

Report Number 29 A

Investment Policy, Smoothing and Bonus Policy

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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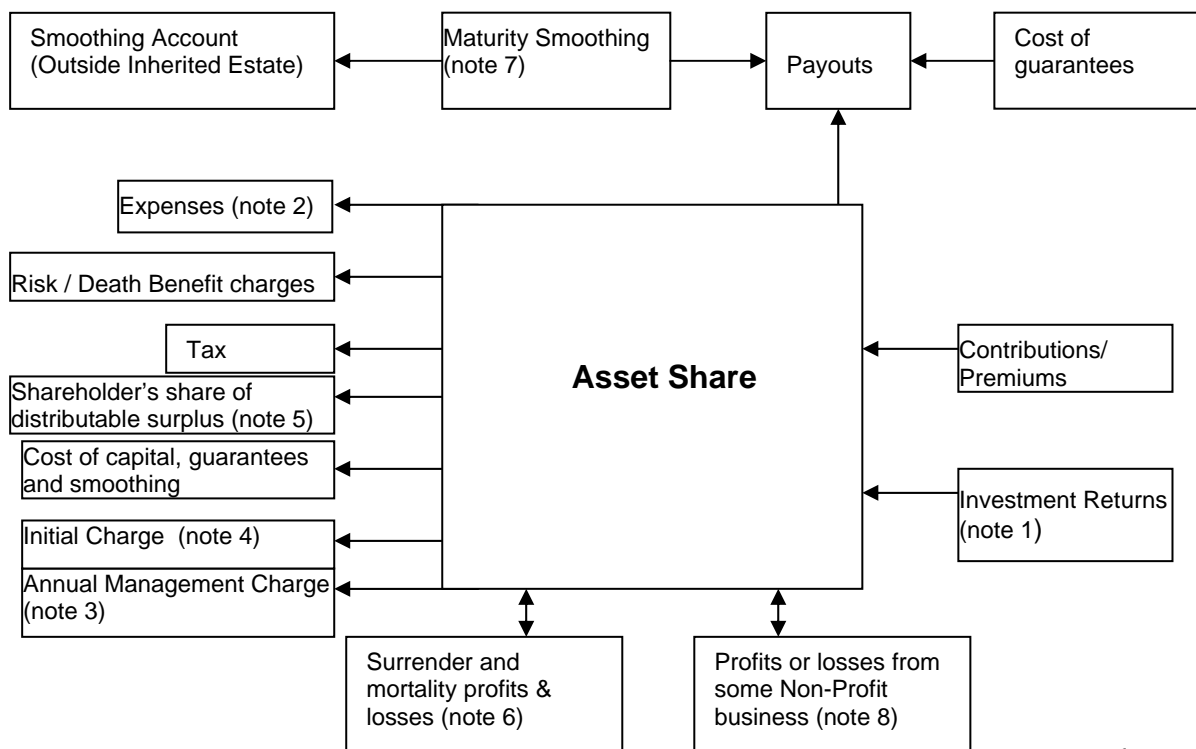
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1.00 Context

The amount that policyholders will receive in return for investment in the with-profits funds of CGNU Life and Commercial Union Life Assurance Company (CULAC) is dependent on the Investment Policy, Asset Share, Smoothing and Payouts Policies. The diagram below illustrates the connection between each of these elements. For certain contractual events, such as maturity and death, the amount paid will be a minimum of the guaranteed benefits in line with the policy terms and conditions.

This paper aims to summarise Aviva's approach to the Investment Policy, Asset Share Calculations, Smoothing and Bonus Philosophy, outline any amendments being made through the reattribution, and to confirm that this will not change Policyholders' Reasonable Expectations (PRE), or the security of policyholder benefits. The illustration below summarises Aviva's approach at the time of writing this paper, with the agreement of the With-Profits Committee, this approach may change in the future.



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Note 1 Investment returns on assets backing asset share of with-profits policies

Note 2 Cost of selling or administering the business charges levied against asset share (where applicable e.g. not applicable for Unitised With-Profits (UWP) policies written since October 2001)

Note 3 Applicable to UWP policies written since October 2001

Note 4 Applicable to UWP policies written since October 2001

Note 5 Some or all of the shareholders share of distributable surplus arising (N.B. no such amounts are taken from the asset share of post-October 2001 unitised with-profits policies)

Note 6 Surrender profits or losses where payouts differ from asset share

Note 7 Maturity profit or losses where payouts differ from the asset share

Note 8 Post reattribution this will no longer happen

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2.00 Introduction – Investing in With-Profits Funds

With-profits is a type of investment that allows participation by investors in the profits and losses of the with-profits fund. This is achieved through a system of bonuses. With-profits is generally regarded as a long-term investment product that operates over a lengthy range of economic and investment cycles.

Bonuses are paid from the 'profits' earned in the with-profits funds. The with-profits funds also offer some guarantees.

There are two types of with-profits investment available:

- Conventional with-profits
- Unitised with-profits

Money invested by policyholders is combined and invested predominately in a mix of assets, consisting of:

- Equities - Company shares (stock market investments)
- Property
- Government Bonds (loans to the government)
- Company bonds (loans to companies)
- Deposits

Investment in company shares and property are higher risk than the other types of investments. Over the longer term, however, they tend to produce higher returns.

