

Appendix 29 B

Investment policy, smoothing and bonus policy

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 amount that policyholders might reasonably expect to receive in return for investment in the with-profits funds of CGNU Life and CULAC is dependent on the funds' policies towards investment, smoothing and bonuses. This appendix responds to Aviva's appendix 29 A on "Investment policy, smoothing and bonus policy".

One way to consider the investments backing the with-profits funds is to split a fund into the following broad areas:

- asset shares and smoothing account;
- cost of guarantees and other liabilities; and
- inherited estate in excess of all the above.

Asset shares are the primary driver in the setting of bonus rates. An asset share is broadly an accumulation of premiums less expenses and other costs, allowing for the actual investment return and any tax due. The items that would typically make up the calculation of the asset share under the two historical accumulation approaches are summarised in the relevant Principles and Practices of Financial Management (PPFMs). We note that not all items of outgoings from the fund are charged to asset shares. Some charges are made to the estate, although they could be charged, under FSA rules, to asset shares directly. There are other charges, such as tax on shareholder transfers, which are not permitted to be charged to assets shares and if there were no estate shareholders would have to pay for these items from their own funds. These items are discussed further in appendix 21 B ("Contributions to the inherited estates").

Some companies, including Aviva, operate a smoothing account which measures the historic over and underpayments (relative to asset shares) due to smoothing. This account is expected to be managed to zero over time.

Companies need to hold additional funds to cover any other liabilities and the expected cost of guarantees which are forecast to be paid to policyholders and which represent payments over and above asset shares due to the level of some policyholders' guaranteed payments exceeding the asset share of the policy. Aviva, like similar companies, will consider its investment policy by taking into account the need to Treat Customers Fairly (TCF), the results of any asset and liability modelling it undertakes and the requirements of a robust business case (from both policyholder and shareholder perspectives).

Bonuses are the method by which the profits in a with-profits fund are distributed to with-profits policyholders. Bonuses essentially come in two forms, regular and final. Regular bonuses (which may be zero) are added to the policy each year, and once added, cannot be taken away. Bonuses are usually specified as a bonus rate (a percentage) which is applied to the sum assured and on some products on existing bonuses. In the case of unitised with-profits the bonus rate is usually applied to the fund value. Final bonuses (which may also be zero) are only added on when a policy matures (including when an insured event occurs). In some circumstances, there may also be a special, one-off bonus prior to the claim stage. Overall bonuses on most categories of with-profits policies are determined by reference to "asset shares", where the asset share represents the value of the contribution of each policy to the assets of the with-profits fund.

Bonuses are used to augment the policy's underlying guaranteed level of benefits to a payout level consistent with that indicated by the asset share. However, bonus rates are calculated and applied on a "pooled" basis across reasonably homogeneous groups of policies, rather than on an individual policy basis. In addition, bonuses are smoothed over time to give a degree of protection against variations in the profits emerging in the fund and, in particular, investment experience.

Under some unitised with-profits policies, the company is entitled to apply a market value reduction (MVR) to payouts. This would occur when the underlying asset value has fallen, and payment of a surrender claim at a level including guarantees and annual bonuses to date would significantly exceed the asset share. However, virtually all of Aviva's unitised with-profits contracts have specific points (such as a 10 year anniversary) where it is guaranteed that no MVR will be applied. On conventional with-profits policies, surrender values are not normally guaranteed and can be reduced if investment returns are poor. Aviva aims to pay out, on average, 100% of asset share on surrenders.

1.03 Summary of KPMG's view

In general, Aviva's approach to investment policy and bonuses is consistent with standard industry practice. The asset shares and smoothing accounts are invested in line with the PPFM both pre- and post-retribution, and the bonus policy also follows the PPFM. Aviva states that the retribution will not result in a change to the bonus policy.

KPMG has no concerns with Aviva's fundamental approach to setting bonuses which is consistent with that we see used by other large companies. We have however made some observations of a secondary nature in this report, which are summarised below.

KPMG agrees with Aviva's view that new investments in the with-profits sub funds (including the inherited estate) should be made with the objective of maximising returns subject to an acceptable degree of risk, i.e. it is the risk-adjusted return that should be maximised.

There are two key areas of potential conflict between shareholders and policyholders who elect to be in the New With-Profits Sub Fund (New WPSF). One is that Aviva could in the future seek to reduce the cost of guarantees to shareholders by following a more conservative approach to investing the assets backing asset shares. The other is the fact that strict governance around the smoothing process and accounting is required to ensure that any costs of guarantees are charged to shareholders as opposed to being charged to policyholders via the smoothing mechanism. The Scheme is predicated on the basis that this separation of costs will take place appropriately.

The Aviva Scheme prevents Aviva from introducing charges to meet the cost of guarantees. This introduces a greater risk that the Board may reduce the equity backing ratio (EBR) to reduce the cost of guarantees to shareholders. Strong governance controls are required to ensure that this does not occur, and we note that there are safeguards in place, in particular, oversight by the with-profits committee (WPC).

In relation to the determination of the EBR, Aviva has commendably gone to great lengths to set out a framework, covering the theoretical approach and the various limits and processes involved to determine the actual EBR. Our view is that Aviva has gone as far as is practicable in setting out this framework. However, we note also that the framework itself, as well as the relevant parameters, can be changed in future. We note that this freedom to make changes in future is unavoidable. The ultimate protection for policyholders in relation to the EBR is the strength of the challenge made at the time by those whose sole role it is to represent the interests of the policyholders, ie the WPC and the with-profits actuary (WPA). The framework which has been introduced should assist in this challenge process as it will make it easier for the WPC/WPA to be aware of and quantify proposed changes.

