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Policyholders' Future Security and Risk Appetite

A summary of Aviva's proposals 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

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1.00 Context

One of the key considerations in the Scheme's design is that after the reattribution, the new AVLAP funds (into which the CGNU Life and Commercial Union Life Assurance Company (CULAC) with-profits policies will be transferred) will be run in a way that is consistent with how the CGNU Life and CULAC funds were run before the reattribution. One of the ways of achieving this will be to continue to follow the preferred management approach and strategy that was used before the reattribution. In order to achieve this, the funds will hold an appropriate amount of surplus capital.

We want to be clear about what that level of capital might be, how it could be described and how this might affect policyholders' prospects of a distribution.

Aviva has followed a guiding principle for this reorganisation of ensuring that policyholders' reasonable expectations and security of their benefits will not be adversely affected by the proposed changes. Indeed, both the Independent Expert and the Financial Services Authority (FSA) have also sought to ensure that this is the case. We believe that one of the keys to achieving this is to continue to follow the same preferred management approach and strategy for the relevant AVLAP funds post reattribution and the design has reflected this accordingly.

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2.00 Individual Capital Assessment

A firm's Individual Capital Assessment (ICA) sets the level of capital required to reduce the risk of failing to meet obligations of the fund to an acceptably low level. Its focus is to make sure enough capital is retained so that even in extreme circumstances, the obligations of the fund can be met.

In line with the Principles and Practices of Financial Management (PPFM), the calculation of the ICA assumes that actions would be taken in adverse circumstances consistent with the actions that the preferred management approach and strategy would indicate should the risks materialise. The ICA is determined each year and provided to the FSA.

FSA views the ICA as the minimum amount that a fund needs to hold to ensure that obligations to policyholders can be met in the next year. The FSA Conduct of Business Sourcebook (COBS) rules and guidance recognise that a firm may wish to hold funds in excess of this amount in order to ensure that the funds are able to withstand market fluctuations and shocks without materially changing its preferred management approach.

The amount of capital that the fund aims to hold above its ICA will reflect the fund's Risk Appetite.

3.00 The Risk Appetite Framework

The Risk Appetite Framework (RAF) is a part of the with-profits governance framework for the CGNU Life and CULAC funds and operates with the full involvement of the With-Profits Committee (WPC).

The development of the RAF, and the concept of the preferred range of surplus, essentially represents a formalisation of the approach that has been followed by the Board in the running of the funds for many years. The establishment of the formal framework took account of actions taken in the past in response to changes in economic circumstances. It also reflected the long-running practice of maintaining very strong funds with relatively high equity backing ratios, using the inherited estate to support new business growth and to cover, for example, guarantee and smoothing costs.

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

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

Following the reattribution, the defined framework will continue to be used by the Old With-Profits Sub Fund (OWPSF) and New With-Profits Sub Fund (NWPSF). The framework uses a risk based capital (RBC) approach involving a projection of the assets and realistic liabilities of the fund for 25 years.

We aim to keep our promises to our customers and for these funds there is a promise of strength (demonstrated by the funds' survival of two world wars, the Wall Street Crash, the stagflation of the 1970s, and the new century bear market) and the current credit crunch and associated general economic downturn. A key requirement by the Boards in setting the risk appetite was the maintenance of this continuing strength and ability for the funds to remain a long term, secure and growing store of value.

3.01 The Preferred Range of Surplus

The RAF expresses a preferred range of surplus within the funds with reference to the probability of ruin and expressed by reference to a notional AA and AAA rating. The Board arrived at this level taking into account past representations to policyholders, in particular the strength of the funds, their high equity content, and the bonus and smoothing policy, as well as the funds' capacity to withstand the type of significant shock discussed above.

