed that it is appropriate to take into account the value of this capital in the negotiations.

Report Number 25 A

3.03 Uses of the Inherited Estate

The uses of the estate which the policyholder advocate considers questionable have had relatively little effect on the outcome of the negotiations since both parties have proceeded on the basis that the amount of special distributions that policyholders are potentially giving up, and the uses to which the estate could be put if there were no reattribution would be determined by reference to the current regulatory position.

Both parties agree that the writing of profitable new business is a legitimate use of the estate but have differed on whether new business which is priced on a basis that effectively transfers the estate between generations without charge can properly be described as profitable and the levels of new business Aviva is likely to write in the future. This is material in the context of the reattribution negotiations since the level of new business will have a relatively large effect on the size of the estate available for reattribution.

Consequently the negotiated offer has been assessed for fairness over a range of new business volumes, including scenarios showing a decline in new business growth, although Aviva's business plans anticipate (and the company has achieved over the past year) higher levels than used in the negotiations. The use of lower new business volumes results in a higher estate being available for reattribution.

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

4.01 General

For the reasons stated in paragraph 3.01 and as set out in the Policyholder Advocate's Appendix on this issue, the Policyholder Advocate has sought guidance from the FSA and has conducted the negotiations against the current legal and regulatory background.

4.02 Rights and Interests

The majority of the Policyholder Advocate's views on rights and interests are addressed in the Aviva legal advice summarised in section 2 of this appendix.

However, a further section which was not addressed in the original policyholder advocate advice and therefore nor in the response of Aviva's legal advisers was in relation to what is referred to as the inter-generational transfer of the inherited estate. This inter-generational transfer is a fundamental feature of with-profits in that the estate supports the writing of future business at no cost to new policyholders and the current policyholders had in their turn benefited from the funding of their new business strain when they purchased their policies.

The Policyholder Advocate's advisers do not claim that this is fundamentally in breach of their five principles but comment only that it would be if new business was written on a scale or on terms which had a material adverse effect on the rights and interests of current policyholders and in particular where the expanding interests of new policyholders significantly diluted the strength of the fund in which the existing policyholders had invested their premiums.

It is common ground that new business should not be written on terms which are materially adverse to current with-profits policyholders but in the view of Aviva's legal advisers it is not necessary to take into account the loss of potential future distributions from the inherited estate for current policyholders who have benefited themselves from the use of the estate to support the writing of their policies (as opposed to a reduction in their security and expected benefits) when assessing whether the new business has a materially adverse effect.

It is also common ground between the parties that the current policyholders have not contributed to the inherited estate and will give up any contingent right to share in any future distributions from it (absent the reattribution) when their policies terminate.

The Policyholder Advocate is concerned that a potential reattribution offer could deliver to the shareholders, without payment, all of what would otherwise have been retained within the fund for the benefit of future policyholders. Whilst it is correct that, absent a reattribution, current policyholders will have no expectations in respect of that part of the inherited estate as it will not be distributed during the lifetime of their policies, shareholders do have such an interest because their expectation is to receive their proportion, i.e. usually 10%, of all distributions from the fund whenever made and to apply the estate for the purpose of writing new business.

Report Number 25 A

In the context of the commercial negotiations and taking the uncertainty of the legal position on this point into account, some value has been attributed to this part of the estate for the benefit of current policyholders even though, absent a reattribution, they would in practice be highly unlikely to realize such value.

4.03 Uses of the Inherited Estate

These issues are addressed in Aviva's legal opinion summarised in section 2 and these uses of the estate are clearly permitted under the current regulatory regime.

- Strategic investments - it is not clear why the Policyholder Advocate talks about investments that are made purely in the shareholders' interests when strategic investments by the with-profits fund are
 - (a) capable of providing benefit to the business as a whole;
 - (b) are strictly controlled by reference to Aviva's strategic investment policy; and
 - (c) could potentially under normal circumstances provide as good or better a return as other investments.
- New business - the differences here between the Policyholder Advocate's views and those of Aviva are addressed above.
- Shareholder tax - the payment of shareholder tax by the estate is an established practice both within the industry and within Aviva and is clearly explained within the company's PPFM. As such it is a use of the estate of which policyholders are aware and which shareholders expect and could considerably reduce the income of investors were it unilaterally withdrawn.
- Misselling expenses - the Policyholder Advocate has acknowledged to the Treasury Select Committee that there may be a case for charging the with-profits fund with "ordinary course" misselling costs.

Additionally, in Aviva's view, it is fairer that the payment of these costs is made out of the inherited estate rather than from policyholder asset shares but the Policyholder Advocate considers that if the deduction is not justifiable from asset shares it is not justifiable from the estate. She does not believe that there should be a distinction between a cost which can properly be made to asset shares and a cost that can properly be made to the estate. Aside from being inconsistent with current regulation, it seems counterintuitive to deduct such amounts from clear entitlements that policyholders currently have rather than from a part of the fund in which they have only a future contingent interest in a distribution.

4.04 Conflicts of Interest

- On the section of the Policyholder Advocate's paper dealing with conflicts, Aviva does not agree that the possibility of a future reattribution would induce it to minimise the level of excess surplus in a fund so as to avoid the need for distribution. It should be pointed out that shareholders also benefit to the degree of 10% from a distribution and it is not in the company or shareholders' interest not to use the assets in the fund in an efficient manner so as to optimize the success of the company as a whole.

Report Number 25 A

- The potential issue of a company's projected new business levels being inflated in the context of a reattribution to reduce the size of estate available for reattribution has been addressed in the negotiations as discussed above. Aviva's projections of new business for the purposes of the VPDP calculations were lower than it truly anticipates (and achieved over the last two years to 31 December 2008) and the Policyholder Advocate herself has used even lower levels in assessing the offer.
- The policyholder advocate suggests that after a reattribution a company has a strong incentive to minimize the capital requirements of the fund so as to maximize distributions of reattributed estate to shareholders. The Aviva Life and Pensions UK Limited (AVLAP) board has duties to the company as a whole in promoting the success of its business and should not be focused totally on extracting the reattributed inherited estate for the benefit of shareholders. The provisions of the Scheme have also been carefully designed, and agreed with the Independent Expert to include governance provisions capable of dealing with any potential conflicts of interest which may have been increased by the terms of the reattribution.