We further note that the EBR framework is predicated on the assumption that equities will provide a greater long term actual return than fixed interest investments. There can clearly be no certainty that this will be the case.

Due to their potentially more risky nature, it is our view that all investments in strategic assets should be held in the reattributed inherited estate external support account (RIEESA), and no such assets should be held within the inherited estate of the old with-profits sub-fund (Old WPSF).

Aviva has substantially de-risked the cost of guarantees. That is, it has changed its investment strategy and reduced the CGNU Life and CULAC with-profits funds' exposure to losses which might arise from an increase in the cost of meeting policyholders' guaranteed benefits as a result of falls in the value of equities held as part of the asset shares. We are supportive of this approach as it locks in the cost of guarantees, and the level of capital support required to be retained in the funds to meet policyholder liabilities is reduced; these

features enable the release of surplus assets in the funds' inherited estates. The accounting treatment for de-risking should not place any additional risk on policyholders. Since returns to asset shares are based on a theoretical EBR as opposed to the actual investments, the operational risk from the internal hedge is reduced and is borne by shareholders.

Assets which form the reattributed inherited estate (RIE) can be invested at the discretion of the shareholders, subject to any constraints in the Scheme. These reattributed inherited estate assets will be released ultimately to shareholders if not required to support the solvency of the funds.

Aviva has prepared internal documentation for use by the WPC in carrying out its governance role. This internal documentation describes the approach to setting the theoretical EBR. It is this theoretical EBR which is used as the basis for determining how much exposure to equity assets can be supported. In practice, this will require a complex stochastic model in order to calculate the theoretical EBR. The model specification and assumptions can impact on the theoretical EBR calculated. To ensure that changes to the model do not affect the investment mix, we believe that there should be controls around the modification of the model. The internal governance and guidance documentation does set out the process for those change controls over the model that require involvement of the WPC. However we consider that in addition, there should be a detailed specification of the model maintained by the WPC and any changes should be documented and impacts reviewed by that committee.

Aviva uses a smoothing account to determine fair bonus payments such that over time payouts represent 100 per cent of asset shares. We agree with Aviva's approach to measuring the cost of smoothing (which for the New WPSF is ultimately borne by policyholders), and the cost of guarantees (which for the New WPSF is borne by shareholders).

Overall, we are comfortable with the concept of using a smoothing account. Aviva's implementation of the concept in a robust and reliable way will be critical to its successful and compliant management post reattribution. Aviva has informed us that processes are being put in place to ensure the accuracy of these calculations and that reliance is placed on the WPC to ensure the process is managed in a fair way.

In addition we note that from 2009 the existing smoothing account is being replaced with three smoothing accounts. For conventional business we have no concerns arising. For unitised with-profits business, although we do not believe that there is any particular bias in the revised methodology which will be used, we do believe that the revised methodology could lead to policies being smoothed downwards beyond what would be reasonably expected unless additional procedures are implemented to ensure that the unsmoothed asset shares are monitored against payouts.

We note that reliance is placed on the WPC to perform its duties in accordance with its terms of reference, and we further note that it will need to be given sufficient information to be able to make informed decisions in the best interests of policyholders. The WPC terms of reference cover the requirement for information to be provided. We note that the WPC has oversight in the areas we would expect. There is one particular area which we feel should have more oversight by the WPC. The Scheme allows industry levies to be charged to asset shares. This introduces a conflict of interest between shareholders and policyholders because pre reattribution any such charges not charged to asset shares would be met by the inherited estates, but post reattribution these would be met by shareholders if charged to the New WPSF. Such levies could be material, and this could impact payouts significantly, yet, although the WPC will be consulted and their views considered by the Board, they do not have the power of veto in this area (except in terms of their power to whistle-blow to the FSA).

1.04 Structure of this Appendix

Section 2 summarises the various sections in Aviva's appendix 29 A ("Investment policy, smoothing and bonus policy") and after each main heading we set out our views on Aviva's position.

2.00 Aviva’s approach and KPMG’s comments

2.01 Introduction – Investing in With-Profits Funds

Summary of Aviva’s view

Aviva sets out some background to with-profits funds and how with-profits funds are usually invested. It states that the inherited estate can be used to provide:

- investment flexibility;
- a cushion of additional security against unexpected adverse events;
- flexibility in the smoothing of payouts; and
- 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.

KPMG’s comments

The types of investments set out by Aviva are consistent with how with-profits funds have traditionally been invested. The first three uses of the inherited estate, investment flexibility, a cushion against adverse events, and flexibility for smoothing, are required to back the guarantees, and protection against extreme market movements offered as part of the benefits of the products.

We note that the Old WPSF may write new with-profits business. We believe this is appropriate if it is written in such a way that it does not erode the inherited estate.

The policyholder advocate has commented in appendices 26 (“FSA guidance letters and responses”) and 39 (“Impact of FSA guidance on policyholders”) on the FSA rules as they stand at the time of writing this appendix, and the views as expressed by the policyholder advocate in these appendices have not been repeated here.

2.02 Investment Strategy

Summary of Aviva’s view

The investment policy for the CGNU Life and CULAC with-profits funds is described in the PPFM.

Aviva states that the investment strategy aims to provide the highest long-term returns balanced against acceptable levels of solvency risk. In its paper, Aviva sets out the published mix of investments backing asset shares for the CGNU Life and CULAC with-profits funds.

It states that the investment strategy of the funds takes into account the nature and time-span of the liabilities and that the pooled investments in the with-profit funds, which are being held to cover the asset share liabilities, are notionally allocated to groups or pools of liabilities.

A pool of assets is held to cover the guarantees on with-profits policies, including the assets that are used to hedge the guarantee costs under the dynamic hedging strategy. A pool of assets 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 specifically hypothecated to the inherited estate:

- strategic assets;
- financial reinsurance 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.

