

Report Number 31 A

## Principles and Practices of Financial Management (PPFM) and Consumer Friendly PPFM

A summary of Aviva's proposals in connection with the reattribution of the inherited estates of CGNU Life and CULAC with-profits funds

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Appendix by: Aviva UK Life – June 2009

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## 1.00 Context

Principles and Practices of Financial Management (PPFM) were introduced by the Financial Services Authority (FSA) in May 2004.

Under FSA Regulations, each company must produce a PPFM for each of the With-Profit Fund that it manages. These guides cover the detailed workings and management of each fund.

From July 2005 the FSA added a requirement for a customer friendly version of the PPFM document (CFPPFM). These cover the main aspects of each fund and replace the old With-Profit Guides.

Aviva has two versions of the CFPPFM:

- One for new business. Which is issued at point of sale and available from Aviva's web-site
- One for existing business. This is issued each year with the yearly bonus pack or annual statement and is available on the Aviva's web-site.

This paper aims to share how the PPFM fits into the governance arrangements for the CGNU Life and Commercial Union Life Assurance Company (CULAC) funds both before and after the proposed reattribution and fund merger takes place.

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## 2.00 Regulatory Requirements

The FSA publishes its regulations for PPFM under the Conduct of Business Sourcebook (COBS) 20. The key principle underpinning these rules is to treat customers in a fair and open manner.

The PPFM should:

- Provide policyholders with a better understanding of the way in which firms carry on their with-profits business
- Promote confidence in the governance arrangements

The rules state that in order to comply with COBS 20 a firm should:

- Establish and maintain a document according to which its with-profits business is conducted
- Retain a record of each version of the PPFM as it changes over time

A firm must

- On request, provide a copy of the PPFM free of charge to policyholders
- If it publishes its PPFM on its web-site, prominently signpost its location there
- Produce a consumer friendly version of the PPFM (CFPPFM) which describes the most important information set out under each heading in the PPFM and keep it up to date as the PPFM changes.
- Express its CFPPFM in clear and plain language
- Provide its CFPPFM free of charge with any
  - (a) written notice on proposed changes to principles
  - (b) annual statements (unless no material change in CFPPFM since last issued)
  - (c) key features document for a with-profits policy
- Make a copy of the CFPPFM publicly available and prominently signpost the availability on its web-site

## 2.01 With-Profits Principles

The rules state that with-profits principles within the PPFM must:

- Be enduring statements of the standards used in managing the with-profits funds
- Describe the business model used in meeting duties to with-profits policyholders, and to respond to longer term changes in the business and economic environment.

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## 2.02 With-Profit Practices

The rules state that with-profit practices within the PPFM must:

- Describe the approach to managing with-profits funds and how it responds to changes in the business and economic environment in the shorter-term
- Contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy

A firm is not expected to change its PPFM unless, in the reasonable opinion of its governing body, that change is justified to:

- respond to changes in the business or economic environment
- protect the interests of policyholders
- change practices to better achieve principles

## 2.03 Scope and Content of the PPFM

The PPFM must cover issues that have a significant impact on the management of the with-profits funds.

The issues include:

- The amount payable under a with-profits policy;
- The investment strategy;
- Business risk;
- Charges and expenses;
- Management of the inherited estate;
- Volumes of new business;
- Arrangements on stopping taking new business;
- Equity between the policyholders in the with-profits fund and between them and any shareholders.

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### 3.00 Aviva's PPFMs

Aviva maintains PPFMs for each of its with-profits funds. These currently cover:

- CGNU Life Assurance Limited (CGNU Life) & Commercial Union Life Assurance Company Limited (CULAC);
- CGNU Life Assurance Limited (Stakeholder Pension);
- Aviva Life and Pensions UK Limited;
- Norwich Union Life (RBS) Limited;
- Provident Mutual Fund.

As the CGNU Life and CULAC funds are managed along similar lines and have similar investment philosophies, the PPFM covering the CGNU Life and CULAC funds is a combined document.

The document covers:

- Section 1 – Introduction
  - Company information
  - Fund background
  - Purpose of PPFM
  - Business covered by the PPFM
  - Governance arrangements surrounding the PPFM
  - Customer Friendly PPFM (CFPPFM)
  - Glossary
- Section 2 – The Amount Payable under a With-Profits Policy
  - Amount payable
  - Asset share methodology
  - Bonus philosophy
  - Market value reduction
- Section 3 – Investment Strategy
- Section 4 – Business Risk
- Section 5 – Charges and Expenses
- Section 6 – Management of the Inherited Estate

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- Section 7 – Volumes of New Business and Arrangements on Stopping taking New Business
- Section 8 – Equity between the With-Profit Fund and shareholders
- Appendix A – Glossary
- Appendix B – Aviva Life Holdings plc – Fund structure chart

## 4.00 Governance Arrangements

It is the Boards' responsibility to ensure that the funds are managed in line with the PPFM.

