

**PROPOSED RE-ATTRIBUTION OF INHERITED ESTATES OF CGNU LIFE
ASSURANCE LIMITED AND COMMERCIAL UNION LIFE ASSURANCE
COMPANY LIMITED**

ADDENDUM TO JOINT OPINION DATED 18 JULY 2007

NOTE: This document has been prepared on the instructions of Clare Spottiswoode CBE solely to assist her in the performance of her functions as Policyholder Advocate for the Reattribution Proposals of CGNU and CULAC pursuant to the Financial Services Authority's Conduct of Business Sourcebook 20.2.42R to 20.2.46G. It should not be relied on by any other person for any purposes whatsoever.

INTRODUCTION

1. We (together with Nikki Singla) advised the Policyholder Advocate (“the PA”) appointed in respect of the proposed re-attribution of the inherited estates of the with profits funds of CGNU Life Assurance Limited (“CGNU”) and Commercial Union Life Assurance Company Limited (“CULAC”) regarding various issues of relevance to the re-attribution in a written opinion dated 18 July 2007 (“the Opinion”). We are now asked to advise the PA regarding a further specific issue which we understand has assumed significance in the course of the negotiations regarding the re-attribution.
2. The issue in question relates to the legitimacy of a practice which has come to be referred to “inter-generational transfer”.
3. It is helpful to address the issue under the following headings:-
 - Overview of inter-generational transfer
 - Policyholders’ understanding and expectations
 - Contravention of restrictions identified in the Opinion
 - Other relevant restrictions
 - Regulatory position
 - Conclusions

OVERVIEW OF INTER-GENERATIONAL TRANSFER

4. With profits policies require capital reserves. As a matter of principle, such capital reserves could be provided either by the policyholders themselves¹ or by a third party. In the latter case, one would expect the third party to require payment by the policyholders of an appropriate charge to reflect the costs and benefits involved in the provision of the reserves.
5. If the capital reserves have been provided by the policyholders themselves, one would naturally expect the reserves (to the extent they have not been called upon) to be paid out to the policyholders on maturity of their policies.
6. By contrast, if the capital reserves have been provided by a third party, one would naturally expect the reserves (to the extent they have not been called upon) to be retained by the third party rather than being paid out to the policyholders on maturity of their policies.
7. We are instructed that the CGNU and CULAC with profits funds have for many years been run in a way which involves the inherited estate providing the necessary capital reserves to support

¹ In practice, the provision of capital reserves by policyholders at the outset of their policies is not realistic in that conventionally priced new business tends to generate negative cash flow at the outset as the first year’s premium is used up entirely to pay sales commission and set up costs. A more realistic picture would involve policyholders relying upon the provision of capital from other sources in the early years of their policies and only providing their own capital over the lifetime of their policies. However, it is not necessary to factor in these complications in this Addendum.

the policies. As we understand it, a small annual charge is made to the policyholders (as part of asset share calculations) for the support provided by the inherited estate and is set at a level which is broadly intended to maintain the level of the inherited estate.

8. We are not clear whether this charge is equivalent to what a third party provider of capital might be expected to charge on an arm's length basis for the provision of such support. We shall assume, for the purposes of this Addendum, that it is.
9. We are instructed that the charge does not, however, include any payment in respect of the possibility that the policyholder may benefit from a distribution from the inherited estate if it is subsequently judged to contain excess surplus.
10. From the point of view of an economist, the effect of the above is that the inherited estate is providing a subsidy to policyholders in that, when account is taken of the possibility of future distributions from the inherited estate, they are paying less than full value for the actual and potential benefits conferred on them under their policies.
11. Consistently with the fact that they are not themselves providing the capital reserves for their policies (they are paying the inherited estate to provide these), policyholders are not credited with any part of such capital reserves when they leave the with profits fund on maturity of their policies. Instead, such reserves remain in the inherited estate where they are available both to support new policies and, in the case of surplus, to be distributed to those policyholders who happen to be current at the time when the surplus emerges as excess to the requirements of the fund.
12. The effect of the foregoing is to produce a "recycling" of capital between generations of policyholders. As policyholders come into the with profits fund, they receive both the actual benefit of support from the inherited estate and the contingent benefit of a right to share in any distribution of excess surplus from the estate. As they leave the with profits fund, they lose both forms of entitlement to benefit from the inherited estate and the capital passes to the next generation of policyholders. It is because of this that the situation has come to be referred to by the convenient shorthand expression of "inter-generational transfer".
13. As we understand it, the element of this process that we are asked to consider is the transfer of the (contingent) entitlement to a share in a distribution of excess surplus for which no charge is made under current arrangements. To the extent that with profits companies may fail to charge commercial rates for the provision of capital reserves out of the inherited estate, that appears to us to raise different and less difficult issues.