Aviva goes on to explain that the recent market volatility has led to a change in the asset mix for the inherited estate, so that less is invested in equities, making the value of the estate less volatile (although the estate can still vary due to other reasons). Aviva states that this is a short-term change in approach, and is as a direct consequence of the application of the Risk Appetite Framework.

Equity Backing Ratio

The equity backing ratio (EBR) is the total proportion assets, which are invested in equity-type assets.

Aviva's method of calculating 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; and
- 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 target.

Set out below are some relevant points from the Scheme, the PPFM and the actuarial function holder (AFH) report.

Section 5 in part 2 of schedule 4 of the Scheme makes it clear that the EBR range referred to in the PPFM (or as otherwise approved by the WPC) must be complied with. The Scheme also states that AVLAP shall not change its with-profits management policies in respect of either the Old WPSF or the New WPSF solely in order to avoid the provision of capital support or to facilitate the transfer of assets in repayment of any capital support.

According to the section 3.2.11 in the PPFM, the overall benchmark EBR for returns allocated to asset shares for the New WPSF is subject to constraints specified in the report of the AFH on the Scheme. The PPFM states that these constraints have been introduced to limit the potential for conflicts between the interests of policyholders and those of shareholders as a consequence of the implementation of the Scheme.

The Return Assets consist of those assets which are used to determine the investment return to be credited to the asset shares of with-profit policies that are allocated to the New WPSF and the Old WPSF. The AFH report states that the investment managers are provided with a benchmark EBR for the Return Assets against which their performance will be assessed. They are, however, free to invest with an EBR which differs from the benchmark EBR within specified limits (tactical limits) with the objective of outperforming the benchmark.

The AFH report explains that the benchmark EBR is currently set using asset liability modelling techniques which involve carrying out stochastic projections of the funds under a

range of future economic scenarios in order to assess the long term trend of the EBR and the level of risk. The objective is to achieve a relatively high stable median EBR over time, with a level of risk which is commensurate with the financial strength of the fund. In particular, allowance is made for the size of the inherited estate relative to the aggregate asset shares. These calculations are carried out on a monthly basis and the calculated EBR which most closely meets these objectives is known as the Theoretical EBR. The intention is that the Benchmark EBR will normally be equal to the Theoretical EBR. However, in order to avoid frequent changes to the investment strategy, small changes in the Theoretical EBR may be ignored. Additionally, the AVLAP Board has discretion to depart from the Theoretical EBR to take into account other factors such as:

- the EBRs of other companies or funds;
- the AVLAP Board's view of the outlook for different categories of investment; and
- the projected trend of the Theoretical EBR.

According to the AFH report, following implementation of the Scheme this Theoretical EBR approach will be used to determine the Benchmark EBR for the returns applying to asset shares of the New WPSF and the Old WPSF. The Theoretical EBR will be based on the AVLAP Board's assessment of an acceptable level of risk, taking into account the combined assets and liabilities of the New WPSF (including those of the RIEESA, as if they formed part of the New WPSF), the Old WPSF and the Stakeholder WPSF.

The AFH report then explains the constraints on the Benchmark EBR which are summarised in the following paragraphs.

The Lower Limit for the Benchmark EBR is the sum of 7.5% and the EBR that would result from investing the aggregate asset shares in a matching portfolio which represents a low risk strategy, taking no account of the existence of the inherited estate and the support that it can provide in meeting policy guarantees. The EBR Lower Limit is subject to a minimum of 40% and a maximum of 65%. Details of the calibration of the EBR Lower Limit are contained in

the internal governance and guidance documentation. The upper limit for the Benchmark EBR (EBR Upper Limit) will be 75%.

In setting the Benchmark EBR for the Return Assets within the constraints imposed by the Scheme, the AVLAP Board will have regard to internal guidelines which have been developed taking into account the views of the WPA and the WPC. Any changes to the guidelines will need to be approved by the WPC.

The AFH report sets out examples (listed below) of when changes in the investment strategy may be made after the Effective Date of the Scheme (that is, the date when the fund transfer and reattribution take place):

- the determination of separate asset share EBRs for particular categories or outstanding durations of with-profits policies, provided that equivalent policies in the New WPSF and the Old WPSF are treated on a consistent basis and that such a change does not lead to a material reduction in the overall EBR for the return assets;
- the determination of a separate asset share EBR for Stakeholder Pension policies that are invested in the Stakeholder WPSF; and
- changes to the Theoretical EBR approach to setting the investment strategy.

Any such changes to the approach to investment strategy which are proposed by the AVLAP Board will be subject to the approval of the WPC.

The AFH report also states that it is possible that the Theoretical EBR approach to setting the investment strategy will be replaced by an alternative philosophy in the future, provided that any changes are such that the AVLAP Board determines (having obtained appropriate actuarial advice) the changes would have been made in the absence of the Scheme. In these circumstances the Unadjusted Theoretical EBR will no longer be calculated and the formula for the EBR Lower Limit will be replaced by one which reflects the change in approach. The recalibration should be such as to preserve the strength of the constraints relative to the calculated EBR, and the floor of 40% on the EBR Lower Limit would continue to apply. Any

changes would be reviewed by the WPC and the resulting EBR Lower Limit would be subject to their approval. In considering whether their approval should be given, the WPC would need to be satisfied that the policyholder safeguards were not materially reduced as a result of the changes. For this purpose it is envisaged that the WPA will reference the details of the original calibration of the EBR.

The EBR Lower Limit is as set out in internal governance and guidance documentation.

