

Appendix 31 B

Principles and practices of financial management (PPFM) and consumer friendly PPFM

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

Reference is made to the Aviva appendix “Principles and practices of financial management (PPFM) and consumer friendly PPFM” and also to the draft PPFM (as updated on [16 March] 2009) relating to certain of the with-profits sub-funds of Aviva Life & Pensions UK Limited which will be formed as part of the reattribution. The sub-funds are the Old With-Profits Sub Fund (OWPSF) and the New With-Profits Sub Fund (NWPSF). This paper sets out the policyholder advocate’s views on the PPFM and the Consumer Friendly PPFM (CFPPFM).

As a general matter, we should start by confirming that although we do have reservations (as expressed below) about the PPFM and CFPPFM, neither represents a deterioration, as compared to the current pre-reattribution position, as regards the safeguarding of policyholder interests. The PPFM have been amended from the version that currently applies only so far as is necessary to reflect the new fund structure referred to above, including additional measures to ensure that policyholders’ normal benefits should not be affected by the reattribution and that the same benefits will be paid on equivalent policies regardless of whether their holder elects to accept the PIP offer or not.

2.00 PPFM, CFPPFM and the policyholder contract

As is clear from Appendix 25 - “Legal issues arising in respect of the rights and interests in and uses of the inherited estates”, there is no dispute between the policyholder advocate and Aviva that the nature of the relationship between policyholders and CGNU Life and CULAC is a contractual one (as distinct from one of trustee and beneficiary). The status of the PPFM and CFPPFM in the context of this contractual relationship is an important and difficult topic. It is difficult because while the FSA rules (COBS 20.3.1R) clearly contemplate that the PPFM should describe (and by implication limit) the way in which important elements of the insurer's “with-profits discretion” are exercised, it is difficult to see how (in the context of a consumer contract such as a with-profits policy) a document which is not in the ordinary course even provided to the consumer at the “point of sale” can have contractual effect (in the sense of overriding what would otherwise be his/her contractual rights)

A separate contractual issue is the extent to which, if the PPFM or CFPPFM do have some contractual effect, changes to these after the policy contract comes into existence will be effective as a matter of contract law. We consider that such changes, if communicated to the policyholders and “accepted” by them (e.g. through maintained premium payments) can modify the policy contract. But material changes (and in particular, changes to what we consider to be the core principles that govern the exercise of the with-profits discretion) would require clear evidence that the policyholders affected had knowingly accepted the change. Further consideration of contractual issues (including Aviva’s perspective) can be found in Appendix 25.

3.00 PPFM

3.01. FSA Rules

The FSA rules require (at COBS 20.3.1R) that a firm carrying on with-profits business must “establish and maintain the PPFM according to which its with-profits business is conducted”.

The firm’s with-profits principles must:

- (a) be enduring statements of the standards it adopts in managing with-profits funds; and
- (b) describe the business model it uses to meet its duties to with-profits policyholders and to respond to longer-term changes in the business and economic environment.

The firm’s with-profits practices must:

- (a) describe how a firm manages its with-profits funds and how it responds to shorter-term changes in the business and economic environment; and
- (b) be sufficiently detailed for a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy with it.

The requirement for practices in (b) above means that the practices must be sufficiently detailed and expressed in a way which is comprehensible to the knowledgeable observer. There is also a general requirement on a firm under Principle 7 of the FSA's Principles for Businesses to pay due regard to the information needs of its clients and to communicate information to them in a way that is clear, fair and not misleading.

COBS 20.3.4R and 20.3.5R set out detailed requirements for the scope and content of the PPFM. The policyholder advocate has not carried out a detailed review of the PPFM to determine whether or not they comply with the prescribed scope and content requirements (nor is this within her role). However, given the significance from a regulatory perspective of the PPFM, the policyholder advocate's team has reviewed them for clarity and comprehensibility and to determine whether they properly reflect what the policyholder advocate regards as the appropriate level of independent oversight through the With-Profits Committee (WPC) of discretions exercised by the board in the management of the relevant funds.

The key areas of comment on the PPFM are set out below.

3.02. Practices and uses

The PPFM enshrines various uses of the inherited estate in the OWPSF that the policyholder advocate objects to, as discussed in more detail in Appendices 13 and 25, notwithstanding that these may be permitted under current FSA rules or that they may be consistent with Aviva's historical practices or with industry practice.

