

## **Appendix 28 B**

### **Policyholders' Future Security and Risk Appetite**

A report for the policyholder advocate in connection with the reattribution of the inherited estates of the CGNU Life and CULAC with-profits funds

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## 1.00 Introduction and Summary

### 1.01. Context

This appendix has been prepared by KPMG LLP for the policyholder advocate, and is a response to Aviva's paper on the same aspect of the proposals. Whilst we have done our best within this appendix to explain technical terms and concepts, it remains the case that this is a technical report intended for readers who have some familiarity with the concepts involved.

### 1.02. Background

The Conduct of Business Sourcebook ("COBS") in the Financial Services Authority (FSA) Handbook specifies a number of rules and guidance relevant to a with-profits insurance company. Since the introduction of the COBS rules around excess surplus in July 2005, companies are required to determine whether any excess surplus exists in the with-profits fund and whether consideration should be given to distribute such surplus to policyholders. The COBS rules do not give any guidance on *how* the excess surplus should be measured, but COBS 20.2.21 onwards clearly states:

*"At least once a year (or, in the case of a non-directive friendly society, at least once in every three years), a firm's governing body must determine whether the firm's with-profits fund, or any of the firm's with-profits fund, has an excess surplus."*

- (1) *If a with-profits fund has an excess surplus, and to retain that surplus would be a breach of Principle 6 (Customers' interests), the firm should:*
  - (a) *make a distribution from that with-profits fund; or*
  - (b) *carry out a reattribution.*
- (2) Compliance with (1) may be relied on as tending to establish compliance with Principle 6 (Customers' interests).

- (3) *Contravention of (1) may be relied on as tending to establish a contravention of Principle 6 (Customers' interests)."*

Aviva uses the risk appetite framework to define acceptable levels of surplus in the funds. The various levels of surplus which are determined by the risk appetite definitions for CGNU Life and CULAC have a direct effect on both the current amount of excess surplus available for distribution within the funds and on the potential for future such distributions.

Further, as Aviva acknowledges, the level of surplus is only "one relevant factor" that needs to be considered when making this judgment. Meeting policyholder expectations or treating customers fairly would arguably be at least as important and possibly more relevant to policyholders. Clearly, however, consideration of excess surplus is itself a major aspect of treating customers fairly.

There is an additional factor in a reattribution in a fund where new business is written on the basis that estate capital is transferred to future generations (also known as intergenerational transfers). New business written in this way delays any potential release of special distributions resulting in an expectation that more of the estate is distributed to future policyholders and not to current policyholders. A reattribution stops this transfer, creating a portion of the estate which 'belongs' to no-one, and which is therefore available to be divided between shareholders and current policyholders. The higher the amount predicted to go to future policyholders, the more shareholders might expect to receive from a reattribution. A higher level of risk appetite will exacerbate the impact since the new business written will itself create capital requirements, thereby delaying releases of capital. There is therefore an incentive for the company to increase its risk appetite in order to be able to offer less to current policyholders from a reattribution than it would otherwise be able to with a lower risk appetite.

As a part of our consideration of what risk appetite would be appropriate taking into account policyholders' security, treating customers fairly and the regulatory requirements, we asked the FSA a number of questions, along with follow-on questions. Its responses are appended to this document (Annexe 1). In summary, as far as the risk appetite framework is concerned,

the FSA has stated it has no objection to a firm setting a high risk appetite so long as there are safeguards to ensure the firm does not set a lower risk appetite post reattribution in order to benefit shareholders.

### **1.03. Our understanding of the Aviva view**

Aviva's views are described in its appendix 28 A titled "Policyholders' Future Security and Risk Appetite".

A relevant factor in the operation of the funds is the level of surplus that needs to be maintained so that it can be operated in line with the preferred management strategy. The preferred management strategy reflects the operation of the fund pre-reattribution.

Aviva's approach is that capital requirements (and hence surplus assets) are set in line with the risk appetite of the Board. This is defined in the Actuarial Function Holder's (AFH) report as being equivalent to a range between AA and AAA in terms of a Moody's credit rating for the with-profits funds. More detail on the exact risk appetite framework is set out below in section 2.

In Aviva's view it is appropriate to maintain this high level of security as this is consistent with how the funds were marketed to policyholders and hence it is in line with policyholders' reasonable benefit expectations.

### **1.04. Summary of KPMG's view**

Aviva's risk appetite is important not only because it defines the level of security for policyholder benefits, and impacts on Aviva's investment freedom, but also because the risk appetite can have a direct impact on the circumstances in which excess surplus from the inherited estates of CGNU Life and CULAC can be distributed. Currently the FSA permits new business to receive the benefit of estate capital from current policyholders through intergenerational transfer. The effect of this is that the higher the risk appetite attributed to this new business, the more estate that has to be held back to cover that risk, and the lower the likely special distributions will be to current policyholders as future policyholders receive a higher proportion of the estate when this capital is finally released. A higher risk appetite

therefore both defers distributions (the higher estate) and dilutes distributions (new policyholders share in special distributions) - see Appendix 38 Aviva's new business forecasts for an explanation of this. The risk appetite is therefore a major determinant under the current FSA rules of the value of potential benefits forgone by those policyholders who elect to take the policyholder incentive payment.

It should be noted that the calculations of the capital requirements for risk appetite purposes assumes three years of new business at the levels projected by Aviva. This increases the amounts of capital required in the estates commensurately. However, more important is the fact that the projections of future potential distributions included an allowance for 25 year's worth of new business and this had a significant impact on the estimated value of benefits forgone by eligible policyholders.