The stochastic model that is used to determine the Theoretical EBRs is being replaced by the fully dynamic stochastic model which is used for other management purposes. The formula for the EBR Lower Limit will not be recalibrated as part of this process.

The AFH also states that the floor of 40% on the EBR Lower Limit may be reduced in the future if, in the view of the AVLAP Board, having regard to appropriate actuarial advice, it becomes necessary in order to maintain an adequate level of financial strength for the New WPSF, the Old WPSF, the RIEESA and the Stakeholder WPSF in aggregate. It is envisaged that the floor would only be reduced in the event that solvency was threatened. In this context the floor would be reassessed if the New WPSF, the Old WPSF and the Stakeholder WPSF taken together could not cover their combined ICA. Any reduction in the floor would need to be approved by the WPC. In considering whether its approval should be given, the WPC would need to be satisfied that the retention of the existing floor would be likely to be to the detriment of policyholders' benefit security.

Derivatives

Aviva states that the policy on derivatives is reflected in the Investment Management Agreement (IMA) and 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; and
- for income enhancement.

The use of derivatives for speculative purposes is not permitted.

Investments

Aviva sets out the types of instruments the funds can invest in, which include:

- quoted investments;
- unquoted securities (based on pre-determined limits); and
- cash and deposit-type investments.

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; and
- give financial assistance or support to other sub-funds within the CGNU Life and CULAC long-term funds

Aviva also states that from 1 July 2006 CGNU Life invested in the profits and losses arising from the unit-linked business of the Provident Mutual (PM) sub-fund of AVLAP by way of a reinsurance agreement.

Strategic assets

Aviva states that the funds can make strategic investments in the equity or debt of companies in which Aviva Plc has a strategic connection or interest, subject to the agreement of the WPC and the Board, after having received advice from the WPA. These investments will be made

for strategic reasons considered to be to the long term benefit of shareholders and policyholders. Aviva states that a strategic investment policy sets out the controls and management processes for strategic assets held by the company, and it sets out these controls in its appendix 29 A (“Investment policy, smoothing and bonus policy”).

KPMG’s comments

We agree with Aviva that the investment strategy should aim to provide the highest long-term returns balanced against acceptable levels of solvency risk.

We also agree that the investment strategy of the funds should take account of the nature and time-span of liabilities.

One potential area of concern is the possible adoption of a more conservative approach to investment strategy for asset shares after reattribution. Currently, the surpluses arising in the inherited estates, if distributed, are allocated between policyholders and shareholders under the normal 90/10 rule. After the reattribution, the way the investment markets impact on surpluses arising to shareholders and policyholders will be different. The impact of investment markets on the reserve for guarantees applying to New WPSF with-profits policies will ultimately flow to shareholders (this could be positive or negative). A lower EBR for asset shares reduces the capital needed to back the reserves for guarantees and increases the amount that can be distributed to shareholders (even if this distribution is not made for some years). On the other hand, a lower EBR for asset shares could also reduce shareholder transfers if this ultimately reduced bonuses to policyholders. The assets backing the cost guarantees are now invested to minimise the risk that the reserve held for the cost of guarantees is insufficient to meet those guarantees. This is done through the de-risking, and we support this approach.

We note the fact that the inherited estates of CGNU Life and CULAC are now invested less in equities-type investments than was previously the case. We understand the reason for doing so is to protect the funds from further falls in the stock market which is in line with the risk appetite’s aim of keeping the funds strong, and we are comfortable with the approach which has been taken.

Equity Backing Ratio

We are pleased to note that the Scheme states explicitly that AVLAP shall not change its With-Profits management policies in respect of either the Old WPSF or the New WPSF solely in order to avoid the provision of capital support, or to facilitate the transfer of assets in repayment of any capital support.

The Scheme states that the EBR is set by considering the total asset and liability position of the Old WPSF, New WPSF, RIEESA and the Stakeholder WPSF. This means that, in theory, the investment strategy for the RIEESA could have an impact on the EBR for asset share returns since different EBRs can be set for the RIEESA and the asset shares. However, it is clear from the AFH report that the EBR for the asset shares is driven by the aggregate calculations and is not impacted by the EBR chosen for the RIEESA.

Following on from the above, given the EBR is set considering the aggregate position of the New WPSF, RIEESA, and the Old WPSF, the EBR can be affected by the performance of the assets held in the RIEESA. Since the RIEESA may invest in strategic assets and Aviva Group companies, as well as the value of future profits that are expected to arise from investment in non-profit business, it is possible that, if these assets underperform, they could reduce the capital support available and thereby reduce the EBR.

This situation is in fact no different from the current position. However, there may be more incentive for the shareholders to invest more in such strategic assets if they believe the returns will outperform equities. This is because the RIEESA will accrue solely to the shareholder if it is not required to meet liabilities of the Old WPSF, the New WPSF or the RIEESA. We do not believe that the shareholders will be deliberately investing in assets which are expected to produce a poor return on capital, and we note that there are additional controls in place around the investments of the RIEESA in strategic assets and Aviva Group companies to reflect the restrictions imposed by the FSA's Conduct of Business Sourcebook (COBS) which apply to with-profits funds. We also note that there are restrictions on the amount of new non-profits business that can be written, which would help to mitigate the risk that such investment has an adverse impact on the EBR. In general, we do not consider there is a conflict between

policyholders and shareholders in this respect, since neither would benefit from the underperformance of the investments of the RIEESA.

It is usual for investment managers to invest assuming an EBR which differs from the Benchmark EBR within specified limits (tactical limits) with the objective of outperforming the benchmark, and we have no issues with this.