These are the use of inherited estate funds for the following purposes:

- (a) to pay shareholder tax;
- (b) to pay shareholders' 10% of distributable profits on certain UWP policies whose asset shares may not be charged for this;

- (c) to acquire strategic investments, make loans to Aviva group companies and make other investments whose primary driver may not be normal portfolio investment considerations; or
- (d) to pay misselling costs and expenses.

We also question:

- (a) in relation to section 2 whether the language as regards the absence of charges for capital on post-Effective Date policies is consistent with the FSA's requirement that policies not be written on terms that are expected to reduce the size of the estate (a similar comment can be made with respect to section 5);
- (b) the absence of any principles on which to base decisions as to the quantity and terms of new business. As explained in Appendix 25, the policyholder advocate believes that new business decisions should be approached in broadly the same way as any other investment decision of the fund. But the PPFM contains no explanation of how these decisions are arrived at, except (in section 7) by reference to the company's business objectives; and
- (c) as a connected point, whether an appropriate reaction to the inherited estate rising above the top end of the preferred range would be to increase new business volumes or to increase guarantees, whether on existing or new business, where this was not something that policyholders were otherwise expecting. In this connection the PPFM would appear to be inconsistent with the AFH report and the Scheme, which limit any such increase to original planned levels (section 6.2.6.6).

A separate issue is whether the extent and implications of the use of the inherited estate in connection with new business is sufficiently apparent from the PPFM. We have, for ease of reference, set out in Annexe 1 a number of detailed extracts from section 6 of the PPFM which explain how the inherited estate may be applied, and section 7 of the PPFM which

explain the company's approach to new business. We do not think it is sufficiently clear from these in respect of the Old WPSF:

- (a) that the terms on which new business will be written will have the effect of transferring the inherited estate, without payment, from the current generation of policyholders to successive ones. There is no explicit linkage between the sections dealing with new business and those which explain the making of special distributions from the OWPSF;
- (b) that shareholders enjoy returns from new business over and above their 10% share in distributed bonus; or
- (c) that generally the uses of the inherited estate referred to above will, other things being equal, reduce special distributions from the estate.

The policyholder advocate also notes that while generally there are restrictions on new charges to asset shares, the PPFM contemplates that Aviva may charge to asset shares industry levies which Aviva has to pay (for example levies by the Financial Services Compensation Scheme).

3.03. Comprehensibility

As a general matter, the policyholder advocate finds the PPFM difficult to follow in a number of places and it is, at least in the policyholder advocate's view, not clear that either the requirement under COBS 20.3.1R (sufficiently detailed for a knowledgeable observer to understand the material risks and rewards) or the general requirement for clear, fair and not misleading communication is satisfied.

The policyholder advocate has particular difficulty in this respect with the following sections of the PPFM :

- (a) Section 2 generally and in particular:

- The absence of sub-headings. For example in section 2.2 it would be useful for there to be sub-headings for the sections dealing with surrender;
 - The interaction between the sections headed “Amounts Payable”, “Asset Share Methodology” and “Bonus Philosophy”; it would, for example, be useful to explain that bonus philosophy is concerned with how much of the smoothed asset share will be added as regular bonus (and therefore guaranteed) and how much will instead be added as final bonus;
 - There are references in 2.2 and 2.3 to a policy grouping concept but it is unclear how policies are grouped and what impact the grouping has;
 - It is not clear why the smoothing account description is in 2.6 as opposed to 2.2. Moreover, the description is very hard to follow, suggesting almost a year-by-year approach to smoothing as opposed to the “long term” or “maximum 5 year period” referred to in 2.2; and
 - The description of market value reductions in section 2.8 is also hard to follow; it could be made clearer that it applies only to unitised with-profits (UWP) policies (and why) and it is not clear that the ability to make an MVR only arises for surrenders or switches, not for normal unit cancellations.
- (b) In section 3.2 (Investment Strategy - Practices), the method used to determine benchmark asset allocation ranges is not comprehensible. For example, unless one understands how the EBR is calculated, it is not possible to understand what the theoretical EBR is intended to achieve (and why it differs from the EBR). The paragraphs describing the guarantee hedge are particularly difficult;
- (c) The use of technical expressions such as “Pillar 2” and “realistic reserves” in section 6 will make this section hard to follow for non-technically qualified policyholders.