KPMG's view is that Aviva's acceptable range of surplus (consistent with an AA to AAA credit rating) is appropriate, but the level at which mandatory distributions is set (distributions are not required unless the fund maintains surplus consistent with 120% of the AAA rating, and only then if 120% of AAA is maintained for three consecutive years) could be considered prudent. Any prudence is good for policyholder security, but would result in a delay in the release of potential surplus in the CGNU Life and CULAC inherited estates. Also, the excess surplus is calculated using a model which assumes that the Board will not depart from the preferred management strategy in terms of the lower limit of the EBR (set at 40%). We note that, in reality, the 40% floor would be reduced in the event that solvency was threatened, and we would expect this to be assumed in the modelling; the fact that it is not results in a level of prudence in the calculations. We have discussed this point with Aviva and have seen evidence that currently this restriction is likely to have an immaterial impact on any capital calculations. Further there is no credit allowed for capital support from elsewhere in the group.

We do note however that the 120% of AAA is derived by considering historic economic events and ensuring that solvency is maintained if such events reoccurred, and, as such, the 20% in excess of AAA represents a part of Aviva's risk appetite. We would see the 20% as an additional margin, a view not shared by Aviva.

It could be argued that financial strength is not the only criterion relevant to deciding the level of surplus and the potential for special distributions. Other factors such as reasonable policyholder expectations are also important. For example, policyholders might prefer higher potential special distributions from the inherited estates now even if that meant a lower EBR in the future.

The model used to determine risk-based capital relies on observed default rates (the probability of a company not honouring its debts), and complex assumptions, such as future investment conditions. Changes to these inputs can result in changes to the risk-based capital and therefore affect the possibility of distributions in the future. In this respect there is a considerable amount of judgment involved in the calculations. Alternative approaches could be considered, such as ICA + margin, which is still a complex calculation, but is in theory more consistent across companies and uses the same allowance for defaults across companies. We accept however that approaches to ICA can vary widely from company to company, and clearly both the assumptions and the margin assumed still use a degree of judgment.

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. It would be more reasonable to assume more flexibility with regard to the strategy, with a subsequent reduction in capital requirements.

The impact of rules around the level at which mandatory distributions are set as described in Aviva's appendix 36 A on "The pre-retribution distribution" was not significant. This is because the pre-retribution distribution was set to leave a level of capital in the fund at midway between AA and AAA, well below the mandatory level at which surplus must be distributed, at 120% of AAA. We consider the amount that was distributed to be appropriate because it left capital in the fund which was sufficient to withstand stressed market conditions but which was not overly excessive.

For the projections used in the negotiations of the policyholder incentive payment, Aviva assumed that distributions would be made at a level of 105% of AAA. Although this is higher than the level at which the pre-retribution distribution was set, it is lower than the 120% mandatory level set by Aviva and, as such, the risk appetite did not reduce the estimated value of potential future distributions to policyholders as much as it would have done had the mandatory level been used. The policyholder advocate used 100% of AAA in her calculations. The fact that Aviva has used 105% of AAA threshold in its negotiations of the policyholder incentive payment could be interpreted as meaning that it "expects" to distribute at that level. By comparison, the 120% mandatory level of 15% higher does appear very high. It appears particularly high since the special distribution announced in February 2008 was at a point midway between AA and AAA.

The key area where the high mandatory limit on special distributions has had an impact on the negotiation process is in respect of those transferring with-profits policies which are allocated, or reassured (to the extent they are reinsured), to the Old WPSF (which will include eligible policyholders who will decide not to elect to receive the PIP). For these policyholders, the potential for future special distributions may be delayed if Aviva decides not to distribute until the mandatory level is reached.

KPMG remains of the view that Aviva's risk appetite in relation to mandatory distributions is prudent, notwithstanding the current (2008 / 2009) volatile economic conditions. As noted earlier, any prudence is good for policyholder security, but would result in a delay in the release of potential surplus in the CGNU Life and CULAC inherited estates and hence reduces the value placed on benefits which would be forgone by eligible policyholders if they accept their offered incentive payment.

For the avoidance of doubt, we do not consider the current level of security in the CGNU Life and CULAC funds to be excessive. The comments made regarding levels of prudence are in respect of the level at which mandatory distributions are required which is far higher than the current level of surplus in the funds.

## **1.05. Structure of this appendix**

In section 2 we summarise Aviva's position (in its appendix 28 B "Policyholders' Future Security and Risk Appetite") without comment. Our views on its position are described in section 3. Section 4 then provides a critique of the model used and considers other potential approaches.

## **2.00 Aviva's Approach**

### **2.01. The Risk Appetite Framework (RAF)**

Aviva aims to hold sufficient capital to maintain its 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.

Aviva states that the development of the risk appetite framework formalises the approach that has been followed by the Board in the past. It will use a risk based capital approach which involves a projection of the assets and realistic liabilities of the fund for 25 years.

Aviva states that the risk appetite framework expresses a preferred range of surplus within the fund and is expressed by reference to AA and AAA rating. The basis for determining the AAA capital threshold is defined in the draft Scheme and AFH report.

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 Old WPSF (120% of AAA) at the upper level. If a 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 the surplus to within the preferred range. If a surplus lies outside of the acceptable range the Board must take action to restore the surplus to at least within the acceptable range.

### **2.02. Maintaining the Preferred Management Approach and Strategy**

Aviva states that maintaining the preferred management approach requires the fund to be able to take a measured approach to management actions and continue to meet policyholders'

expectations in adverse conditions. The framework defines the acceptable and preferred ranges of capital.