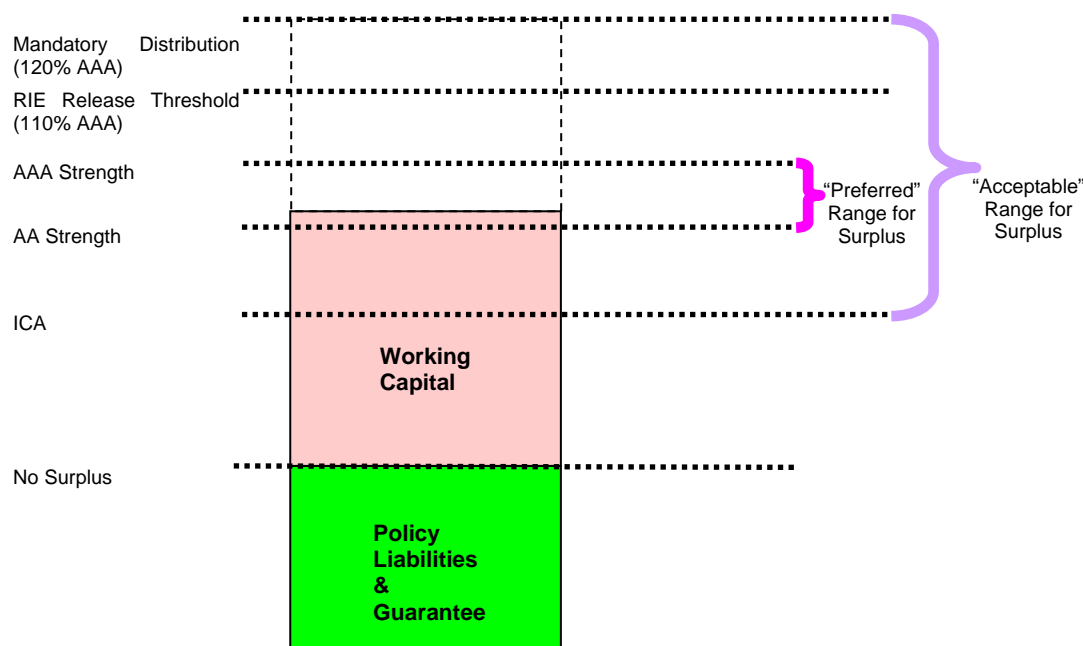
The basis for determining the AAA capital threshold is defined in the Scheme and Actuarial Function Holders (AFH) Report.

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The Board is responsible for selecting the course of action to follow when surplus falls outside the preferred range (AA to AAA). In doing so, it will seek advice from the With-Profits Actuary (WPA) and the WPC.

The preferred range sits within a wider acceptable range of surplus. The boundaries for the acceptable range are the ICA at the lower level and the mandatory distribution point for the OWPSF (120% of AAA)¹ at the upper level. If surplus lies inside the acceptable range, but outside of the preferred range of surplus, the Board is required to consider what reasonable actions it might take to restore surplus to the preferred range. If surplus lies outside of the acceptable range the Board must take action to restore surplus to at least the acceptable range.

The following diagram illustrates this:



3.02 Assessment and reporting of Financial Strength

Assessment of the financial strength of the funds, measured by consideration of the level of surplus relative to the preferred range, requires calculation of the funds' RBC results.

The RBC results and the resultant assessment of the level of surplus relative to the preferred range are provided to the WPC, and Boards.

¹ The mandatory distribution threshold for the OWPSF was added to the Risk Appetite Framework to help to avoid conflicts of interest between policyholders and shareholders after the reattribution.

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3.03 Changes to the Risk Appetite Framework

Since the RAF anticipates that we will continue to manage the funds in the future in line with past practices, no changes to the RAF will be made as a result of this reattribution. The reorganisation documentation (including the Scheme) requires the Board to manage the fund in line with the RAF.

3.03.01 What is the probability of the risk appetite changing in the future?

The Scheme does allow for the possibility that the RAF could evolve in the future. For instance, capital management and measurement techniques underpinning the RAF may change in the future.

Such change is only possible if the Board decides it is appropriate having regard to its fiduciary duties and Treating Customers Fairly. In addition, any change can only happen following a review by the WPC. The FSA will also need to be engaged in any such change. Aviva's assessment of the probability of a change to the RAF in the foreseeable future is low.