The methodology for setting the benchmark EBR is described in the AFH report, and the AFH report states that the techniques are fully described in the internal governance and guidance documentation which is available for use by the WPC in carrying out its governance role. Broadly, the benchmark EBR is set such that the level of capital support available gives the same level of security as was in place at the end of 2007. For example, an increase in the EBR reduces the benefit security as the projected asset shares become more volatile and vice versa, so the benefit security level can be set by changing the EBR. Assumptions are made within the stochastic projections as to the future EBR, and this takes into account the fact that the guarantees mature over time and have become less onerous. We are comfortable with this approach.

We have no issues with the Benchmark EBR being different from the Theoretical EBR to avoid small changes in the Benchmark EBR. The AVLAP Board has discretion to depart from the Theoretical EBR to take into account other factors such as:

- the EBRs of other companies or funds;
- the AVLAP Board's view of the outlook for different categories of investment; and
- the projected trend of the Theoretical EBR.

To ensure no conflict of interest we believe that any departure of this nature should be agreed by the WPC. We are comfortable with the constraints that have been placed on the Benchmark EBR. We also note that any changes to the guidelines will need to be approved by the WPC.

The AFH report sets out examples of where changes in the investment strategy may be made after the Effective Date of the Scheme. We agree that the Board requires this flexibility, and note that any changes to the approach to investment strategy will be subject to the approval of the WPC. However, subject to the associated level of risk, we would not want changes to be made which would reduce the potential returns to policyholders. For example, the determination of separate asset share EBRs for particular categories or outstanding durations of with-profits policies should only be considered if solvency were to be an issue.

It is possible that the Theoretical EBR approach to setting the investment strategy will be replaced by an alternative philosophy in the future provided that any changes are such that the AVLAP Board determines (having obtained appropriate actuarial advice) would have been made in the absence of the Scheme. We agree that in these circumstances the formula for the EBR Lower Limit will need to change to reflect the change in approach. We also note that the WPC will have oversight of the process and we agree with this.

We also understand the requirement to be able to refine the stochastic model that is used to determine the Theoretical EBRs. We see no problem with this since any changes would be reviewed by the WPC and the resulting EBR Lower Limit would be subject to its approval.

It is envisaged that the 40% floor would only be reduced in the event that solvency was threatened. In this context, the floor would be reassessed if the New WPSF, the Old WPSF and the Stakeholder WPSF taken together could not cover their combined ICA. Any reduction in the floor would need to be approved by the WPC, and we agree with this control.

Under the current framework, the EBR will be set between 40% and 75%, and we believe these limits to be appropriate.

Derivatives

We note that Aviva's policy on investing in derivatives is in line with the industry and we note that the use of derivatives for speculative purposes is not permitted.

Investments

The Scheme permits investment in non-profit business for the benefit of policyholders. This can be done after the Effective date of the Scheme with the approval of the WPC. In our view, this should only be done where it maximises the risk-adjusted return and the Scheme or the AFH report should have some guidelines on the required level of profitability, such as return on capital or minimum internal rate of return.

We note that 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, and we are informed that the amount of such property is currently immaterial.

We note also that under certain conditions, loans or investments in other Group Companies are permitted. Clearly there could be potential for conflict of interest in these types of investments. Similar governance and restrictions around these investments applies and, for all intents and purposes, they are treated as if they were strategic assets, and it is our view that the Old WPSF should not be used to invest in such assets due to the potential conflict of interest.

Strategic assets

Strategic assets are potentially more risky in nature, for example due to additional concentration risk. We therefore believe that, on reattribution, all the existing strategic assets should be transferred into the reattributed inherited estate or other non-profit or shareholder funds along with the other investments of the estate of the New WPSF. Any strategic assets that would be allocated in the first instance to the estate of the Old WPSF should be replaced with ordinary investments in that fund.

We also note that holding strategic assets at the beginning of 2008 led to a loss in the value of the estate over the year in excess of what the loss would have been had the assets been held in the normal basket of equities instead, and this had a direct impact on the PIP offered.

2.03 Investment strategy for the inherited estates

Summary of Aviva's view

Aviva sets out the current differences in how the inherited estates and the asset shares are invested. Currently, the following investments are held in the inherited estates, but not asset shares:

- all strategic investments;
- unit linked reinsurance with AVLAP (PM sub fund);
- inter-company loans.

In addition, as a short term measure to address the unprecedented market volatility, the asset mix for the inherited estate has been changed so that less is invested in equities.

KPMG's comments

We agree that strategic assets and inter-company loans should not be used to back asset shares. We note that no non-profit business is used as an asset for asset shares currently, and we do not object to this.

Post reattribution, the inherited estates will be split between the New WPSF (i.e. RIEESA) and the Old WPSF. We note that the Scheme allows for a separate investment policy for assets in excess of those assets backing the with-profits benefit reserve (which is essentially the asset shares). Further the AVLAP Board can adjust the investment strategy for these assets to move the capital resources position into the preferred range.

We would not have an issue if the shareholders wished to reduce the EBR of the RIEESA as this would not impact the expected benefits to policyholders.

Aviva's intention is for new with-profits business to be reinsured to the Old WPSF in line with the Old WPSF Proportion, and the Scheme allows this. The Old WPSF Proportion is broadly the proportion that the aggregate amount of the Policyholder Incentive Payments offered to holders of Eligible Policies whose Policies are allocated to the Old WPSF as at the

Effective Date compares to the aggregate amount of the Policyholder Incentive Payments offered to all policyholders.

We note that the implication is that all future new with-profits business, to the extent that it is invested in the Old WPSF in line with the Old WPSF Proportion, will share in any future distributions from the inherited estate of the Old WPSF.