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 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 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
- Changing the investment strategy for the estate
- Changing new business strategy to reduce levels of new business
- Changing regular bonus strategy (within PPFM boundaries)
- Changing asset share EBR (within constraints)
- Changing assumed management actions in stressed conditions of the RBS or the ICA as permitted by the PPFM
- Introducing product specific asset share EBRs
- Changing asset share EBR methodology or bonus philosophy.

### **2.03. The Prospects of Special Distributions**

Aviva states that in order to achieve ultimate transparency the Board has set a threshold of 120% of AAA to define when management discretion ceases, and mandatory distributions of the Old WPSF surplus must take place. Releases to shareholders from the reattributed

inherited estate external support account (RIEESA) are permitted, though not required, only where 110% of the AAA threshold is achieved.

Aviva states in its appendix that where the Old WPSF has assets in excess of those required to meet liabilities, and those excess assets are above the relevant AAA+ threshold (120%), for a period of 3 consecutive years, the Board is obliged to distribute that excess part of the inherited estates of the Old WPSF.

When the Scheme becomes effective the RIEESA will be retained to provide capital support to the new with-profits sub-fund (New WPSF) and the Old WPSF if this is required.

Aviva states that the Board considers that further special distributions from the inherited estates are unlikely in the short to medium term. No release from the RIEESA can be made, until at least six years from the effective date of the Scheme. The six year restriction does not apply to distributions from the Old WPSF.

#### **2.04. Policyholders' Future Security**

Aviva states that the security of policyholders' benefits and its ability to run the funds using the preferred management approach and strategy are key principles underpinning the running of the funds both before and after the reattribution. .

### **3.00 KPMG's comments on Aviva's approach**

This section sets out our comments on Aviva's appendix 28 A "Policyholders' future security and risk appetite".

#### **3.01. The Risk Appetite Framework (RAF)**

Aviva has developed a series of risk-based capital measures to determine the amount of excess (or distributable) surplus in the funds both before and after reattribution. These measures are in addition to the ICA calculated for FSA solvency purposes and have been determined so that the chances that management may, at some point in the future, have to depart from its preferred approach to running the business are minimal.

Under the Aviva framework the “acceptable” range is bounded on top by the “Required Distribution Threshold.” At this point the surplus is considered so large that any assets above this limit are not necessary for the ongoing management and solvency of the fund. As a result, subject to certain conditions as set out in the AFH report, they must be distributed to policyholders. The acceptable range of surplus is however quite wide. To be consistent with its stated, preferred approach to managing its with-profits business – as well as its objectives for the financial strength of the fund – Aviva has also defined a “preferred” range for the surplus in the fund. This range has been defined in credit rating terms as stretching from the capital required notionally to achieve an AA rating on the fund to the capital required for an AAA rating. The capital required to meet the lower limit of the preferred range (AA rated) is significantly higher than the minimum theoretical level at which a distribution could be made (in Aviva’s case, the ICA). This should ensure that the financial strength of the fund remains well above the FSA minimum. At the upper limit though, the capital associated with an AAA rating is considerably less than Aviva’s Required Distribution Threshold specification (i.e. a 20% difference). The CGNU and CULAC funds have historically been strong financially. Given Aviva’s objective to maintain similar levels of financial strength in future, while the risk appetite framework allows a distribution to policyholders where capital falls in the preferred range, Aviva says it is unlikely that it would do so. However, if surpluses in excess of the AAA upper limit were to arise then it would be increasingly probable that a distribution would be made before the Required Distribution Threshold was to be breached.

Aviva has carried out a pre-retribution special distribution of £2.4bn. We note that at the time of this pre-retribution distribution, surplus was left such that at the end of 2007 the fund strength was in the middle of the AA to AAA preferred range. Aviva has stated that it is unlikely that future special distributions will be made until the surplus is over AAA. In addition, the FSA has provided the policyholder advocate with guidance that in reviewing excess surplus it would treat distributions as probable at the AAA level (see Annexe 1).

We welcome the pre-retribution distribution. We also note that it could lead policyholders to expect future special distributions to be consistent with a surplus position at the level at

which the funds were at the end of 2007 (that is, in the middle of the AA to AAA preferred range).

It is our view that Aviva's approach to setting the mandatory distribution point, as described in its paper, could be considered prudent as it adds margin upon margin – ie having the 20% margin on top of the AAA level, and requiring this to be the case for as long as three consecutive years. We note however that the pre-retribution distribution was made at a level much lower than the upper limits discussed above. The situation at the time was that the surplus was at a level which was substantially in excess of the top of the preferred range of surplus (as a result of the de-risking), and the amount of the distribution was set against the background of the development of the retribution proposals. In particular, Aviva has told us that the amount distributed was determined so that the prospect of further distributions after the Effective Date was low.

Aviva has claimed that as policyholders have been informed of the strength of the funds they will expect this level of strength to be maintained. As we mentioned above, the strength of the fund is only one factor affecting the expectations of policyholders. Guarantees and total payouts are also important. At the end of 2006, the difference between the AA and AAA capital requirements was of the order of [REDACTED] which is [REDACTED] compared to the size of the inherited estates. At the end of 2007 the difference was of the order of [REDACTED].<sup>1</sup>

In response to this point Aviva has stated that its approach has helped to maintain payout levels in difficult market conditions. Consequently policyholders have chosen to remain with Aviva. While some policyholders would have remained with Aviva for this reason, this would not be the case for all policyholders.