4.00 Maintaining the Preferred Management Approach and Strategy

Our promises to policyholders are underpinned by the strength of the funds. In considering the funds' strength it is easy to consider only "disaster" scenarios as so much of the regulatory environment concentrates on these stress tests. Fund strength also provides further flexibility for both smoothing and to allow the Board to maintain a relationship between reversionary and terminal bonuses that meets policyholder expectations.

Strength also means that the fund can take a measured approach to management actions, and continue to meet policyholders' expectations in adverse conditions. The CGNU Life and CULAC funds are both strong and have been sold on this basis. The preferred management approach and strategy for the funds maintains this strength.

When surplus has fallen outside the preferred range, the Board must consider the financial position of the fund and decide what action, if any, should be taken to restore the funds capital position to the preferred range. In developing the proposed course of action, input will be sought from both the WPC and the WPA.

The course of action to be taken must be decided within three months of the Board first being advised of the change in surplus position. In practice, it is expected that the Board would wish to determine whether the fund's surplus position was sustainable or likely to recover naturally over time, and in these circumstances actions might be deferred for a number of months.

In assessing the need for and nature of the action to be taken, the Board will take into account:

- The extent to which surplus was outside the preferred range;
- The expected future change in surplus position; and
- Its duties more generally, including treating customers fairly.

The Board cannot agree on a course of action which is contrary to the terms of the PPFM unless agreement to this has been provided by the WPC and any necessary policyholder communication has been undertaken. The Board cannot agree on a course of action which is contrary to the Scheme.

The principal management actions that might be taken in order to change the funds' surplus position relative to the preferred range are:

- Distribution of surplus to policyholders and shareholders
- Changes in the investment strategy for the estate

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- Changes in new business strategy – to reduce levels of new business²
- Changes in regular bonus strategy (within PPFM boundaries)
- Changes in asset share Equity Backing Ration (EBR) (within constraints)
- Changes in assumed management actions in stressed conditions of the realistic balance sheet (RBS) or ICA – as permitted by the PPFM
- Introduction of product specific asset share EBRs
- Changes in asset share EBR methodology or bonus philosophy.

or a combination of some or all of them. Some of these actions are not required for the NWPSF and reattributed estate – particularly the need to distribute surplus to policyholders.

Many of these actions require input from or the approval of the WPC and so there is no guarantee that the Board will be able to take all of the actions listed.

² For the avoidance of doubt it should be noted that new business levels can also go back up to the original planned levels once the surplus position improves

5.00 The Prospects of Special Distribution

Transparency about the management of surplus can provide:

- Policyholders in the OWPSF with an indication of the likelihood and timing of special distributions; and
- Policyholders with the assurance that the funds are being managed in line with the preferred management approach and strategy.

In order to achieve ultimate transparency, the Board has set a threshold of a multiple of AAA (120%) to define when management discretion ceases, and mandatory distributions of the OWPSF surplus must take place. Similarly, the point when surplus may be (but is not obliged to be) released to shareholders from the RIEESA will also be a multiple of AAA (110%)³. These multiple thresholds could be called “AAA+”

The detail of this is described in the Scheme and the AFH report.

The Board must carry out annual investigations for the OWPSF to determine whether the assets of the fund will exceed those needed to meet its liabilities for each of the next 25 years, with a probability consistent with the RAF. Where the OWPSF has assets in excess of those required to meet such liabilities, and those excess assets are above the relevant AAA+ threshold for a period of three consecutive years, the Board is obliged to distribute part of the Inherited Estate of the OWPSF.

When the Scheme becomes effective the Reattributed Inherited Estate (RIE) will be represented by the value of the RIEESA (the Reattributed Inherited Estate External Support Account). The RIEESA is a separately identifiable account to be maintained within the non-profit funds of AVLAP. The purpose of retaining the RIEESA is to provide capital support to the OWPSF and the NWPSF if this is required, as described further in section 6.00.

It should be noted that the prospect of future special distributions is dependent on a buoyant equity and property market. At this point, the Board (in consultation with the WPC) considers that further special distributions from the inherited estate are unlikely in the short to medium term. No release from the RIEESA can be made to shareholders until at least six years from the effective date of the Scheme.