In line with the FSA guidance, governance arrangements have been put in place to assure policyholders that the PPFM is working:

- A 'Compliance with PPFM Report' is produced annually.
- A With-Profits Actuary has been appointed to advise the Board. The With-Profits Actuary will report annually to With-Profits Policyholders.
- A majority independent With-Profits Committee (WPC) has been established. Part of its role is to:
  - review any changes proposed to the PPFM
  - advise the Board on compliance with the PPFM
  - provide some independent judgment in assessing how competing rights and interests of policyholders and shareholders have been addressed

More detail on the role of the WPC is provided in the 'With-Profits Governance Arrangements' appendix provided to the Policyholder Advocate.

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## 5.00 Changes being made in the light of Reattribution and Fund Merger

Following the completion of the reattribution and fund transfer some changes will need to be made to the PPFM to reflect the new fund structure. The Scheme includes provisions for the management of these funds. The new PPFM will describe the management of the Old With-Profits Sub Fund (OWPSF) and the New With-Profits Sub Fund (NWPSF) in more detail.

The PPFM changes proposed below have been reviewed through the usual governance processes (including the With-Profits Committee) and discussed with the FSA, the Independent Expert and the Policyholder Advocate. This is intended to further safeguard policyholder interests in the reattribution and fund merger.

Specific changes to the PPFM will be made in the following areas:

### 5.01 General

- The establishment of the OWPSF, the NWPSF and the Reattributed Inherited Estate External Support Account (RIEESA). This also covers:
  - The allocation of transferred policies
  - Liabilities and assets
  - The existence within the NWPSF of the Core Asset Account
  - Any necessary support to the NWPSF and the OWPSF being provided by the RIEESA through a contingent loan arrangement.
- The With-Profit Committee and its role in the governance of the with-profits funds.
- Consistency in the management of the with-profits business of the NWPSF and the OWPSF.
- Internal reinsurance to the OWPSF of its proportion of new with-profits policies written in the NWPSF.
- Tax allocated to the NWPSF and the OWPSF each being determined on a stand alone basis.

### 5.02 Inherited Estate

- Inclusion of the mandatory distribution point for OWPSF (120% of AAA) and the permitted RIE release point (110% of AAA)
- Factors that will be taken into account by the With-Profits Actuary in giving his advice to the Board in relation to future distributions/releases

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- Allowing a target asset mix of the estate when testing for releases from the RIEESA
- Inclusion of the preferred range for the Inherited Estate (to give AA to AAA financial strength)
- Provisions covering releases to shareholders from the RIEESA
- Provisions covering distributions from the OWPSF by reference to the OWPSF mandatory distribution point and any deferred distribution created as a result of the allocation of the inherited estate at the time of the reattribution
- Use of the RIEESA to write non-profit new business and to invest in strategic assets, subject to appropriate limits
- Investment policy of the assets in the funds including those in the inherited estate.

### **5.03 Amounts Payable on With-Profits Policies**

- Equivalent policies in the NWPSF and OWPSF having the same:
  - Bonus rates
  - Market Value Reduction (MVR)
  - Investment returns
  - Expenses
  - Charges
- The combined assets and liabilities of the NWPSF (including the RIEESA) and the OWPSF
- No future guarantee charges will be applied to the asset shares of transferred policies (other than explicit charges under the terms of the policy).

### **5.04 Investment Policy**

- Inclusion of constraints on the minimum and maximum asset share Equity Backing Ratio (EBR)
- Reference to the use of internal guidelines for the asset share EBR. Any changes are subject to the approval of the With-Profits Committee
- Limitations that apply to investment of the RIEESA in non-profit new business and in strategic assets
- The ability to transfer pre effective-day non-profit business into the RIEESA subject to constraints
- Economic effect of derivatives allowed for in establishing the asset share EBR.
- When setting the investment strategy for the NWPSF the assets and liabilities comprising the RIEESA will be taken into account

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- Equivalent policies in the NWPSF and the OWPSF will have the same investment strategy for assets backing asset shares.
- The aggregate asset shares and guarantees of policies in the NWPSF and OWPSF is used in setting the Theoretical Equity Backing Ratio
- Strategic assets will be allocated to the OWPSF inherited estate or the reattributed inherited estate and not to asset share. Not more than the OWPSF proportion of strategic assets may be allocated to the OWPSF.