Aviva Group's own rating (AA- for Standard & Poor's, Aa3 for Moody's as at October 2008) was below that of the target rating for the funds, and we question why the with-profits funds need capital at a level above that of the group. In general it is possible for particular securities

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<sup>1</sup> The references here to results of the capital requirement calculations have been redacted (i.e. blanked out). This has been a requirement of Aviva, in order to prevent the public disclosure of information which Aviva believes is commercially sensitive. The policyholder advocate does not agree that this information is commercially sensitive and believes that the redaction is inappropriate and unnecessary.

(e.g. senior debt with very strong covenants) offered by a company to have higher ratings than the group itself. However we believe that the current mandatory distribution point specified by Aviva is very prudent. Aviva disagrees with this point and its view is that policyholders have their contract with the with-profits funds as opposed to Aviva Group.

### **3.02. Maintaining the Preferred Management Approach and Strategy**

The principal management actions that might be taken in order to change the funds' surplus position relative to the preferred range are set out in section 2.02, and the actions as discussed are consistent with what we would expect. There is one area of management actions cited by Aviva which we would comment on:

- Aviva states that management actions could be changed under stressed conditions of the realistic balance sheet (RBS) or the ICA. We believe that both the RBS and the ICA should take account of the management actions relevant to the particular circumstances for the particular scenario in question, and that these management actions should reflect actions allowable by the PPFM in all extreme situations. We do not fully understand how a change to management action can be classified as a management action. We assume that the comment relates to current practical limitations to modelling which may constrain the flexibility of modelling the full range of possible management actions. Not taking these actions into account in the modelling could mean that the capital requirements are overstated.

### **3.03. The Prospects of Further Special Distributions**

The AAA+ criterion being used in the definition of excess capital means there is a high hurdle before any further surpluses can be distributed from the Old WPSF. Under this criterion, special distributions are only mandatory where the excess assets exceed 120% of the AAA capital threshold for three consecutive years, although clearly distributions could be made at a lower level than this.

Setting the criteria for a potential special distribution unnecessarily high would delay the potential distributions from the inherited estates and, while new policyholders receive estate

capital without charge, this reduces the amount current policyholders would expect to receive from the estate, and would therefore affect policyholder voting. If the risk appetite were not so prudent in this respect, more policyholders might regard the prospect of a special distribution in the medium term as being likely and might then decide not to elect for the reattribution but instead remain in the Old WPSF. We note that the policyholder advocate's assessment of the offer assumed that distributions were made at 100% of AAA, and as such the guidance to policyholders will be based on this.

We note that under Aviva's draft Scheme no release to shareholders from the RIEESA can be made until after the Scheme has been effective for six years. We believe that this restriction is irrelevant to the negotiations, and the policyholder advocate has therefore not taken this added delay into account when determining the value of the reattribution to the shareholders. We would note that the 6 year delay is a restriction put in place by Aviva, not the FSA. The FSA has specified a three year restriction (see Annexe 1).

We also note that the threshold for mandatory distributions from the Old WPSF and the threshold for permitted releases from the RIEESA are 120% and 110% respectively. The 120% is a mandatory threshold and distributions below 120% are likely if not probable at the higher end, whereas the 110% is the level at which releases are *permitted*. We do not believe the 10% differential to be unreasonable.

### **3.04. Policyholder's Future Security**

The Independent Expert's (IE) report sets out in detail the arrangements for capital support from the RIEESA.

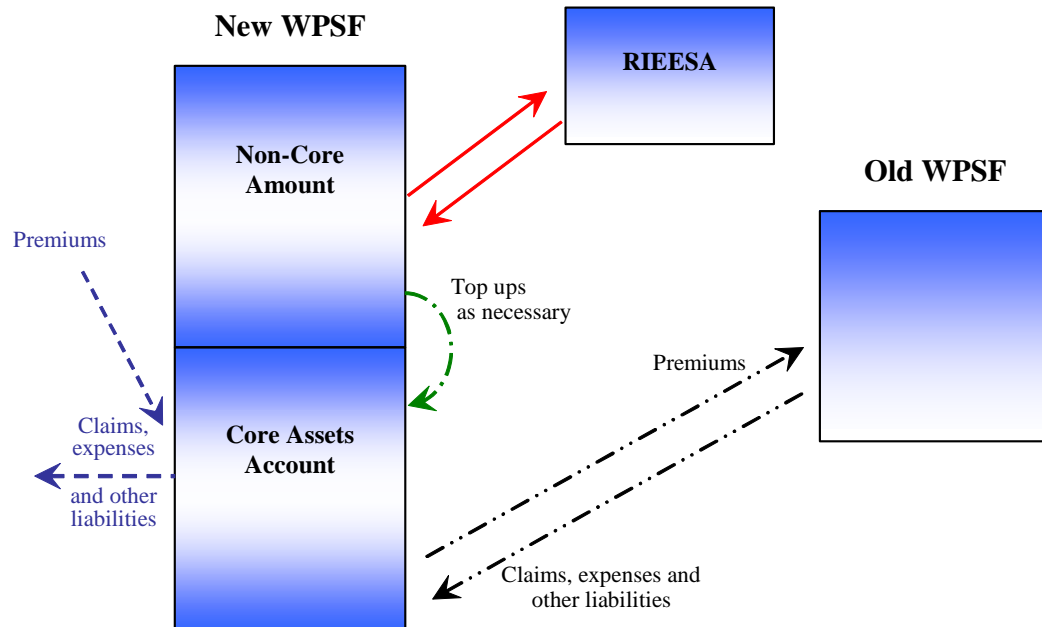
When the reattribution is implemented, sufficient transferring assets will be directly allocated to the New WPSF to cover broadly the asset shares of the with-profits policies of policyholders who elected for the reattribution (including provision for smoothing).