³ The release threshold for the RIEESA was added to the risk appetite framework to help to avoid conflicts of interest between policyholders and shareholders after the reattribution

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6.00 Policyholders' Future Security

Both the security of policyholders' benefits and ability to run the funds using the preferred management approach and strategy are key principles underpinning the running of the funds after the reattribution. They both provide policyholder protection.

With these principles in mind, the RIE will be used to provide capital support for the new with-profits sub funds in AVLAP (being both the OWPSF and NWPSF).

In line with FSA rules, an Independent Expert, Nick Dumbreck, Consulting Actuary, Milliman Limited has examined Aviva's proposals in great detail and will report to the High Court on how the benefits and security of all policyholders affected by the Scheme will be safeguarded.

The method by which support is provided is set out in detail in the Scheme.

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7.00 Impact on Aviva's Offer

The basis of the Aviva offer reflects a realistic approach to the application of the risk appetite framework.

After taking into account the size of the special distribution announced in February 2008, Aviva used a set of assumptions to assess the impact of a wide range of possible economic scenarios over the next 25 years.

The outcome of this analysis leads Aviva to believe that the reattribution offer is good value for almost all eligible customers (99%), and represents excellent value for at least 95%.

- The offer is considered "good value" if a policyholder would have to wait at least 10 years before the estimated value of any future distributions could exceed the offer.
- The offer is considered "excellent value" if a policyholder would have to wait at least 25 years before the estimated value of any future distributions could exceed the offer, or if the offer will always exceed the estimated future distributions.

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

8.01 General

In general Aviva would consider there to be two elements to this topic:

- the risk appetite framework for the management of the CGNU Life and CULAC funds both before and after reattribution. This determines both the capital required to ensure that the fund can meet its liabilities and the working capital required to support the business; and
- the level of risk appetite assumed during the negotiation of the aggregate policyholder incentive payment (PIP) offer and how this assumption influences the assessment of potential future distributions to policyholders

Aviva accepts that the Office of the Policyholder Advocate has sought to challenge the level of the risk appetite for the purposes of the PIP negotiations, but finds it surprising (particularly in the current turbulent economic circumstances) that they appear to be suggesting that a weakening of the of mandatory levels at which distributions should be made is desirable.

As stated earlier in this paper, the ICA sets the level of capital required to reduce the risk of failing to meet obligations of the fund. Its focus is to ensure that enough capital is retained so that even in extreme circumstances, the obligations of the fund can be met in the next year. Simply put this means that the funds would be able to withstand what is assumed to be a 1 in 200 year event (or economic shock) – such as the current economic crisis.

Over the last century alone it could be argued that the economy (and as a result the funds) has suffered 6 such events – including the current crisis. This highlights why the perceived 'more prudent' approach to the risk appetite for the CGNU Life and CULAC funds both before and after reattribution is needed. Setting an appropriate capital requirement above the minimum ICA level ensures that Aviva can continue to weather significant economic crises whilst keeping our promises to our customers.

One of the factors that have attracted investment in the CGNU Life and CULAC funds is their long-term financial strength. The risk appetite framework formalises the approach that has been followed by the Board in the running of the funds for many years. Indeed, if the Board were to increase the risk in the funds following the reattribution they would arguably not be treating customers fairly (by not keeping their promises) and fall foul of one of the key outcomes used by the FSA to judge the appropriateness of reattribution transactions – "Ignoring the scope for future distributions, policyholders' benefit expectations are no worse under the proposals than if the reattribution does not take place"⁴. Given the current economic volatility (and the failure of a large number of financial

⁴ House of Commons Treasury Committee. Inherited Estates: Financial Services Authority and Office of Fair Trading Responses to the Committee's Twelfth Report of Session 2007-08

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institutions) the Boards can see no justification for changing the management of the funds in this respect.

It's important to note that the de-risking exercise served to substantially reduce the funds exposure to the risk of falling equity & property values. However, even after this de-risking, the fund and hence the inherited estates remains exposed to a number of other economic and insurance risks, e.g. credit risk and equity volatility risk. This highlights the need to ensure that the fund maintains adequate levels of capital to act as a buffer against these risks.