#### **5.05 With-Profits Committee (WPC)**

- WPC role and the provision of detailed information to assist their governance role.

#### **5.06 Risk Appetite**

- Overview of the risk appetite framework

#### **5.07 Other**

- Miscellaneous changes identified in the AFH Report paragraph 5.14 (Further changes to the PPFM).

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## 6.00 Aviva's view of the Policyholder Advocate's Approach

The Office of the Policyholder Advocate has made a number of observations during the negotiations about the content of both the PPFM and CFPPFM. Where it was felt appropriate changes were incorporated into these documents. The Office of the Policyholder Advocate's appendix sets out their views; we have considered these views and set out our thoughts below.

In general, we would note that the PPFM and CFPPFM fully meet the requirements laid out in COBS and that it is therefore our opinion that the views expressed by the Policyholder Advocate, whilst strongly held, are not entirely consistent with the FSA's regulations and guidance.

### 6.01 PPFM, CFPPFM and the Policyholder Contract

Aviva's views on this are covered in the appendix "Legal Issues arising in respect of Rights and Interests in & Uses of the Inherited Estates", and therefore other than reiterating that Aviva has a different perspective on this, our views are not repeated here.

### 6.02 Practices and Use

The Office of the Policyholder Advocate has repeated her views on the uses of the inherited estate which she objects to.

Whilst we fully accept that these are the Policyholder Advocate's views, they do run contrary to current FSA rules and guidance (as set out in COBS) which were developed following an extensive With-Profits Review. During the negotiations process the Policyholder Advocate was able to challenge the FSA on these points and they have provided her with detailed clarification which shows that the practices and uses which Aviva applies to the inherited estates comply with COBS and current industry practice<sup>1</sup>.

Section 6.2 of the PPFM explains the actions that might be taken by the Board if the inherited estate rises above the top end of the 'preferred range' of the Risk Appetite Framework. The PPFM provides a broad description of these possible actions; details of any limitations on those actions are documented in the Scheme.

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<sup>1</sup> The FSA is currently consulting on its rules around the cost of compensation for misselling

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Section 6.3 of the PPFM explains how in managing the OWPSF Inherited Estate, current practice allows its use to pay the costs of the following items where they arise in connection with policies that are allocated to the OWPSF:

- the additional tax associated with shareholder transfers out of the Fund
- any cost of compensation for mis-selling of business that the Fund has an interest in
- guaranteed annuity option costs in excess of those charged to policies and other guarantee costs where these exceed the policy value indicated by asset share
- costs arising from payouts at MVR free points
- costs arising in respect of payouts of money back guarantee being different to expected
- costs arising from the Mortgage Endowment Promise
- costs associated with restricting charges to asset shares for certain contracts, including the cost of shareholder transfers
- any expenses not charged to asset share
- cost of any approximations in the calculations.
- any financing of smoothing of payouts (over the longer term the cost of smoothing is expected to be neutral)

Similarly, the current practice in relation to the Reattributed Inherited Estate (RIE) to the charging of such costs is also explained.

It therefore seems unhelpful and potentially misleading to policyholders to repeat these views in this appendix as, taken in isolation, they could be misconstrued as implying that the company was in some way acting in a way that runs contrary to COBS.

### 6.03 Comprehensibility

As acknowledged within the Office of the Policyholder Advocate's paper, the PPFM is meant to be sufficiently detailed for a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy. Inevitably, this means that it is technical in nature and whilst every effort is made to try to explain technical terms as clearly as possible (including by providing a glossary of terms) it becomes a matter of personal preference whether the style works for the reader or not.

Revisions to the PPFM go through a robust review and sign-off process to ensure that they fully comply with the FSA requirements.

From discussions with the Office of the Policyholder Advocate we understand that their concern is the level of clarity that policyholders may have over where their policy is allocated (whether New With-Profits or Old With-Profits sub-fund) and the implications of this for their rights and interests.

Having considered this further, we would suggest that the PPFM is not the most appropriate place to explain this level of detail since:

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- At the effective date the allocation of eligible policies to either NWPSF or OWPSF is determined by whether the policyholder elected to accept the reattribution offer or not, and
- The allocation of new business to the NWPSF, with proportionate reinsurance to the OWPSF further complicates how this can be messaged in general to policyholders.

We will however continue to explore whether there are other more appropriate means of providing this type of information to policyholders.

#### **6.04 CFPPFM**

Revisions to the CFPPFM go through a robust review and sign-off process to ensure that they fully comply with the FSA requirements and that they are clear, concise and not misleading communications.