Part of the with-profits fund directly backs the policy benefits including guarantees. The rest is the funds' working capital (or inherited estate) and can be used to provide:

- Investment flexibility
- A cushion of additional security against unexpected adverse events
- Flexibility in the smoothing of payouts
- Finance to support new business growth

After the reattribution, there are restrictions on the management of the reattributed inherited estate to ensure that it continues to be available for these purposes.

Sections 6.1 and 6.2 of Principles and Practices of Financial Management (PPFM) give more details.

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3.00 Investment Strategy

The investment strategy for the CGNU Life and CULAC funds is described in the PPFM.

The investment strategy aims to provide the highest long-term returns balanced against acceptable levels of solvency risk.

The funds are invested in a range of assets. Investment returns are benchmarked against indices, such as the FTSE All Share Index (UK equities), the FTSE World Europe (ex UK) Index (European equities) and the IPD Life and Pension Funds Index (UK property).

From time to time, maximum and minimum exposure and performance benchmarks are set for the different groups of assets.

The published mix of investments for the CGNU Life and CULAC with-profits funds backing asset share are set out in the table below:

	31/12/08 %	31/12/07 %	31/12/06 %	31/12/05 %	31/12/04 %	31/12/03 %	31/12/02 %	31/12/01 %
UK shares	24.2	35.3	43.2	41.3	42.9	41.4	31.1	48.0
International shares	13.6	17.8	9.8	13.1	8.0	9.3	9.0	14.0
Property	17.9	18.4	21.0	18.0	16.0	14.5	14.3	11.0
UK Fixed Interest	11.8	6.8	6.7	9.7	12.1	13.2	17.0	13.0
Corporate Bonds	23.8	9.9	9.6	9.7	11.9	12.9	17.2	9.0
International Bonds	6.9	5.3	4.2	2.9	3.7	4.4	4.7	3.0
Cash	1.8	6.5	5.5	5.3	5.4	4.3	6.7	2.0

The investment strategy of the fund takes into account the nature and time-span of the liabilities.

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The pooled investments in the with-profits fund, which are being held to cover the asset share liabilities, are notionally allocated to groups or pools of liabilities. This is called hypothecation. We do not hypothecate assets to individual policies.

A pool of assets is held to cover the guarantees on with-profits policies. This includes the assets that are used to hedge the guarantee costs under the dynamic hedging strategy (described in section 5 below).

A pool of investments backs the inherited estate, and in normal circumstances this is managed with the objective of achieving the same asset mix as the assets backing asset share, with the exception of the following which are hypothecated to the inherited estate:

- Strategic assets,
- Financial reassurance with the Provident Mutual (PM) sub-fund of AVLAP

After reattribution, there will be a number of explicit pools but the overall approach will remain the same.

The Risk Appetite Framework that applies to CGNU Life and CULAC does envisage that the investment strategy of the inherited estate would be used as a mechanism to control the level of risk in the fund, and in particular that the mix of assets would be altered to reduce risk in adverse conditions.

Consistent with this, in response to the recent market volatility the asset mix for the inherited estate has been changed so that less is invested in equities. This has the effect of making the value of the inherited estate less volatile, but it does not stop the size of the inherited estate varying. Section 2.00 of our appendix "Size of the Inherited Estate" provides the explanation for this.

This short-term change in approach is as a direct consequence of the application of the Risk Appetite Framework in times of unprecedented market volatility and is not considered to be a long-term change to the practices for managing the fund (as described in the PPFM). As a consequence, when conditions improve, we would expect to return to using a similar asset mix for the pool of investments which back the inherited estate to that of the assets backing asset shares.

3.02 Equity Backing Ratio

A degree of matching between assets and liabilities is maintained in order for the funds to meet their guarantees. This is achieved by calculating a suitable proportion of equity-type assets, consisting of company shares and property, compared with the remaining asset mix. This is known as an Equity Backing Ratio (EBR).

The method currently used to calculate asset allocation ranges is as follows:

- A Theoretical EBR is determined for aggregate asset shares and guarantees. This is used as the basis for determining exposure to equity assets that can currently be supported. The assessment is performed using asset liability modelling techniques
- The Board, through its investment committee, decides on the asset mix for the remainder of the Fund and has discretion to depart from the theoretical EBR assets.

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The investment strategy for the inherited estate usually mirrors this approach. Although, as noted in Section 3 above, in the current economic conditions this is currently not the case. The EBR can be changed with the authority of the Board.

Additional controls on the EBR of the funds asset shares will be introduced post reattribution. Section 12 of this paper gives further details.

3.03 Derivatives

The fund follows the Company's derivatives policy, as set by the Board. This is reflected in the Investment Management Agreement (IMA). This covers:

- The types of exchange-traded and over-the-counter derivative contracts which can be used
- Maximum gross exposures which can be held in each derivative type.

The total exposure to an asset class within a fund, allowing for derivatives, must be within the benchmark asset allocation ranges specified for that fund in the IMA.

Derivatives are used:

- For efficient portfolio management
- To reduce investment risk
- As an integral part of a product design
- For income enhancement

The use of derivatives for speculative purposes is not permitted.

With the exception of warrants and convertible loans, borrowing money to increase an investment in the expectation that the return will more than cover the debt is not permitted. This is known as gearing.