Further comments on some specific points raised are given below:

8.02 Policyholder expectations of distributions of excess surplus

In their appendix the Office of the Policyholder Advocate has suggested that "Given the COBS rules surrounding excess surplus, we believe that policyholders have some expectations with regard to potential future special distributions from the inherited estates, and we believe that following the introduction of the COBS rules, it is unreasonable to assume that the funds can be run in precisely the same way as they were before the rules were put in place. We therefore believe that it is unreasonable to adopt the preferred management strategy in all adverse circumstances, as this serves to increase capital requirements."

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

In its submission to the Treasury Select Committee Inquiry into Inherited Estates the FSA confirmed "Our rules require firms with with-profits funds to consider at least once a year whether the fund(s) contain an 'excess surplus' (which is surplus over and above the value of assets required to match the fund's liabilities and the amount required as working capital). If they do, firms must consider whether retaining it would be in breach of Principle 6 of our Principles of Business..."⁵. They go on to state that "... capital held as part of the inherited estate is needed as working capital (both to protect policyholders against adverse market conditions and to allow the fund to stay open to new business). It may therefore not be available for distribution to policyholders (and shareholders) in the foreseeable future and, indeed, may never be distributed during the lives of many current policies. Furthermore, during the time the capital is employed as working capital it can go up or down in value, and hence any future distributions, if made, would be of an uncertain amount."

Since the CGNU Life and CULAC funds have been, and continue to be managed in line with these principles over many years, we believe that it would be unfair to policyholders to change.

For the purposes of the negotiations both parties made assumptions in order to assess the impact of a wide range of possible economic scenarios over the next 25 years. By doing this we were able to conclude that the negotiated aggregate PIP offer is in excess of possible future special distributions under a wide range of scenarios.

⁵ Memorandum from the Financial Services Authority dated 14th April 2008

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8.03 Credit ratings

The Office of the Policyholder Advocate has challenged whether it is appropriate for the with-profits funds to have a risk appetite credit rating that is higher than that of the parent company (Aviva Plc).

The credit rating and risk appetite of Aviva Plc defines the acceptable level of risk that the Board considers reasonable for shareholders to take to avoid the Company being in default of its obligations. Such decisions may include raising more capital, closing seemingly profitable product lines, selling parts of the business etc. The risk appetite credit rating is key to capital raising particularly non equity capital, i.e. debt.

The RAF for the with-profits funds, by contrast, conforms to a similar definition of risk, but sets its thresholds higher. It seems reasonable to challenge this, as shareholders (viewed in isolation) should be no more willing to take risks with a non-profit fund where their interests are 100% than a with-profits fund where their interests are only circa 10%.

The critical difference is that if a with-profits fund declines in strength, the Board will take actions within the fund (in accordance with their PPFM) such as reductions in equity backing ratio, reversionary bonus rates etc. long before the shareholder has to face the sort of issues described above. The strength is what allows with-profits funds to delay implementing these actions and/or helps to reduce their impact on policyholders.

Arguably therefore the credit rating for Aviva Plc provides a financial indicator to potential investors of the credit worthiness of the company, whereas the references to AA and AAA used in the risk appetite framework indicates the CGNU Life and CULAC funds ability to weather significant economic shocks whilst maintaining our preferred management approach and strategy and keeping our promises to our customers. These are clearly different requirements and therefore there is no logic for assuming that the risk appetite for Aviva Plc and the with-profits funds should be the same.

The Boards, in consultation with the WPC are satisfied that it is appropriate to continue the past practice of maintaining a high financial strength for the CGNU Life and CULAC funds irrespective of the credit rating for Aviva Plc.

8.04 Preferred management approach and strategy

The Office of the Policyholder Advocate questioned whether it is reasonable to adopt the preferred management strategy in all adverse circumstances.

The Policyholder Advocate comments seem to suggest that the company will follow the preferred management approach and strategy for the funds regardless of the situation it faces. This suggests that two elements have perhaps become confused, namely, the assumptions made in estimating the capital requirements now and in the future for the purposes of the realistic balance sheet versus the actions the company may take if faced with adverse circumstances in reality (such as now).