In addition to meeting the risk return requirements on returns on the capital used to fund new business, FSA rules also currently permit the capital itself in the estate to be passed on to new policyholders. It is the policyholder advocate's view that transferring the estate in this way without compensating current policyholders for that transfer constitutes a subsidy. It also means that the amount current policyholders can expect to receive from the estate is primarily affected by how many new policies are written, and therefore that new business is not profitable for the fund or its policyholder participants. New business is discussed in greater depth in Appendix 38 B ("Aviva's new business assumptions").

2.04 Investment Strategy for the Cost of Guarantees

Summary of Aviva's view

During 2006 the FSA advised Aviva that, for the purposes of assessing the fairness of the reattribution proposals, it 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 an internal 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 returns for the purposes of calculating the asset shares backing policy liabilities. As a result of the change in investment strategy, less working capital is needed to cover the risks arising from guarantees attaching to with-profits policies in the CGNU Life and CULAC with-profits fund.

KPMG's comments

We support Aviva's decision to assume a de-risked strategy in respect of the cost of guarantees applying to with-profits policies. This reduces the risks of the funds, and this reduced level of risk can be (and has been) taken into account in the overall negotiations. Largely as a result of the de-risking a special distribution of £2.3bn was announced in February 2008 which followed the normal proportions of 90:10 to policyholders and shareholders.

2.05 Investment Management Agreement

Summary of Aviva's view

An Investment Management Agreement (IMA) exists between CGNU Life, CULAC and Aviva Investors Global Services Limited. This legal agreement appoints the Fund Managers, sets out the guidelines for their activities and the governance necessary to monitor their activities.

KPMG's comments

We have no issues with Aviva's policy in this area. We have not carried out any analysis or benchmarking of the fees payable by the with-profits funds going forwards under these investment management agreements as it was not within scope to do so.

2.06 The Use of Asset Shares to Determine Bonus Payments

Summary of Aviva's view

According to Aviva, the funds' long-term aim is to return, on average, 100% of asset shares to maturing groups of with-profits policies. Maturity and surrender payouts should normally fall in the range of 80% to 140% of asset share for conventional with-profits, and 80% to 120% for unitised with-profits. Payouts can fall outside this range in exceptional stock market conditions. Under those circumstances the aim would be to bring average payouts back in line with 100% of asset share over a maximum 5 year period (subject to meeting guarantees already built in).

Aviva goes on to explain the elements which make up the asset shares. In particular, it states that currently the application to asset shares of charges for guarantees is very limited and,

after the reattribution, in line with the Scheme, no additional guarantee charges may be introduced in respect of business in force at the time of reattribution. It also states that, for unitised with-profits 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.

KPMG's comments

It is usual practice to base bonus payouts on asset shares. Aviva's target ranges are not out of line with the industry and we have no concerns with them.

2.07 Bonus Philosophy

Summary of Aviva's view

Smoothing

Aviva states that smoothing is applied by spreading relevant profits and losses from one year to the next, with the intention that, in the long-term, the cost of smoothing is broadly neutral across generations of policyholders.

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

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

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

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

Aviva states it replaced the existing smoothing account with the following three smoothing accounts (in addition to the smoothing and guarantee account for the Stakeholder With-Profit 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 WPA and in consultation with the WPC. Once implemented, smoothing principles for all material books of business will be aligned.

Fair Payouts

Aviva sets out in its appendix 29 A (“Investment policy, smoothing and bonus policy”) how any difference between maturity payouts and asset shares is calculated and then split between guarantee costs or a smoothing costs. 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-profit fund, although, if these prove to be insufficient, it can be charged to the RIEESA. 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). Aviva goes on to state that, 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.

Aviva also sets out briefly the approach to paying surrender values for both conventional with-profits and unitised with-profits products. For conventional with-profits 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. For all conventional with-profits business, in the last years leading up to maturity or retirement, anticipated maturity values are set so as to avoid sudden changes year on year. The surrender bases are reviewed when there is a 5% movement in underlying market indicators.

Aviva states that for unitised with-profits there are a number of factors to consider when assessing a fair payout for non-guaranteed surrender values. These include a policyholder's share of the assets backing policyholder benefits in the with-profit fund, early termination charges, and MVRs. It then goes on to explain MVRs in more detail. Aviva states that MVRs aim to deliver fairness and protect the interests of policyholders still invested in the fund. 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. Any differences between surrender payouts and asset shares would be credited or debited to the relevant smoothing account.

Bonuses

Aviva states that 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; and
- the need to ensure that policyholders' reasonable benefit expectations are maintained.

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; and
- projected regulatory solvency levels, now and in the future.

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

KPMG's comments

The bonus philosophy and smoothing policy have no impact on whether an eligible policyholder should elect to accept the offered incentive payment, in which case his policy will be allocated to the New WPSF, or not accept the payment, in which case his policy will be allocated to the Old WPSF, since their position in these respects will be the same whichever fund they are in. However, as a part of the review we have considered whether there is any additional conflict of interest as a result of the reattribution, and, where there is, we have considered the safeguards which have been put in place.

Smoothing

Aviva's approach to smoothing is to aim broadly to pay 100% of asset shares over time and set broad limits as to how much payouts can change year on year. Companies approach smoothing in a variety of ways. An alternative method would be to use smoothed asset shares (as per asset shares but with smoothed returns), and these could be used as a starting point for payouts. An example of this approach, which we see several companies using in practice, is to use a 3 year rolling average of investment returns to determine a smoothed asset share, which would then be further subject to a maximum change-per-year test (as currently practiced by Aviva).

However, we believe that the use of a smoothing account alongside target payouts and limits on changes is a valid approach and, in particular, fits well with the requirements to ensure that over time smoothing costs should have minimal impact on the inherited estate. Therefore, we support this methodology.