A limited amount of options may be written if they are covered by underlying assets. Other than this, the writing of options by the Company is not permitted.

3.04 Investments

The Fund invests mainly in quoted investments in order to maintain liquidity at a high level.

Based on pre-determined limits, the IMA specifies limits on the level of investment in unquoted securities.

Cash and deposit-type investments are also used to back current liabilities to provide a greater level of liquidity within the fund.

The flexibility to use new investment instruments will be balanced with the need to identify the risk inherent in them. No investment is made in new investment instruments until a proposal has been made and approved by the Board (or relevant committee).

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The fund can invest in properties used by Aviva Plc to administer CGNU Life or CULAC business. Where this is done, it is on a commercial basis.

Under certain conditions the fund can:

- Make a loan or invest in other Group Companies
- Give financial assistance or support to other sub funds within the CGNU Life and CULAC long-term funds

From 1 July 2006, CGNU Life invested in the profit and losses arising from the unit-linked business of the Provident Mutual (PM) sub fund of AVLAP by way of a reinsurance agreement.

3.05 Strategic Investments

The Funds can make strategic investments in the equity or debt of companies with which Aviva Plc has a strategic connection or interest. This is subject to the agreement of the With-Profits Committee and the Board, after having received advice from the With-Profits Actuary.

These investments will be made for strategic reasons considered to be to of long term benefit to shareholders and policyholders.

A strategic investment policy sets out the controls and management processes for strategic investments held by the funds.

Constraints are set to limit the exposure of the fund to strategic assets:

- Individual strategic holdings are subject to a limit of 1% of invested funds. Stock concentrations would be allowed beyond the normal limits if this is due to good performance within the underlying stock, with further constraints
- Total strategic holdings are subject to a limit of the lower than 2.5% of invested funds or 20% of the inherited estate after making realistic allowance for liabilities

Strategic holdings will be allocated to the inherited estate.

Additional limitations on strategic investments will be introduced post reattribution. Section 12 of this paper provides further information.

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4.00 Investment Strategy for the Inherited Estate

The investment strategy for the inherited estate can differ from the rest of the fund. Usually, the vast majority of the investments are the same as asset shares, consistent with the preferred management approach and strategy of investing in growth assets.

Currently, the following investments are held in the inherited estate, but not asset shares:

- All strategic investments
- Unit linked reinsurance with AVLAP (PM sub fund)
- Investments in other Group companies and in loans to such companies

As noted in Section 3 above, the Risk Appetite Framework that applies to CGNU Life and CULAC does envisage that the investment strategy of the inherited estate would be used as a mechanism to control the level of risk in the fund, and in particular that the mix of assets would be altered to reduce risk in adverse conditions.

Consistent with this, and in response to the recent market volatility, the asset mix for the inherited estate has been changed so that less is invested in equities. This has the effect of making the value of the inherited estate less volatile, but it does not stop the size of the inherited estate varying. Section 2.00 of our appendix "Size of the Inherited Estate" provides the explanation of this.

This short-term change in approach is as a direct consequence of the application of the Risk Appetite Framework in times of unprecedented market volatility and is not considered to be a long-term change to the practices for managing the fund (as described in the PPFM). As a consequence, when conditions improve, we would expect to return to using a similar asset mix for the pool of investments which back the inherited estate to that of the assets backing asset shares.

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5.00 Investment Strategy for the Cost of Guarantees

The investment strategy for the CGNU Life and CULAC inherited estates was, on the whole, the same as that for the rest of the fund. This meant that the inherited estate was exposed to equity and property risk from three sources:

- Exposure from the equities and property held in the inherited estate
- Exposure from investing asset shares in equities and property
- Exposure from backing the liabilities for the cost of guarantees in equities / property

These (and other risks) are reflected in the calculation of the funds' capital requirements.

During 2006 the Financial Services Authority (FSA) advised Aviva that, for the purposes of assessing the fairness of the reattribution proposals, they would assume that the investment strategy for the assets backing the cost of guarantees had been de-risked.

Having assessed the implications of this approach, during 2007 the CGNU Life and CULAC Boards took the decision to change the investment approach for the assets backing the cost of guarantees. In doing so they implemented a dynamic hedging strategy which reduced the funds' exposure to losses that might arise from an increase in the cost of guarantees as a result of falls in the value of equities and property held as part of the asset shares.

This change in approach did not affect or remove investment in equity and property for the inherited estate or the assets backing policy liabilities.

As a result of the change in investment strategy, less working capital was needed to cover the risks arising from guarantees attached to with-profits policies in the CGNU Life and CULAC with-profits fund.

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6.00 Investment Management Agreement

An Investment Management Agreement (IMA) exists between CGNU Life, CULAC and Aviva Investors Global Services Limited¹. They are currently our main provider of fund management service, although we do also work with a number of others.

This legal agreement appoints the Fund Managers, sets out the guidelines for their activities and the governance necessary to monitor their activities. Specifically, Schedule 4 of the agreement sets out the Investment Objectives for the funds and gives the benchmark parameters and limits.