However, the New WPSF needs more assets than this - for example, to meet the expected cost of meeting guaranteed benefits over the level of the asset share, to meet claims arising under the non-profit policies allocated to the New WPSF, to meet expenses that will not be charged

to with-profits policyholders, and to cover the minimum level of capital that the FSA requires firms to hold in respect of with-profits funds.

The RIEESA will provide those additional assets to the New WPSF on a contingent basis. The arrangement will be contingent in the sense that if subsequently those assets are not required to meet liabilities of the New WPSF then they will be repaid and will ultimately accrue to the AVLAP shareholder in accordance with the rules set out in the reattribution draft Scheme. A significant proportion (in some situations all, or even more) of the additional assets required by the New WPSF are expected to be required to meet the cost of guarantees applying to with-profits policies or other liabilities of the New WPSF. This arrangement whereby the RIEESA provides assets to the New WPSF is the "capital support" referred to above by Aviva.

The diagram below is taken from the IE report, and gives a visual explanation of the structure. Further detail can be found in the IE report.



- >** Cashflows in respect of all with-profits business allocated to the New WPSF.
- ...>** Cashflows in respect of the 'Old WPSF Proportion' of transferring with-profits policies that are not Eligible Policies and of new with-profits business allocated to the New WPSF after the Effective Date.
- >** Additional assets of the New WPSF are allocated as necessary so that the market value of the assets backing the Core Assets Account is not less than the balance on the Core Assets Account.
- >** Contingent loan

As discussed above, we believe that the security of policyholders' benefits and the ability to run the funds using the preferred management approach and strategy can be met with a lower risk appetite than is used in the determination of the estimated value of potential distributions forgone, and indeed Aviva itself has in practice set the level lower than the level used in this estimation of special distributions, by allowing the pre-retribution to bring the capital to below the AAA level. This is not inconsistent with the stated risk appetite.

We agree that capital support should be provided by the RIEESA as described.

We also note that we believe that the working assumptions used in Aviva's modelling of the preferred management approach are in some areas too prudent. For example, Aviva wishes to maintain a high EBR level (no less than 40%), even in extreme circumstances where we

believe it reasonable to take some management action. The implication of this assumption is to produce a higher capital requirement which would delay any future special distributions from the Old WPSF. We have however discussed this with Aviva and we are told that the implications of this restriction in the modelling are not material. We have seen results of some testing which confirms that the impact is likely to be immaterial.

#### **4.00 KPMG's critique of Aviva's current modelling approach for determining capital requirements**

Aviva has not referred to its modelling approach in its paper but we believe the approach taken to determining the capital requirements is important and we have therefore considered this as part of this appendix.

##### **4.01. Aviva's risk based capital (RBC) approach**

In order to work out what capital is required to meet a given level default probability, a model is used.

The Aviva model used has the following key features:

- Projected forward for 25 years
- Allowance is made for three years of new business supported by capital from the inherited estates which therefore delays the capital available for special distributions. This support is on the basis of not charging for the cost of capital which is required in respect of the new business, and the policyholder advocate points out that this lack of charging for the cost of capital is effectively a subsidy to the with-profits new business. Note, however, that even if a charge were made, the potential releases of special distributions from the inherited estate would still be delayed.
- An equity backing ratio decision maker and reversionary bonus decision maker are used to model management actions. These are algorithms in the model which try to replicate what equity backing ratios and reversionary bonus rates the management will set based on feedback from the model such as the

investment return. This means that any management actions can only be approximated. It is not unusual for a model to make approximations and assumptions like this.

The level of capital is determined such that the assets cover liabilities at each future year with the required level of probability

There is no allowance made for temporary capital support that might be provided from other funds in the group. In practice in severe scenarios there is a capital support facility from the shareholder sub-fund. When a fund is unable to meet its obligations to policyholders, then capital can be sourced from other sub-funds or from its shareholders. However, the risk-based capital calculations assume that the fund is stand-alone and do not give credit for this support.

Aviva has used a reference to a credit rating to determine the probabilities to adopt. We briefly look at the general approach used by rating agencies below.

#### **4.02. Credit rating agencies' approach**

The rating awarded to a company is based on an assessment of a number of factors. A credit rating agency does not purely target a particular default probability. However, rating agencies do say that certain ratings are equivalent to certain default probabilities.

#### **4.03. Default probabilities**

The default probabilities applied by Aviva are based on observed default rates taken from a Moody's study. The use of observed default probabilities can have significant shortcomings since the observed sample may have included companies that are in different industries, geographic regions, etc. For example the data may include industries such as the automobile parts sector. We note, however, that there is little other data available which could be used to determine the default probability.

The definition of default is not closely aligned with measurement of risk for a with-profits fund. In addition the use of a default probability does not equate to a particular level of benefits paid to the policyholder. Ideally, more thought should be given to how the risk

appetite framework will best meet policyholders' expectations now and in the future and provide the level of benefits they would have expected when purchasing the policy. However, we acknowledge that this is a complex area and that Aviva's approach is not out of line with the industry.

The definition of defaults as used by rating agencies often include events such as:

- (1) A missed or delayed disbursement of interest and/or principal;
- (2) Bankruptcy, administration, legal receivership, or other legal blocks (perhaps by regulators) to the timely payment of interest and/or principal.