POLICYHOLDERS' UNDERSTANDING AND EXPECTATIONS

14. When considering the legitimacy of inter-generational transfer in this sense, it is helpful to start (as in the Opinion) by considering the reasonable understanding and expectation of Aviva's with profits policyholders in relation to this use of the inherited estate.

15. Any assessment of such understanding and expectations should take account of all of the circumstances canvassed in the Opinion, including the nature of with profits business, the terms of the relevant policies, the terms of any other relevant communications between Aviva and its actual or prospective policyholders, and the relevant regulatory environment.
16. Having regard to such circumstances, it seems to us that Aviva's with profits policyholders must reasonably be taken to understand and expect as follows:-
 - (1) They are participating in a fund which includes an inherited estate.
 - (2) The inherited estate represents a substantial and persisting surplus of assets over liabilities.
 - (3) The inherited estate is not something to which the existing body of policyholders has contributed or to which new policyholders would be expected to contribute to any significant extent during the lifetime of their policies.
 - (4) The inherited estate would be potentially available to support the benefits guaranteed under their policies.
 - (5) The inherited estate would also operate as something akin to the fund's working capital and as such would be used to further the purposes of the fund explained in the Opinion.
 - (6) It seems to us less clear whether policyholders would anticipate that a specific charge would be levied on policyholders for such support but we think on balance that such a charge could reasonably be anticipated by analogy to a third party provider of capital to the fund.
 - (7) The fund is likely to remain open for new business in the future. That is not to say that circumstances might not change and necessitate the closure of the fund at some point in the future but simply that policyholders would normally take out policies with a fund known to have a substantial inherited estate on the understanding that the present intention and expectation of the company would be that the fund will be staying open for new business.
 - (8) New policyholders will enjoy much the same benefits from the inherited estate as past and present policyholders had enjoyed or were continuing to enjoy.
17. We do not think that policyholders would necessarily have any clear understanding regarding the sources of the inherited estate but, to the extent that policyholders have any understanding regarding this, it seems likely to be to the effect that the inherited estate had arisen over time because (with the benefit of hindsight) the company had not made full distribution to past generations of policyholders. It seems to us to follow that policyholders would have a general expectation that the inherited estate, as a kind of historic "endowment" of the fund, would be retained rather than distributed unless and until its retention was no

longer justified in accordance with the principles that we have identified in our Opinion. It seems to us equally to follow that policyholders would have no expectation that a charge would be levied on them by the company to reflect the possibility that the inherited estate might at some point in the future prove excess to such requirements and then distributed to the policyholders existing at that time.

18. If we are right that policyholders' understanding and expectations are along the lines summarised above, it is difficult, at least at first sight, to see how policyholders could object to inter-generational transfer, i.e. the failure to levy a charge on new policyholders to reflect their contingent entitlement to a share in a distribution out the inherited estate. If anything, their understanding and expectation is that something along the lines of inter-generational transfer is taking place and will continue to take place in the future.
19. In order to be able to object to inter-generational transfer, it seems to us that current policyholders would need to be able to show that their understanding and expectations included one or more of the following:
 - (1) they had contributed or would be contributing to the inherited estate;
 - (2) the inherited estate would be shared out among them and other existing policyholders on maturity of their policies;
 - (3) new policyholders would not be entitled to share in a distribution from the inherited estate in the same way as they had been when they took out their policies;
 - (4) the inherited estate would be or was likely to be distributed to them during the lifetime of their policies but not those of new policyholders; and/or
 - (5) they had some kind of privileged position in relation to the inherited estate.

However, we find it difficult to identify a serious basis for asserting an understanding or expectation along any of these lines, which would require a credible cut off date to be identified to separate those policyholders who were and those who were not entitled to a share in a distribution out of the estate, none of them having been charged for this possibility.

20. Having regard to the above, we would not expect inter-generational transfer to involve any breach of the principles identified in the Opinion or indeed any other restriction that might be implicit in the policyholders' relationship with Aviva. However, we have gone on to consider these issues for the sake of completeness.