¹ Previously known as Morley Fund Management Limited (Morley)

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7.00 The Use of Asset Shares to Determine Payouts

Asset Shares are used as a guide to determine the amount payable under most with-profits policies: it represents the underlying value of the policy. The calculations are either based on specimen policies or groups of policies in determining an appropriate final bonus rate for that group of policies. Payouts are not set on an individual policy by policy basis. In practice payouts may be more or less than the asset share depending on the circumstances at the time of payment.

For asset share calculation purposes, similar types of product are grouped together. A more detailed explanation of the asset share methodology is given in section 2 of the PPFM.

For certain small blocks of business, where asset shares are not available or appropriate, a comparable policy or past practice may be used to determine payouts.

The funds' long-term aim is to return, on average, 100% of asset shares to maturing groups of with-profits policies. In any year, the amounts payable on maturity could be more or less than 100%. This is due to the effects of smoothing, guarantees and the grouping of policies for the purposes of setting bonus rates.

Maturity and surrender payouts should normally fall in the range:

	<i>% of asset share</i>
Conventional with-profits	80% to 140%
Unitised with-profits	80% to 120%

There is an FSA Conduct of Business Sourcebook (COBS) rule requirement for the firm to aim for at least 90% of payouts to fall within these ranges.

Payouts can fall outside of this range in exceptional stock market conditions. Under these circumstances the aim would be to bring average payouts back in line with 100% asset share over a maximum 5 year period (subject to meeting guarantees already built in).

The parameters and assumptions used in the derivation of asset shares are reviewed each year. Any changes are documented and are subject to the approval of the With-Profits Actuary.

7.01 Conventional With-Profits Policies

Asset shares for conventional with-profits policies are calculated taking into account:

- Premiums paid

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- An allocation of investment return
- Costs of selling and administering the business
- Costs of death or other risk benefits
- An allocation of other experience profits/losses from the with-profits fund
- A tax adjustment
- The shareholders' share of distributable surplus
- Costs for the use of capital, guarantees and smoothing.

Currently the application of charges for guarantees to asset shares is very limited and after the reattribution no additional guarantee charges may be introduced in respect of business in force at the time of reattribution.

Provisions in the scheme do however provide the facility to charge industry levies to asset shares. The inclusion of this facility is a response to regulatory change and is not a consequence of either the reattribution or fund transfer. As noted above, transferring policyholders will benefit from restrictions, which are introduced in the scheme, on certain new charges to asset share, and it is therefore necessary to document an exception (noted in paragraph 1 (c) of Part 2C of Schedule 4 of the scheme) to deal with industry levies as a contingency measure against potential financial security issues.

The facility to allocate industry levies to asset share is not intended to be utilised in the normal course of events, but is intended to deal with a situation where there is either a large levy or number of levies imposed on insurers. Any ability to make such a charge will be subject to the terms of the policy and to TCF. The Principles and Practices of Financial Management (PPFM) make it clear that in considering whether or not to make such a charge the AVLAP Board will have regard to appropriate actuarial advice and the views of the With-Profits Committee. Aviva has considered the policyholder advocate's comments and remains satisfied that an appropriate combination of governance controls has been put in place to deal with this potential financial security issue.

7.02 Unitised With-Profits Policies

Asset shares for unitised with-profits policies and deposit administration business are mainly based on the same factors as for Conventional With-Profits (CWP). For business issued since October 2001 the charge for expenses is made by way of specific charges under the terms of the policy rather than the underlying expenses.

The factors taken into account in the calculation of asset shares are explained in more detail in Annexe A.

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8.00 Bonus Philosophy

8.01 Smoothing

Investment returns on shares and property are much more variable than for lower-risk types of investment. Investments may do well in one year, and badly in the next. A with-profits fund aims to even out some of the fluctuations. This is called smoothing.

The principles in Section 2 of the PPFM describe this as being necessary to provide an element of stability in the returns to policyholders. Smoothing is applied by spreading relevant profits and losses from one year to the next.

It is intended that the long-term cost of smoothing is broadly neutral across generations of policyholders. As a result of smoothing, the investment risk and the potential rewards on policies invested in a with-profits fund is lower than investing directly in the same shares and property.

Section 2 of the PPFM describes this in more detail.

The aim of the current smoothing policy is to limit changes to no more than 15% of:

- Year on year policy values for unitised business or
- Comparable maturity payouts from year to year for conventional business

Since 2004, Aviva has operated a smoothing account for maturity payouts. This account is held and reported separately from the inherited estate. Losses and gains arising from the operation of smoothing practices before this point were absorbed within the inherited estate.

In contrast, smoothing of non-guaranteed surrender values on unitised policies has been recycled through asset share.

As part of the continuous improvement process for the management of these funds, Aviva, in consultation with the With-Profits Committee replaced the existing smoothing account with 3 smoothing accounts (in addition to the smoothing and guarantee account for the Stakeholder With-Profits Fund) from January 2009:

- the conventional smoothing account;
- the unitised life smoothing account, and
- the unitised pensions smoothing account.

Further refinement to the procedures covering Whole Life products is underway to ensure that any profits or losses arising as a result of smoothing of payouts will be recycled for policyholders, not shareholders. This will be carried out with full input from the With-Profits Actuary and in consultation with the With-Profits Committee. Once implemented, smoothing principles for all material books of

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business will aligned. Details of the proposed changes have been shared with the Office of the Policyholder Advocate.

The PPFM outlines what can be credited or charged to each account.