This definition is more appropriate for an entity as a whole which has a range of financial obligations and is not necessarily appropriate for with-profits funds such as those of Aviva where the sole obligation is to meet policyholders' guaranteed payments and distribute profits to policyholders and shareholders in the proportion 90:10. The default data may not capture instances where individual insurance funds default or reach ruin.

We note that Aviva changed from using Standard & Poor's data to Moody's data towards the end of 2006. Aviva says this was for the following reasons:

- a) Moody's series provides a 20 year time horizon rather than a 15 year time horizon ;
- b) Moody's provide data in a consistent format from year to year; and
- c) The time period in the Standard and Poor's data covers a mostly benign period (1981 – 2006), in which there were very few defaults of highly rated companies.

The Moody's data is used unadjusted except for years 1 and 2 where the historic default rate is zero so the first non-zero figure (year 3) is turned into an annualised rate to ensure convergent results.

The difference in capital requirements between the Moody's and Standard & Poor's data at end 2006, post de-risking, post distribution capital requirement was £175m for AAA (higher under Moody's), and £300m for AA (lower for Moody's).

We would therefore note that there can be significant differences in default rates depending on the source of the data, and it is this that drives the impact on capital requirements as shown above.

The default assumptions used by Aviva for the projected capital requirements in determining the pre-retribution distribution, and for all AAA and AA labelled capital requirements in the analysis for the retribution, were based on 2006 data, with minor adjustments (the AAA Year 1 and Year 2 figures are taken as one third and two thirds of the year three figure since there were no observed defaults in the data at those years). An extract of the assumptions as provided by Aviva are set out below:

Average Cumulative Issuer-Weighted Global Default Rates (%) 1920 - 2006

Rating	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
AAA	0.000	0.000	0.019	0.077	0.163	0.255	0.370	0.529	0.702	0.894
AA	0.062	0.184	0.290	0.447	0.718	1.024	1.344	1.651	1.971	2.311

Source: Aviva

To put the table above into context, the ICA requires sufficient capital to be held such that the company remains solvent over a 1 year period with a probability of 99.5%. This is often referred to as the risk of insolvency being a "1 in 200 year event" (since  $1/0.005 = 200$ ).

If we consider the one year rate we can derive from the year three AAA rate above, the equivalent probability of remaining solvent over one year is 99.9937%, or a "1 in 16,000 year event"). Similarly if we did a broad calculation on the 10 year rate above, so instead of looking at how the three year rates apply to an annual rate, we look at the annual rate required which would result in the above 10 year rate observed in the table (0.894), we would get an annual rate of 99.91% of remaining solvent, or "a 1 in 1,100 year event". Clearly these are very extreme events.

We conclude that the use of default rates at the very extreme tails is placing heavy reliance on observed rates which may not be totally consistent with the requirements of a with-profits fund. The risk appetite is totally dependent on the default rate assumed. In addition we note the differences in rates depending on how the rates are derived or depending on time periods assumed (as evidenced by the differences shown in using Moody's' versus Standard & Poor's). The table above illustrates how sensitive rates can be in the early years to experience. Occurrence of a few defaults can make a big difference to the analysis, and we can also see that there is no experience of default in years 1 and 2 for AAA rated companies.

We would also note that the European Union is currently consulting on its new Solvency II initiatives which are set to take effect in 2011/2012. These are currently progressing along similar lines to the FSA's ICA concept and work at the same "1 in 200" ruin probability over one year. Arguably this enhances the credibility of quantifying the excess surplus as the ICA (or Solvency II risk capital amount as the case may be) plus a margin. Clearly companies would have discretion as to the margin to be set, but this approach would make comparability easier.

## **Annexe 1 The FSA's answers to the policyholder advocate on capital requirements in relation to the CGNU Life and CULAC funds**

The policyholder advocate (PA) needed to assess the amount of capital that it was reasonable for Aviva to retain in the CULAC and CGNU Life with-profits funds, in order to ensure that the funds remain financially secure, both pre- and post-retribution. To inform this assessment the policyholder advocate asked the FSA a series of questions, in order to understand the constraints that FSA regulations place on Aviva's CULAC and CGNU Life funds. The questions posed and the FSA's answers are set out below.

### **Questions and Answers – July 2007 (COBS updated for November 2007 revisions)**

***Q1. The PA understands that the FSA minimum prudential capital requirements (MPCR) are that companies must hold the Individual Capital Assessment (ICA). As far as the FSA regulations are concerned, would the company be free in principle to distribute excess surplus above these MPCR for the funds?***

A1. The FSA said that it would expect companies, where possible, to hold capital to support the with-profits fund which is greater than the FSA's MPCR. In the case of Aviva, the FSA added that holding only the MPCR would additionally be unacceptable as this would not be consistent with the way in which the funds had been run in the past – if the company was operating on the bare minimum capital this would constrain its investment policies. The de-risking policy would reduce the capital effect of investment policy but can never completely immunise the fund from the impact of returns on the asset share investments. The fund had been sold to policyholders as being financially secure and should remain so.

The FSA said that its views on the inadequacy of holding only the MPCR followed from the FSA's Principles for Business, as outlined in the FSA Handbook, particularly the principles of sound and prudent management and adequate capital resources.

The FSA emphasised that the company's risk appetite is to be determined by the company itself and not the regulator. However in this case, for reasons set out above, the FSA said that it would expect the company's risk appetite to be set at a level above the ICA. Aviva has proposed a risk appetite of between AA and AAA and this has been accepted by the FSA.