We believe that the smoothing methodology should be as transparent and non-judgmental as possible. Aviva does have rules in place which are set out clearly in the internal governance and guidance documentation, but this documentation is not made available to the public, therefore we recommend that further information is made public in the PPFM.

We note that, for the 2008 realistic balance sheet (RBS), Aviva assumes that any smoothing account will be recouped or paid back over time via a percentage deduction/uplift to asset shares and hence, except in extreme cases, the smoothing cost as shown in the RBS is broadly

equal to the smoothing account. Following on from this, we believe that actual practice should be consistent with the measurement of smoothing costs which are calculated for RBS purposes. For example, if the factor required to neutralise smoothing costs is a 1% deduction from asset shares, then we would expect the 1% to be applied to asset shares maturing in the next year (subject to other constraints). Our understanding is that this is the approach that Aviva takes.

Overall, we agree with the use of the smoothing account as a way of ensuring that smoothing over time is cost-neutral. However, Aviva has recently decided to change the approach to smoothing with effect from January 2009. We have considered the changes, and have the following comments:

- we have no issue with smoothing being measured separately for conventional with-profits, unitised with-profits life and unitised with-profits pensions business, provided that the amount of business involved in each category is large enough to avoid the smoothing becoming too volatile;
- we note the fact that refinements are underway to ensure that profits or losses on business for which asset shares are not calculated or are not relevant will be recycled to policyholders not shareholders in the majority of cases. Clearly, however, there could come a time when the number of remaining endowment policies used to determine the bonuses on whole life contracts is a small proportion of the remaining whole-life policies. In this event we would expect there to be a process to determine the method for declaring bonuses on the whole life contracts;
- we note that the revised smoothing rules for the conventional with-profits business do not cover with-profits annuities, and other minor with-profits policies for which asset shares are not calculated. Our understanding is that any profits or losses of any type made on this business (which sits in the New WPSF) will accrue 100% to the core asset account, but will not actually impact enhanced asset shares. In effect any profits or losses will reduce or increase

the cost of guarantees charged to the RIEESA, and will hence benefit or be a cost to shareholders. The volume of with-profits annuity business is currently small, and so we are comfortable with this approach, particularly since guarantees on this type of business are usually more significant than smoothing, and the determination of the split between the smoothing profits and losses and guarantee costs can be complex. If however, this business grew in the future, then we would expect the approach to be revisited by the WPC;

- the usual smoothing constraints should be maintained, and there should be limits in terms of setting a maximum enhancement to the target payout and a maximum charge to the target payout for smoothing. We also believe there should be a minimum level below which the smoothing account cannot be reduced. This is to avoid the smoothing account becoming more and more negative in a falling market;
- we note that the current proposals suggest that at the end of each calendar year the balance on the unitised with-profits smoothing account will be recycled to asset shares through an addition to / deduction from the credited investment return. A maximum per-annum percentage deduction from asset shares will be set. We understand the reasons for taking this approach; in particular, it has the advantage that new business will share in any smoothing profits or losses made whilst in-force, but will not share in smoothing profits or losses made before the date of entry (except potentially where the maximum deduction applied in the prior year). We do however, have some concerns which are set out below:
 - asset shares will effectively include all historic smoothing costs, and it could be difficult to monitor how much asset shares have been affected by smoothing. For example there appear to be no formal controls to stop asset shares being reduced year after year, although we note there are limits on the annual maximum deduction that can be made;

- this approach could invalidate the determination of smoothing profits and losses (which in most cases will accrue to policyholder) and guarantees costs (which in most cases will be met by the shareholder for New WPSF with-profits policies) which in total are meant to be based on payouts over asset shares, not smoothed asset shares (which is the implication of the proposals);
- We recommend that Aviva measure unsmoothed asset shares alongside the smoothed asset shares so that it is clearer by how much policies are impacted by smoothing and it makes the guarantee costs easier to measure.

Fair Payouts

We agree with Aviva's approach to measuring the difference between maturity payouts and asset shares in terms of whether it contributes to being a guarantee cost or a smoothing cost. We also agree that this methodology ensures that any smoothing or discretion applied in determining payouts will not affect the guarantee costs and this eliminates most of the potential conflict between policyholders and shareholders over the level of payouts affecting the cost of guarantees.

Aviva's approach to setting surrender values is in line with the industry and we have no issues with its approach. In particular we acknowledge that the use of MVRs aims to deliver fairness and protects the interests of policyholders still invested in the fund.

Bonuses

Subject to the comments made above, Aviva's overall approach to setting bonuses is in line with their past practice and we see no problems with its approach.

2.08 Analysis of Bonus Payouts made by CGNU Life and CULAC

Summary of Aviva's view

The Aviva paper sets out the contributions to and from the smoothing account since 2004 and estimated average payouts as a percentage of asset shares from 2002 to 2007.

Aviva concludes that a comparison of payouts with changes in the markets, as illustrated by the FTSE 100 position for the last 6 years, 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 estates to supplement payouts;
- as markets improved, payouts have gradually been targeted closer to 100% of asset share;
- the turbulent market conditions during 2008 has impacted investment performance, the inherited estate has therefore been used to help smooth payouts. This meant that payouts during the year have been higher than asset share and;
- on average over this period payouts have been in excess of 100% of asset shares.

KPMG's comments

Aviva has been operating a smoothing account since 2004, but this has not been on the full range of policy types and has not been fully in line with the definitions of smoothing costs as set out in its paper. In particular, it is possible that some costs of guarantees have been included in the historic smoothing account, although these are unlikely to be significant given the size of the account. Aviva is not able to provide details of the likely impact.