8.02 Fair Payouts on Maturity

Asset share forms the basis for assessing the level of a fair payout.

The amount paid on maturity is the initial guaranteed benefits, plus bonuses which represent a fair share of the distributable surplus from assets backing asset shares earned by the relevant fund over the period of investment, subject to the policy terms and conditions.

Decisions on the level of payouts relative to asset share are taken by the Board, following advice from the With-Profits Actuary and review by the With-Profits Committee.

There are a number of different factors that contribute to actual payouts. On average payouts are targeted to equate to asset share over time and are a fair reflection of policyholder expected benefits. The payouts depend on:

- Asset share
- Guarantees
- Adjustments for smoothing

Where policy guarantees exceed the level of asset shares on payout, the difference is currently met from the remaining assets of the with-profits fund. Post reattribution, this will continue to be charged to the remaining assets of the with-profits fund, although if these prove to be insufficient, it can be charged to the Reattributed Inherited Estate External Support Account (RIEESA).

The table below provides further details on the possible payout scenarios and how these are split between smoothing and the guarantee costs:

It is necessary to calculate three benefit levels (Stakeholder pensions business has its own separate smoothing account):

- Asset share (A)
- Smoothed payout – the amount that would be paid as a result of smoothing alone, in the absence of any guaranteed amount (S)
- Guaranteed level (G)

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There are six possible scenarios (although not all equally likely)

	smoothing account	guarantee costs	policyholder receives
1. G>A>S	0	G-A	G
2. G>S>A	0	G-A	G
3. A>S>G	Repay A-S	0	S
4. S>A>G	Borrow S-A	0	S
5. A>G>S (very unlikely)	Repay A-G	0	G
6. S>G>A	Borrow S-G	G-A	S

By splitting the difference between payouts and asset shares in this way the cost of guarantees is unaffected by the level of the payout and only relates to the asset share (which is well defined). Therefore, any smoothing or discretion applied in determining payouts will not affect the guarantee costs and this eliminates any potential conflict between policyholders and shareholders over the level of payouts affecting the cost of guarantees.

8.03 Fair Payouts on Surrender

8.03.01 Conventional With-Profits

There are a number of factors to consider when assessing a fair payout for non-guaranteed surrender values:

- The group-of-policyholders' share of the assets backing policyholder benefits in the with-profits fund
- Early termination charges (as set out in the policy conditions)
- Details of any early termination charges for a particular product are set out in the policy conditions. These charges cover the balance of reclaiming initial costs e.g. selling and set up.
- Any deductions necessary to protect the interests of remaining policyholders. This is a permissible deduction available within the FSA COBS rules.

For conventional pension business particularly if payouts occur in the early years of a policy term, the payouts have regard to actual premiums paid rather than being based solely on asset share.

In the last years leading up to maturity or retirement, anticipated maturity values are run in so as to avoid sudden change in the last year – to illustrate this in simple terms this means that if a

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policyholder were to surrender their policy say one month before their selected maturity date there would not be a dramatic change in the payout value.

The surrender bases are reviewed when there is a 5% movement in underlying market indicators (reviewed against the last bases change) and when there is some sign of stability at that new level.

8.03.02 Unitised With-Profits

There are a number of factors to consider when assessing a fair payout for non-guaranteed surrender values:

- The group-of-policyholders' share of the assets backing policyholder benefits in the with-profits fund
- Early termination charges (as set out in the policy conditions)
- Market Value Reduction (MVR)

The MVR is an adjustment to the value of the units, including final bonus which is sometimes used when there is a strain on the fund, for instance as a result of large or sustained falls in the stock markets. This endeavours to deliver fairness and protects the interests of policyholders still invested in the fund.

If an MVR applies, the company aims to gradually reduce its level as markets improve or increase it if the market worsens.

An MVR is currently determined by calendar year of investment, except for CGNU Life fund bonds which are monthly due to policy conditions. The aim is to rebalance MVR rates when there is a 5% movement in underlying market indicators and some sign of stability at that new level. As a result, payouts may include both units on which an MVR has been applied and units on which an MVR has not been applied.

Where practical, policyholders applying for a payout will be told if an MVR is likely to be applied. This gives them the option to decide to defer surrender until a point where no MVR is applied.

Most products have points at which exit is free of MVR. They may be after 10 years on some Bonds or on death or at maturity depending on the product design.

- Any further deductions necessary to protect the interests of remaining policyholders. This is a permissible deduction available within the COBS rules.

Any differences between surrender payouts and asset shares would be credited or debited to the relevant smoothing account.

Any changes in approach in terms of systems, methods, assumptions or parameters are documented and are subject to formal change control procedures with appropriate levels of authorisation. For instance, minor changes in assumptions would normally be authorised by the With-Profits Actuary.

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8.04 Bonuses

In general, asset share calculations are used as a guide to determine final bonus rates. Current practice in deciding bonus rates is to target an average payment on maturity, for each group of policies, which is equal to asset share.