***Q2. What restrictions (if any) does the FSA impose on MPCR in the CULAC and CGNU Life funds? In particular are there restrictions on what can back these MPCR? For example, could they be backed (in whole or in part) by the value of in force non profit business (NP VIF) or strategic investments?***

A2. The FSA said that its Conduct of Business Rules published in the FSA Handbook applied restrictions to all of the assets held in the long-term funds. The FSA stated that the reattribution proposals made by Aviva mean that the reattributed inherited estate will still be used to support the with-profits funds post-reattribution, even though the reattributed inherited estate itself will be within a non profit sub-fund (outside of the with-profits sub-funds). In recognition of this the FSA aims to ensure that the rules which currently apply under the FSA handbook to the with-profits funds will continue to apply to the reattributed inherited estate after it is transferred to the non profit fund in the reattribution.

The FSA explained that the calculation of the MPCR includes the application of the appropriate stress tests. This means that if the MPCR were to be backed by relatively illiquid assets such as NP VIF and strategic investments, it could have the effect of increasing the FSA's MPCR.

The FSA further noted that there is an extra regulatory restriction on the investment of Aviva's reattributed inherited estate. This is because the FSA has concerns about

the potential for Aviva to transfer some of its existing block of non profit business into the reattributed inherited estate from other parts of the company after the reattribution, which would lead to a capital substitution effect for the firm, but a diminished level of security for the transferring policyholders (by increasing the overall illiquidity of the funds). The FSA said that the restrictions proposed by the company in the AFH report on the movement of existing NP VIF into the reattributed inherited estate are consistent with the FSA's regulatory requirements.

***Q3. From the FSA's perspective, are there any restrictions in relation to where with-profits funds' MPCR need to be held? Are there any additional minimum FSA requirements in this regard resulting from this reattribution? For example, could the MPCR be held, in principle, in the shareholder funds?***

A3. The FSA said that it is theoretically possible for the MPCR backing with-profits funds to be held in funds other than the relevant with-profits fund. Nevertheless, in practice it is difficult to envisage regulatory approval for the assets being held in the shareholder funds. This is because the COBS rules state that the MPCR must be fully dedicated to fund support. To this end it must be ring-fenced and not hypothecated, so as to ensure that the capital cannot be used for investments which may benefit shareholders but which may lessen the security of the funds (if, for example, they were relatively illiquid and/or would reduce the value of the funds). The FSA also considered that placing the MPCR in the shareholder funds could potentially jeopardise the prioritised position of policyholders in extreme situations. The FSA noted that ensuring that the capital was appropriately ring-fenced would be significantly more difficult if it were to be located in the shareholder funds. The FSA also said that its principle of Treating Customers Fairly would need to be considered if such an arrangement was proposed.

***Q4. Could the FSA confirm that the sub-fund established for non-electing policyholders, the old-with profits sub fund (OWPSF), (and within that the relevant proportion of the inherited estate) would continue to be subject to existing regulatory requirements of a with-profits fund with an inherited estate? Are there***

*any additional FSA regulations in relation to the OWPSF resulting from this reattribution? For example, are there additional restrictions linking the OWPSF with the sub-fund established for electing policyholders, the new with-profits sub-fund (NWPSF)?*

- A4. The FSA stated that all existing regulations will apply to the OWPSF and the NWPSF. In addition to these regulations, the FSA said that it wants to ensure that both of the sub-funds will be run in the same way in the future as they have been in the past when they formed the CULAC and CGNU Life with-profits funds. In particular, the FSA wants to avoid a situation where the company can change the investment mix of the assets in the NWPSF post-reattribution, so as to reduce the probability of needing to inject capital from the reattributed inherited estate (which will become 100% shareholder owned). A change in investment strategy towards less risky investments could impact the benefit expectations of policyholders in the NWPSF. To address this issue, Aviva has proposed linking the investment mix of the New WPSF and Old WPSF post-reattribution, which the FSA has confirmed is consistent with its regulatory requirements. The FSA noted that if the company assumes de-risking, as the FSA has required of the company for the purposes of the reattribution, the chances of the company needing to contingent-loan capital back into the New WPSF from shareholder assets is reduced. However, as de-risking cannot eliminate risk completely, the FSA's view is that the potential for different investment strategies in the Old WPSF and the New WPSF still needs to be addressed in the Aviva proposals.

In addition to the company's proposed linking of the sub-funds, the FSA also said that there was an additional regulatory safeguard. Consistent with FSA requirements, the company states its asset share equity backing ratio (EBR) – stated to be between 40 and 75 per cent – in both the AFH report and the firm's Principles and Practices of Financial Management (PPFM). The FSA said that, although the range is a wide one, the company will be further constrained by its theoretical EBR (tEBR) as this will be codified in its PPFM and set out in more detail in the With-Profits Reference

Document which will be available to the With-Profits Committee (the establishment of which is advised by FSA guidance). A caveat is that the EBR will be based on the Board's assessment of an acceptable level of risk.

***Q5. The PA understands the FSA does not impose any requirements on with-profits funds in relation to their risk appetite, for example their policies in relation to their chosen EBR. In regard to this reattribution, are the FSA imposing any additional requirements in relation to risk appetite/EBR?***

A5. The FSA confirmed that the EBR is a decision to be made by the company's Board. However the FSA will consider whether the Board's decision is consistent with the Principle of Treating Customers Fairly and Policyholders' Reasonable Expectations. The FSA has therefore asked Aviva to codify information about its current EBR practices. This additional clarity will assist the company's With Profits Committee to consider the extent to which Aviva is diverging from past practice.