The lower limit of EBR is cited as an example of inflexibility in the application of the preferred management approach. For the avoidance of doubt, the Board, following the advice of the with-profits committee, will take the action deemed to be appropriate to a particular adverse circumstance. The description of the preferred management approach and strategy described in Section 4.00 above illustrates the actions that might be taken by the Board.

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Aviva has clarified that through its governance framework, the With-Profits Committee and the With-Profits Actuary will continue to scrutinise the new business plans to ensure that they would not have a material adverse effect on the interests of existing with-profits policyholders.

Any changes to the planned volumes of new business as a result of management actions in particular market conditions could either be to reduce planned volumes of new business sales or increase back up to the earlier planned levels. Any actions would be taken in line with the governance framework and include full consultation with the WPC.

8.05 Prospects of future special distributions

The KPMG paper makes reference to the AAA+ criterion for excess surplus being a high hurdle before distributions from the OWPSF inherited estate can be made. As explained in section 3.01 above the RAF expresses a preferred range of surplus within the funds with reference to the probability of ruin and expressed by reference to a notional AA and AAA rating. This preferred range of surplus sits within an acceptable range, at the top of which is the mandatory distribution point of 120% AAA.

The comments in the Office of the Policyholder Advocate's paper could mislead the reader into assuming that the mandatory level set for distributions from the OWPSF is a new and more onerous limit set for distributions of inherited estate following a reattribution – this is not the case. Those eligible policyholders who elect not to accept the reattribution offer are in at least the same position as they would be if no reattribution took place. In fact, it could be argued that they are in a stronger position now that the mandatory distribution point has been defined.

Distributions will, of course, still be able to be made in the future at a level lower than 120% AAA, as now, if the Board considers this to be appropriate. When talking of a mandatory distribution point the Board has to be careful it is not forced into distributing at a time when such a distribution could threaten the fund's security and hence there is a need for a bigger discretionary margin before this happens.

During the negotiations the Office of the Policyholder Advocate adopted an assumption that distributions would be made at 100% AAA. Aviva adopted a different assumption of 105% AAA in order to reflect commercial sensitivities whilst recognising that assessing potential future distributions to policyholders at a level lower than the mandatory 120% AAA (and within the acceptable range of surplus) would ensure that a fairer outcome was achieved for eligible policyholders (when comparing PIP offered against potential future distributions).

These assessments led both Aviva and the Office of the Policyholder Advocate to conclude that the aggregate PIP offer was in the interests of the vast majority of eligible policyholders. The impact of the economic conditions reduced the value of potential distributions to policyholders; whilst, under the restructured offer the PIP would also now reduce in these scenarios Aviva has concluded that the offer now represents excellent value for almost all eligible customers.

In their paper, the Office of the Policyholder Advocate has suggested that "The fact that Aviva has used 105% threshold in its negotiations of the policyholder incentive payment, could be interpreted that it "expects" to distribute at that level." Aviva is concerned that this statement could mislead policyholders and set unrealistic expectations.

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For the avoidance of doubt we will reiterate that management discretion exists on the distribution of excess surplus in the inherited estate of the OWPSF whilst the surplus sits within the acceptable range. The Board, with advice from the WPC, will carry out annual investigations for the OWPSF to determine whether the assets of the fund may exceed those needed to meet its liabilities for each of the next 25 years, with a probability consistent with the RAF. Where the OWPSF has assets in excess of those required to meet such liabilities, and those excess assets are above the relevant 120% AAA threshold for a period of three consecutive years, the Board is obliged to distribute part of the Inherited Estate of the OWPSF.

Although, as noted by the Office of the Policyholder Advocate, the FSA concluded that a 3 year limit on releases was a sufficient safeguard of policyholder interests, Aviva has set a limit for releases of the RIE of 6 years (this means that no monies can be considered for release to shareholders for 6 years rather than 3 years from the Effective Date). The Board took this decision in order to treat customers fairly by ensuring that there was a longer period of stability for policyholders after the reattribution.

They have also taken steps in the Scheme (particularly schedule 8) to safeguard non-electing policyholder interests against the effects that changes to the risk appetite may have on their expectations of future potential distributions.

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9.00 References

- The Scheme
- The AFH Report