In determining a fair distribution of profits Aviva considers:

- The need to ensure that the fund is able to meet its regulatory liabilities
- The current and projected capital needs of the fund
- The investment strategy of the fund
- The bonus philosophy of the fund
- The need for an appropriate level of security for policyholder benefits
- The need to ensure that policyholders' reasonable benefit expectations are maintained

8.05 Regular Bonuses

The amount of regular bonus depends on:

- The profits earned in the fund over recent years
- Long-term investment return expectations
- Potential margin for final bonus
- Guarantees on all existing with-profits policies in the fund
- Projected regulatory solvency levels, now and in the future

Regular bonus declarations take into account the rates the company expects to be able to maintain over the terms of both existing and new policies.

This is achieved by projecting current asset shares for specimen policies against a range of future investment returns on the fund. A target regular bonus rate is then chosen which allows for the financing of the final bonus.

Regular bonus rates are normally reviewed once a year. These are sometimes called reversionary bonuses.

8.06 Final Bonuses

Final bonus rates are set so that, in the long-term, the aim of paying 100% of the asset share for maturing groups of policies can be achieved, subject to smoothing.

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Final bonus rates are influenced by the total return on investments. In normal conditions, they are reviewed at least twice a year. However, they may be changed at any time, particularly in adverse financial conditions.

These are sometimes called Terminal Bonuses.

8.06.01 Conventional With-Profits

Where applicable, final bonus is payable on death; maturity; retirement and surrender claims.

8.06.02 Unitised With-Profits

Where applicable, upon cancellation of units in the unitised with-profits funds, a final bonus is payable.

For the unitised With-Profits Income Fund, any such bonus paid supplements the income paid in a particular year.

8.06.03 With-Profits Annuity Payments

Final bonus for with-profits annuities are known as 'Top-up Bonus'. If declared, this applies to all with-profits annuity payments during the period.

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9.00 Analysis of Payouts made by CGNU Life & CULAC

The smoothing account costs for each of the past 5 years has been:

	2004 £m	2005 £m	2006 £m	2007 £m	2008 £m
CGNU Life/CULAC	60	-7	-20	-19	31

A positive entry means overall payouts are in excess of asset share, a negative entry means overall payouts are less than asset share.

Losses arising from the operation of smoothing practices before this point were written-off by the fund.

In aggregate, although some payouts over this period have been below asset share, fair payouts for policyholders have been supported by smoothing practices.

Since 2004, Appendix 9.4A of the FSA returns for CGNU Life and CULAC provides audited details of average payouts for the previous 3 years as a percentage of asset shares. Prior to this, there were no regulatory requirements to collect and publish this information.

Full details for the period 2002 to 2008 are given below.

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CGNU Life	Conventional Life	Conventional Pensions	UWP Life	UWP Pensions	UWP Stakeholder
2002	128%	n/a	110%		
2003	110%	n/a	110%		
2004	99%	n/a	108%	105%	98%
2005	95%	n/a	102%	100%	95%
2006	98%	n/a	100%	96%	94%
2007	92%	n/a	98%	95%	97%
2008	103%	136%	107%	105%	106%

The figures for 2005 to 2008 are estimates based on actual maturity and surrender payouts.

The figures for 2004 are estimates based on actual maturity and surrender payouts for the period April to December.

The figures for conventional business for 2007 are not directly comparable with 2006 because of enhancements in the analysis. There were no changes in the method between 2007 and 2008.

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CULAC Direct	Conventional Life	Conventional Pensions	UWP Life	UWP Pensions
2002	123%		109%	n/a
2003	118%		118%	n/a
2004	99%	108%	101%	n/a
2005	96%	104%	94%	n/a
2006	95%	99%	92%	n/a
2007	93%	92%	93%	n/a
2008	106%	80%	102%	107%

CULAC Reinsured in	Conventional Life	UWP Life	UWP Pensions	UWP Stakeholder
2006	98%	100%	96%	94%
2007	92%	98%	95%	97%
2008	103%	107%	105%	106%

The figures for 2005 to 2008 are estimates based on actual maturity and surrender payouts.

The figures for 2004 are estimates based on actual maturity and surrender payouts for the period April to December.

The figures for CGNU Life relate to all CGNU Life written business, and not just the business reinsured into CULAC.

The figures for conventional business for 2007 and 2008 are not directly comparable with 2006 because of enhancements in the analysis. There was no change in method between 2007 and 2008.

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9.01 Conclusion

If payouts are compared to changes in the markets, as illustrated by the FTSE 100 position for the last 6 years, this shows that:

- Average payouts have been within a far tighter range than the ones described in the PPFM,
- When markets fell substantially in the 2000 to 2003 period, payouts made to policies of both CGNU Life and CULAC were significantly more than asset share. This approach was achieved by using the inherited estate to supplement payouts.
- As markets improved, and in line with the stated aims in the PPFM, payouts have gradually been targeted closer to 100% of asset share.
- The turbulent market conditions during 2008 have impacted investment performance and the inherited estate has enabled payouts to be smoothed. This meant that payouts during the year have been higher than asset share.
- On average over this period payouts have been in excess of 100% of asset share.

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10.00 How is this Governed?

The Board appoints committees, such as the monthly Investment Committee, quarterly Investment Committee, and the Asset Liability Committee to:

- Manage the relationship with the Fund Managers,
- Set the strategic direction,
- Review performance against benchmarks.

Their activities include:

- Agreeing the appointment of the Fund Manager
- Investment Management Agreements
- Credit and counter-party limits
- Approving major, special or strategic investment decisions

These committees are responsible for

- Reviewing both competitor activity and economic outlook against expected returns

The investment strategy is formally reviewed at least once per year. A report to the committee responsible for investment strategy is then produced.