***Q6. Are there any other additional FSA minimum restrictions on with-profits funds generally or on the proposed reattributed funds in particular, which are not listed above?***

A6. The FSA confirmed that there are no further specific minimum restrictions on the operation of the with-profits funds pre- or post-reattribution beyond those which are currently in the public domain, but the company must in addition have regard to the FSA's principles for business as published in the FSA Handbook.

***Q7. To the extent that there are additional FSA restrictions which relate to the reattribution as discussed above, could you identify the FSA documents or other documents in which these will be set down and identified?***

A7. The FSA stated that the reattributed inherited estate is not covered by its current COBS rules for with-profits funds. This means that the minimum requirements for the reattributed inherited estate need to be set out elsewhere and must be consistent with the existing COBS rules for inherited estates which have not been reattributed.

Aviva has proposed statements to this effect in both the PPFM and in the Scheme. The FSA said that it has chosen not to extend its COBS rules and guidance to the reattributed inherited estates and it relies instead on the company observing the FSA's Principles for Business including Treating Customers Fairly. In this context the FSA said that the usual process is for the company to present proposals to the FSA in its Scheme, AFH report, PPFM, and With Profits Manual, and for the FSA to offer feedback. It is through this iterative process that the FSA's minimum requirements, as discussed above, are taken into account, and the FSA will identify these requirements as such in the Aviva proposals.

**Questions and Answers – October/November 2007 (extracts from the policyholder advocate supplementary request for guidance October 2007 and the FSA response November 2007)**

**Restrictions on releases to the shareholder**

*Q8. A further issue, which we have previously raised with you, is the extent to which restrictions in Norwich Union's Scheme (which gives effect to the proposed reattribution) are restrictions imposed by the FSA or ones which originate from the firm itself? In this regard, we have two related concerns. The first is that Norwich Union will place artificially high restrictions on releases to shareholders from the reattributed inherited estates, which they will then take into account in a lower policyholder incentive payment (PIP) offer to policyholders than if such self-imposed restrictions were not in place. Examples of such restrictions are the current capital standards in the Scheme which place a high hurdle on the firm before releases in the form of special distributions can be made to shareholders post-reattribution, and the current overlay on the capital standards that there should in any case be no releases for a minimum period of six years after the reattribution. We expect that post-reattribution it will be likely that the firm will have incentives, for example for tax efficiency reasons, to retain monies in the fund. It seems therefore that these restrictions, if they are represented by Norwich Union as reducing the shareholders' return from the reattribution, will reduce the*

*PIP that Norwich Union might reasonably offer to policyholders. Therefore the sole effect will be to disadvantage policyholders. Could you therefore please clarify whether these are FSA requirements or whether they come from Norwich Union itself? If they are FSA restrictions, can you please explain why you consider them to be in the interests of policyholders?*

A8. During late 2005 the FSA discussed shareholder releases with the firm and felt that a six year limitation was appropriate to protect policyholders against releases being considered relatively soon after the reattribution. As we understand it the six years is the sum of two three year components. Firstly there is a restriction that there will be no consideration of releases to the shareholder in the first three years post-reattribution. Secondly on calculating whether a release is possible the shareholder must meet the requirements for release over an average of three years.

Since last 2005 the structure of the deal has changed considerably, in particular with the introduction of de-risking and the pre-reattribution distribution. Therefore the FSA is content, providing the Independent Expert has no issues, for the restriction that there can be no releases in the first three years post-reattribution to be removed. However we wish to retain the three year averaging as this remains an important guard against inappropriate releases caused by, for example, temporary stock market exuberance.

#### **Restrictions on releases to policyholders**

*Q9. Our second concern is that Norwich Union will place artificially high restrictions on releases from the inherited estates to policyholders who do not elect for the reattribution. In particular, we have concerns about the current 3 year Scheme restriction on special distributions from the unreattributed inherited estates (i.e. future distributions to policyholders who choose not to elect for the reattribution). This restriction could have the effect of suppressing special distributions which, on the basis of reasonable capital standards alone, would occur soon after the reattribution. The restriction could therefore provide an incentive for policyholders to accept the PIP offered by the company, which they would not accept if this 3*

*years restriction on inherited estate payouts was not in place. Again it appears to us that this restriction favours shareholders over policyholders. Could you please explain whether this is an FSA requirement, and if so why the FSA regards it as being in the policyholders' interest for such a restriction to be in place?*

- A9. On restrictions on distributions to policyholders we understand the firm has written to you clarifying the proposed three year limit (that it only applies to mandatory distributions and so distributions driven by the current risk appetite can occur regardless). Should you have further questions about the issue then we will be happy to discuss.

**Questions and Answers – February 2008 (raised at meeting with FSA 28 February 2008, and written response received from FSA 29 February 2008)**

*Q10. In order to estimate current policyholders expected future special distributions from the inherited estate it would be helpful if the FSA could clarify what its likely position would be when reviewing the reasonableness of Norwich Union's annual calculations of excess surplus in relation to the CULAC and CGNU Life funds. In particular:*

- a) will the FSA reassess Norwich Union's new business projections afresh each year; and*
- b) will the FSA look critically at Norwich Union's level of capital retention in the funds, before the firm considers it appropriate to distribute surplus to policyholders?*

- A10. You asked whether we would look at new business projections afresh each time we discuss excess surplus with a firm. I can confirm that when reviewing a firm's annual review of excess surplus we will critically assess the new business assumptions made. For Norwich Union Life our assessment of excess surplus will be driven by their risk appetite. This states that distributions are probable from AAA.