CONTRAVENTION OF PRINCIPLES IDENTIFIED IN OPINION

21. The principles are as follows.

Principle 1: Aviva will establish and maintain a with profits fund into which premiums will be paid

Principle 2: the purposes of the with profits fund are to meet guaranteed benefits and, subject to this, to generate profits for distribution to policyholders

Principle 3: the with profits fund will be managed for those purposes and not for other purposes

Principle 4: any profits earned by the with profits fund will be distributed insofar as their retention is not justified for the purposes of the with profits fund

Principle 5: Aviva will exercise its powers and discretions reasonably and fairly

22. Whilst we can see ways in which it might be argued that inter-generational transfer involves a breach of the principles, we think that the principles do not, when properly analysed, prohibit inter-generational transfer.
23. *Principle 1* clearly does not have any bearing on inter-generational transfer.
24. As for *principles 2 and 3*, the position is less straightforward in that we explained in the Opinion that principle 3 requires (among other things) that funds must not be invested on uncommercial terms which are not expected to secure an appropriate return to the fund having regard to the risks undertaken. Failure to observe this requirement would run counter to the purposes of the fund because it would reduce the ability of the fund to generate profits for distribution to policyholders and, in an extreme case, it might also endanger the ability of the fund to meet guaranteed benefits.
25. We can see that it might be argued that inter-generational transfer involves such an application of funds because it involves the provision of a subsidy to both existing and incoming policyholders in the respects explained above. There is, at first sight, some force in this argument. However, we think that such an argument will ultimately fail because it fails to take account of the understanding and expectations of with profits policyholders explained above.
26. In our view, principles 2 and 3 must be interpreted and applied in the light of such understanding and expectations. Seen in that light, we do not think that the principles prohibit inter-generational transfer.
27. On analysis, inter-generational transfer has two aspects. The first aspect relates to the failure to distribute the inherited estate to departing policyholders. We find it difficult to see how this falls foul of principles 2 and 3. This is the case irrespective of the understanding and expectations of policyholders explained above. However, when one has regard to that understanding and expectation, it becomes even more difficult to see an inconsistency. Of course, if the inherited estate contained excess surplus at the material time, there would be a contravention of our principles but the objectionable feature would not be inter-generational transfer but a contravention of the requirement of full distribution under principle 4.

28. The second aspect concerns the failure to require incoming policyholders to pay for the prospect of receiving future distributions from the inherited estate. It is this which provides the beginnings of an argument that inter-generational transfer contravenes principles 2 and 3 because it involves an application of the fund on terms which involve, from an economist's point of view, the provision of a subsidy to incoming policyholders.
29. We accept that, in principle, it would be open to the company to start writing new business on terms which require incoming policyholders to pay for the prospect of future distributions from the inherited estate. If it were to do so, this would presumably result in a greater proportion and perhaps all of the inherited estate quickly becoming surplus to the requirements of the fund with the result that distributions of excess surplus would begin to be made. These would benefit the current generation of policyholders who remain in the fund at the relevant time and also the new policyholders who have joined the fund in the meantime.
30. The fact that the company could start to do this does not mean, however, that it must do so. It is a matter for the company to decide what terms to offer new policyholders. Principles 2 and 3 mean that it should not offer uncommercial terms which are not expected to secure an appropriate return to the fund having regard to the risks undertaken and, in particular, that it should not offer terms which are expected to run down the inherited estate to the detriment of current policyholders. However, principles 2 and 3 do not mean that the company must go further and charge new policyholders for the prospect of distributions from the inherited estate in the future.
31. The argument would be stronger if there was a clear market for new business on such terms. If this was the case, current policyholders could perhaps argue that the company was passing up the opportunity to exploit the assets of the with profits fund in a more profitable fashion. However, as we understand it, this is not the case. On the contrary, as we understand it, there would be no appetite amongst potential new policyholders for policies which require them to pay for the prospect of future distributions from the inherited estate.
32. This being the case, the argument would have to be that the company should stop writing new business altogether. However, we think that this is too extreme in the light of the understanding and expectation of policyholders explained above. If policyholders see the inherited estate as the working capital of the fund and do not expect any distribution from such working capital unless it becomes surplus to the requirements of the fund, why should the company be required to run the fund in a manner which achieves the opposite of this and treats the inherited estate as, in effect, belonging to the current generation of policyholders? We think that the company must respect policyholders' understanding and expectation and therefore not use the inherited estate in ways which do not further the objects of the fund by supporting guaranteed benefits and, subject to this, generating profits for distribution to policyholders. However, we do not think that the company must go further than this.
33. Turning to *principle 4*, if we are right in saying that principles 2 and 3 do not prohibit inter-generational transfer, principle 4 should also not present an obstacle to inter-generational transfer. Principle 4 would prohibit the retention of funds within the inherited estate for the

purpose of supporting new business if such new business is being written for its own sake and not in furtherance of the purposes of the fund. However, if the new business is being written because a view has been taken that such new business will put the fund in a better position to meet guaranteed benefits and, subject to this, to generate profits for distribution to policyholders, then principle 4 would allow the retention of the necessary funds within the inherited estate, notwithstanding that the terms on which such new business is written may involve inter-generational transfer. Principle 4 would require distribution of inherited estate to the extent that its retention was *not* justified for such purposes, but that appears to us to be a distinct issue from the issue of inter-generational transfer.