Smaller reviews occur more frequently to monitor and take account of the experience of the fund.

Allocations between asset categories can be varied by the Fund Manager within tight constraints. The results are reviewed monthly by the committee.

More generally the Board has appointed a With-Profits Committee to provide some independent judgement on material issues, in assessing compliance with the PPFM, and on any competing or conflicting rights and interests of policyholders and shareholders.

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11.00 Bonus Notices / Yearly Statements

Depending on the type of policy, a bonus notice or yearly statement is produced and sent to policyholders each year.

These provide:

- An update on how the policyholders' investment is doing overall*
- Answers to frequently asked questions
- An update on how Aviva manages the With-Profits Fund
- An investment report
- Contact details for Aviva

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12.00 What Safeguards are being introduced after Reattribution?

The reattribution serves to clearly define the interests of shareholders and policyholder in the inherited estate. As a result this introduces increased potential for conflicts of interest between policyholder and shareholders. In view of this some additional safeguards are to be introduced post reattribution.

After reattribution, Policyholder reasonable expectations and benefit security are safeguarded by:

- For similar policies in the Old and New With-Profits Sub Funds (OWPSF, NWPSF) the asset share investment strategy and bonuses, other than bonuses which arise as a result of future distributions from the inherited estate of the OWPSF, will be identical
- The aim is that the investment strategy for asset shares will be no different to the approach before the reattribution
- EBR limits based upon objective measures, e.g. published cost of guarantees, that are linked to the existing practice and which take into account the risk appetite framework
- No new asset share charges for guarantees are to be introduced on existing business after reattribution
- Limits on the writing of non-profit business in the RIEESA
- Limits on the level of strategic assets in the RIEESA
- The role of the With-Profits Committee.

Full details of the proposals in these areas can be found in the Scheme.

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

13.01 Strategic Investments

The Office of the Policyholder Advocate has put forward a view that, due to their risky nature, neither existing nor new strategic investments should be held in the OWPSF inherited estate.

Aviva has a strategic investment policy which sets out the controls and management process for strategic investments held by the company. The strategic investment policy is applied separately to the NWPSF (including RIEESA) and the OWPSF.

The appropriateness and amount of strategic investments is regularly reviewed through the governance arrangements explained in section 10 above.

Limitations have been set on the level of strategic investments that can be held in the With-Profits Fund (including RIEESA) and these have been clearly defined in the appropriate PPFM.

Various controls and actions taken by the company since 31st December 2007 mean that the levels of strategic investment currently held in the funds represent a very small proportion of the total CGNU Life and CULAC funds' value. There are strict controls in place to manage increases in strategic investments or new strategic investments.

The policyholder advocate has noted the loss on strategic investments in excess of what could have been the case if they had been held in the FTSE All-Share Index equities during 2008, but has not gone on to explain that the reason for this is due to the fact that the majority of the strategic investments at that time were in Banks. Since strategic investments are deemed by their nature to be long-term and the value of investments in the banking section has been hit particularly hard by the effects of the current economic turbulence, it is not helpful to make this single year comparison of performance.

13.01.01 Existing Strategic Investments

The basis for allocation of existing strategic investments following the reattribution will largely depend on the number and types of policies that vote to accept or reject the reattribution offer – since the effective date benefit securities of the policies in the OWPSF and NWPSF (plus RIEESA) need to be broadly similar. This necessarily means that careful matching of the assets and liabilities of each group will have to take place.

At this stage it is difficult to rule out the need to allocate strategic investments in the OWPSF inherited estate – this is something that will need to be considered, in conjunction with the WPC, once the reattribution voting patterns are known. Any decisions taken will adhere to the principles outlined in the Scheme, requirements of COBS and treating customers fairly.

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13.01.02 New Strategic Investments

New strategic investments for the With-Profits Fund (including the RIEESA) are only made if they are considered to be of long term benefit to shareholders and policyholders. All new strategic investments are made after taking full considerations of:

- The Company's strategic investment policy
- COBS requirements
- Treating Customers Fairly (TCF) obligations

New strategic investment proposals require the consideration and express approval of the WPC before the Board can proceed. Additionally, the PPFM confirms that it is envisaged that no new investments in strategic assets will be held in the OWPSF inherited estate.

13.02 Investment Strategy for Asset Share

In their paper the Office of the Policyholder Advocate has commented that it is concerned that the Board may choose to adopt a more conservative approach to investment strategy for asset shares following reattribution in order to reduce the cost of guarantees and therefore accelerate the release of the Reattributed Inherited Estate (RIE) to shareholders.

In section 12 of this paper we have confirmed that our aim is that the investment strategy for asset shares will be no different after the reattribution to the approach taken before the reattribution, and this has been written into the Scheme. The PPFM confirms that "monies of the Fund will be invested in a range of assets which are considered appropriate bearing in mind the Risk Appetite Framework. Investment returns are benchmarked against appropriate indices..." As a result, unless there were other extenuating circumstances which required a more conservative investment approach to be adopted (such as difficulty in the funds meeting their Individual Capital Assessment (ICA) requirement), it is difficult to see how such a proposal could be justified under the terms of the Scheme, PPFM or the company's TCF obligations.