We agree that the definition of the smoothing costs and guarantee costs as described in Aviva's appendix is now in line with the FSA's definitions. We have been told that the historic smoothing account had not been accumulated with interest, but we understand that, as from last year, allowance for returns on the smoothing account has been made. We believe

that the smoothing account should be accumulated at the earned rate, and agree with Aviva's revised approach.

It is important that, in future, the smoothing account is measured accurately and that any leakage of guarantee costs into the smoothing account cannot occur. For example, if part of any payment over asset share in the New WPSF is incorrectly measured as smoothing costs rather than guarantee costs then this cost will eventually be borne by remaining policyholders rather than by the shareholders. Such a result needs to be avoided after the reattribution. It is important to ensure that policyholders' funds are maintained and that any cost of guarantees is not inadvertently paid for by policyholders rather than shareholders.

We are told by Aviva that, in calculating the smoothing, Aviva was only able to report on the claims that are covered in the asset share database (around two thirds of maturities), but we are told that this issue is currently being addressed. We also understand that the split between smoothing and guarantees was not accurate. We are told that improvements to systems are currently being implemented. Our understanding is that the Board and the AFH have to sign off compliance with the PPFM and Scheme. However, since it is important that the figures calculated are accurate, and given the complexity and potential approximations in the calculations, we would prefer to see the smoothing account subject to independent external review on an annual basis.

Although coinciding with the introduction of PPFMs which formalised the way with-profits companies managed their business, the adoption of 2004 as a starting date for the smoothing account is somewhat arbitrary, and we know there are some broad approximations in the current calculations. Due to the broad approximations assumed in the historic calculations, for the purposes of the reattribution, the account could be set to zero on the Effective Date of the Scheme when the Old WPSF and New WPSF are created. This would, we believe, form a more objective criterion given the major reorganisation of the funds which is being undertaken. However, Aviva has decided against this approach.

Overall, we are comfortable with the concept of using a smoothing account, but we remain concerned as to whether Aviva is able to implement the concept in a robust and reliable way for all of the relevant business.

We note also that, due to historical payouts being high and due to smoothing limits, for practical reasons the payouts on some small blocks of conventional with-profits business cannot be brought down towards asset shares quickly and hence the target ranges in the PPFM for conventional with-profits (80% to 140%), are out of line with the unitised with-profits business (80% to 120%). Aviva has confirmed that the impact of this over-smoothing is not material. The PPFM as at August 2005 stated the two ranges as both being 80% to 120% but the upper limit was changed in October 2006 to 140% for conventional with-profits business. We would expect these ranges to be the same in due course, and given that the range of 80% to 140% is wide, we would expect the 140% to come down to 120%. This issue illustrates the fact that the smoothing account and limits were not in place historically.

2.09 Governance

Summary of Aviva's view

Aviva sets out the various committees that are appointed. It states that more generally the Board-appointed WPC will provide independent judgment on material issues, in assessing compliance with the PPFM, and on any competing or conflicting rights and interests of policyholders and shareholders.

KPMG's comments

We agree that the approach as set out above is necessary, and believe that the WPC should be involved in all areas which could potentially impact policyholders. We note that ultimately the strength of the protection for policyholders will be a function of the quality of the individuals who comprise the WPC.

We note also, that the Scheme allows some or all of future industry levies to be charged to asset shares. This potentially introduces a conflict of interest between shareholders and policyholders because before the Scheme was in place these could be charged to the inherited estate, but post the Scheme and the reattribution, the shareholders would be liable to those

costs determined to be applicable to New WPSF policies if they are not charged to asset shares. Such levies could be material, and this could impact payouts significantly, yet, although the WPC will be consulted and their views considered by the Board, they do not have the power of veto in this area (except in terms of their power to whistle-blow to the FSA). We cover this further in our comments on the WPA report in appendix 18 B (“The With Profits Actuary's report”).

2.10 Bonus Notices / Yearly Statements

Summary of Aviva's view

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

KPMG's comments

We agree that the approach as set out above is in line with the industry.

2.11 Post- Reattribution Safeguards

Summary of Aviva's view

Aviva states that, after reattribution, policyholders' reasonable expectations and benefit security are safeguarded by:

- identical asset share investment strategy and bonuses for similar policies in the Old WPSF and New WPSF, other than bonuses which arise as a result of future distributions from the inherited estates of the Old WPSF, those arising in respect of incentive payments paid in the form of additional benefits and those arising from any enhancement to asset shares of Elected Policies arising from the new business clawback mechanism;
- an investment strategy for asset shares that is no different from the approach before the reattribution;
- EBR limits based upon objective measures that are linked to 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 and investments in Aviva group companies in the RIEESA; and
- the role of the With-Profits Committee.

KPMG's comments

In addition to Aviva's comments in its appendix 29 A ("Investment policy, smoothing and bonus policy"), we note that internal governance and guidance documentation states that, for all with-profits funds, the WPC will look to ensure that any significant change in investment approach can be considered to be in the policyholders' interest. We have considered the areas where its approval would be sought and agree that there is sufficient oversight in terms of potential changes to the investment approach.

Our key areas of concerns are the management of the smoothing account to ensure no leakage of guarantee costs being measured as smoothing costs and the potential for the shareholders to invest assets backing asset shares more conservatively. Our views on the smoothing approach are covered in section 2.07 above.

We would note that we are placing reliance on the WPC to act in accordance with the principles set out by the FSA. The WPC is not solely bound by the PPFM, and can take a broader view of the interests of policyholders. The implication of this is that the individuals who form the WPC need to be technically capable of understanding the issues relating to with-profits business and need to be provided with sufficient information to make informed decisions, and to act robustly on behalf of with-profits policyholders. We also reiterate our concerns that the approval of the WPC is not required if the Board determines that it would be appropriate to charge some or all of future industry levies to asset shares.