34. This leaves *principle 5*. As with principles 2 and 3, we can see an argument for saying that inter-generational transfer involves a contravention of principle 5. The argument starts from the fact that principle 5 prohibits undue discrimination between different classes of policyholders. It might be said that inter-generational transfer involves undue discrimination in that it involves a subsidy being given to new policyholders which prejudices existing policyholders.
35. There is certainly a sense in which inter-generational transfer prejudices existing policyholders in that, if no new business was written, the entirety of the inherited estate would be distributed over time to existing policyholders as their policies mature and the capital needs of the with profits fund diminish. Writing new business on terms which maintains or increases the capital requirements of the fund without requiring new policyholders to meet the full costs of such requirements reduces the existing policyholders' expectations of distributions from the inherited estate because the inherited estate will need to be retained to support the policies taken out by the new policyholders. This could be avoided if new policyholders were required not only to provide (or to pay for the provision of) the capital reserves for their policies but also to pay a charge reflecting their contingent entitlement to a share in any distribution of excess surplus. The present inherited estate could then be paid out over time to existing policyholders because there would be an alternative source of capital reserves to support the new policyholders' policies.
36. The problem with this argument is that it is difficult to see why any of this involves undue discrimination against existing policyholders and in favour of new policyholders. Existing policyholders have themselves already enjoyed and are continuing to enjoy the benefit of the provision from the inherited estate of the necessary capital reserves to support their policies. They also enjoy the contingent benefit of a share in any distribution of excess surplus, a benefit for which they are not charged. It is difficult to see why they should be able to object to the provision of the same benefit to new policyholders unless when they joined the with profits fund they were led in some way to believe that the company would not continue to subsidise new business in this way. If this had been the case, it might have been possible to argue that current policyholders had "bought into" the fund on the basis that (subject to the insurer's right to a 10% share of profits) they were the only persons entitled to benefit from the inherited estate and that the inherited estate should therefore be paid out to them alone as their policies mature and the requirement for capital reserves diminishes. However, as explained above, it seems to us to be difficult to argue that this was the case. If anything, their understanding and expectation was to the contrary.

OTHER RESTRICTIONS

37. We have also considered whether there are any other restrictions (i.e. in addition to the principles identified in the Opinion) implicit in the relationship between Aviva and its with profits policyholders which might have a bearing on the legitimacy or otherwise of inter-generational transfer. However, we find it difficult to identify any other relevant restriction. We have set out in paragraph 18 above what we think would be necessary to ground such a restriction. In essence, one would need to be able to show that existing policyholders have a reasonable understanding and expectation that they are the only persons entitled to benefit from the fund's inherited estate and that the benefits conferred on them by the inherited estate would not be conferred on new policyholders in the future. It is difficult to argue with any real force that this is the case. Indeed, the company would be likely to argue that the effect of such an argument, were it to be accepted, would be to confer an uncovenanted windfall benefit on the current generation of policyholders and to compel the company to alter the terms on which it wrote new business to recover the costs of providing that benefit, to the prejudice of new policyholders.

REGULATORY POSITION

38. Commenting briefly on the regulatory position, we have not been able to identify any regulatory provision which directly prohibits inter-generational transfer. There are a variety of regulatory provisions (of which the most obvious is the general duty to treat customers fairly) which might have the effect of indirectly prohibiting inter-generational transfer if Aviva's with profits policyholders had some independent legal right to object to inter-generational transfer or some reasonable understanding or expectation inconsistent with inter-generational transfer. However, if we are right in the analysis above, Aviva's with profits policyholders do not have any such legal right or any such reasonable understanding and expectation and therefore such provisions are not material. As indicated, the company would no doubt argue that its obligation to treat customers fairly applies to new as well as current policyholders and that it would not be consistent with that obligation to confer a windfall benefit on current policyholders to be paid for by new and future generations of policyholders.

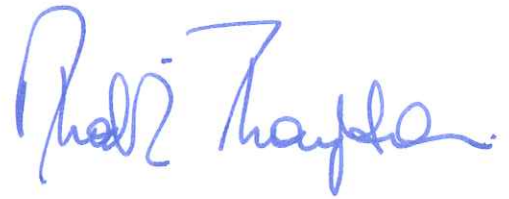
CONCLUSION

39. The legitimacy of inter-generational transfer is a difficult issue and not one which admits of a clear answer. As we have explained above, we can see ways in which it might be argued that inter-generational transfer contravenes the principles identified in the Opinion and is therefore impermissible. However, we think that these arguments would ultimately fail and that the better view is that inter-generational transfer is permissible provided that new business is written in accordance with the principles that we have described in the Opinion.

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24 June 2009

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ASSURANCE LIMITED AND COMMERCIAL UNION LIFE ASSURANCE
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