Nonetheless, if such a change were proposed it would constitute a significant change to the investment philosophy for the funds and therefore would require the consideration and express approval of the With-Profits Committee.

Later in their paper the Office of the Policyholder Advocate does acknowledge that their concerns on asset share investment are safeguarded by the governance controls in place for the with-profits funds.

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Annexe A – Asset Share Calculations

	Conventional With-Profits (CWP)	Unitised With-Profits (UWP)
Investment return	The investment return used in the asset share calculations is based on the assets backing the with-profits policies.	The investment return used in the asset share calculations is based on the assets backing the with-profits policies.
Allocation of profits/losses	With-profits policies currently share in profits arising from some non-profit business sold since 2004. Allowances are also made for mortality profits and losses.	With-profits policies currently share in profits arising from some non-profit business sold since 2004. Approximate allowance is made for profits or losses of this business. Allowances are also made for surrender and mortality profits and losses through the operation of the smoothing accounts.

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	Conventional With-Profits (CWP)	Unitised With-Profits (UWP)
Cost of selling and administering the business	<p>The expenses of selling and administering CWP policies are included in the asset share calculations. This includes the costs of commissions paid on the policies.</p> <p>Since 1 October 1998, these expenses are based in the charges set out in various management agreements with other companies. Investment expenses charged to asset share are based in the fee rates charged to the funds under an Investment Management Agreement (IMA).</p>	<p>For pre-October 2001 business – the expenses of selling and administering these policies are included in the asset share calculations (as described for conventional business)</p> <p>With effect from 6 April 2001, the charge to asset share for Group and Individual personal pension contracts sold before 1 December 2000 is limited to 1% per annum.</p> <p>For post-October 2001 business – the policy charges for expenses and commission (such as any initial charges and the annual management charge) are included in the asset share calculations. The difference between those charges and the actual expenses and commission accrues to the inherited estate.</p>
Cost of death or other risk benefits	<p>Mortality costs are charged to asset shares based on past experience. Except in the case of With-Profits Annuities, which are based on the mortality rates assumed in the premium rates.</p> <p>An initial charge is made to asset shares for With-Profits Annuities to allow for the minimum floor guarantee.</p>	<p>Where selected life cover expenses and charges for risk are taken (where death benefit exceeds the value of the units), these are deducted through unit cancellation. No further charge therefore needs to be taken from asset shares.</p>

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	Conventional With-Profits (CWP)	Unitised With-Profits (UWP)
Adjustment for tax	<p>An allowance for income and capital gains tax is made in the investment return for Life business.</p> <p>On income: the prevailing rate of policyholder tax is applied to the gross income yield.</p> <p>On capital gains: indexed gains are taxed at a policyholder rate, reduced for deferral</p> <p>Allowance is also made for tax relief on expenses for Life business (with due allowance for the deferral of that relief). The prevailing rate of policyholder tax is applied to the gross expenses.</p>	<p>For pre-October 2001 business - an allowance for income and capital gains tax is made in the investment return for Life business.</p> <p>On income: the prevailing rate of policyholder tax is applied to the gross income yield.</p> <p>On capital gains: indexed gains are taxed at a policyholder rate, reduced for deferral</p> <p>Allowance is also made for tax relief on expenses for Life business (with due allowance for the deferral of that relief). For post-October 2001 business – no allowance is made for tax relief on expenses as this is reflected in the policy charges.</p> <p>The prevailing rate of policyholder tax is applied to the gross expenses.</p>
The shareholders' share of distributable surplus	<p>Shareholders receive a share of the distributable surplus of the fund. This is charged to asset shares, based on the cost of new regular and final bonuses each year.</p>	<p>Shareholders receive a share of the distributable surplus of the fund.</p> <p>For pre-October 2001 business - this is generally charged to asset shares based on the cost or new regular and final bonus each year.</p> <p>For post-October 2001 business – no charges are made for shareholders' transfers</p>
Costs for the use of capital, guarantees and smoothing	<p>An additional charge can be made on the asset shares to cover the provision of capital, guarantees and smoothing in the fund.</p>	<p>An additional charge can be made on the asset shares to cover the provision of capital, guarantees and smoothing in the fund.</p>

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	Conventional With-Profits (CWP)	Unitised With-Profits (UWP)
Annual management charge		Where an annual management charge (AMC) has not already been taken through unit cancellation, the asset share will be reduced by the AMC. The AMC is expressed as a percentage of the asset share.

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Asset share methodology		
	Historical Accumulation Method	Historical Accumulation using Policy Charges
	Premiums paid	Allocated premiums
Plus	Investment return	Investment return
Minus	Expenses	Policy charges
Minus	Commission	-
Plus / minus	Tax	Tax
Plus / minus	Mortality profits / losses	Mortality profits / losses
Plus / minus	Surrender profits / losses	Surrender profits / losses
Minus	Shareholder transfers	-
Plus	Non-profit business profits	Non-profit business profits
Plus / minus	Miscellaneous profits / losses	Miscellaneous profits / losses
Minus	-	Cost of rider benefits
Minus	Charges for capital, g-tees, smoothing, etc.	Charges for capital, g-tees, smoothing, etc.
Equals	Asset Share	Asset Share