3.04. Governance

The PPFM refers in various places to the review or approval of the WPC Committee (WPC). The policyholder advocate has asked Aviva to explain (for the purposes of the PPFM and more generally) the rationale behind categorising the input of the WPC variously as “reviewing”, “confirming” or “approving” – it is not clear what substantive distinction there is between reviewing and confirming, nor is it clear to the policyholder advocate on what basis matters are allocated between those which merely require review or confirmation and those requiring WPC approval.

The policyholder advocate has commented separately (in Appendix 30 “With-profits governance arrangements”) on the role of the WPC in relation to changes to the PPFM itself.

4.00 CFPPFM

Under the FSA rules (COBS 20.4.5R) a firm must:

- (a) produce a CFPPFM describing the most important information set out under each of the headings in its PPFM and keep it up to date as the PPFM changes over time;
- (b) express its CFPPFM in clear and plain language that can be easily understood by a with-profits policyholder, or potential with-profits policyholder who does not possess any specialist or technical knowledge.

The CFPPFM which will apply after the reattribution had not been produced at the time of writing but sample pre-reattribution CFPPFM have been reviewed¹.

These CFPPFM are well written and set out and contain useful charts and summary tables. However, while this is inherently a subjective judgment, the CFPPFM are in our view too brief. The concept of the inherited estate receives only scant mention, the possibility that

¹ “A guide to conventional with-profits investment and how we manage the fund – for customers investing through a pension or endowment plan” (02/2009) and “A guide to your with-profits investment and how we manage the fund – for customers investing through the Portfolio, our investment bond” (02/2009).

policyholders may receive distributions from it is not mentioned, and there is no explanation of how its use is differentiated from the rest of the fund. In particular, there is no reference in the CFPPFM to the fact that the inherited estate in the OWPSF can be used for the purposes which the policyholder advocate has questioned (and which are referred to in part 3 of this Appendix). Without such an explicit reference it does not seem to us that the CFPPFM can be said to meet the criterion referred to in (a) above. Nor for that matter do we think that any contractual limit on the use of the estate in this way (cf. Appendix 25) would be overridden.

The current CFPPFM also list the size of the inherited estate and the balancing of the interests of policyholders and shareholders as “business risks”. We are unclear why it is appropriate to refer to these matters as business risks.

In respect of unitised with-profits policies it is accepted that particular difficulties arise in explaining these policies in simple terms in a few pages. With that proviso, the following observations may be made about the current unitised with-profits CFPPFM which we have reviewed:

- (a) the graphs in the current CFPPFM suggest that the value of policies will steadily increase, which may of course not be the case;
- (b) the CFPPFM does not explain how the “unit value” changes with the performance of the fund, nor how this relates to “90/10 profit sharing”, nor how performance-related changes in unit value inter-relate with regular bonus additions to value, nor whether bonus additions to value are different in concept from performance-related changes to value (and whether MVRs can remove bonus additions); and
- (c) policy value is stated to be subject to Market Value Reductions (MVRs) but it is not clear whether MVRs apply at all times or only on early surrender.

Looking forward, we would expect the new CFPPFM to explain that new with-profits policies are allocated to the Old WPSF and the New WPSF, and the significance of this. We would expect that some reference should be included to the possibility of future special distributions



from the inherited estate of the OWPSF and of the impact on this possibility of the inter-generational transfer and the estate uses referred to above.

Annexe 1 - PPFM extracts

“6.2.2 Bonus rates, new business levels and investment policy will (subject to the limitations imposed by the Scheme) be managed in order to keep the **inherited estates** at levels which, in the opinion of the Board (having regard to the advice of the **With-Profits Actuary**) is appropriate for the business. In determining the appropriate levels for the **inherited estates** the Board will take into account the levels of risk being “run”, or expected to be run, by the business and in particular it will generally seek to maintain **inherited estates** at levels which are consistent with its risk appetite as described in the **Risk Appetite Framework** sections 6.2.6 and 6.3.3 below”.

“6.2.5 Uses of the inherited estates

6.2.5.1 The **inherited estates** may be used, at the Board’s discretion, to:

- provide investment flexibility by enabling a higher proportionate investment in potentially higher reward but higher risk assets than would otherwise be the case;
- provide a cushion of additional security against unexpected adverse events;
- permit flexibility in the smoothing of maturity and surrender payouts for with-profits policies;
- finance new business growth. The expectation is any financing would be repaid over the term of the policy;
- meet such other purposes as permitted by law and consistent with the Company’s duty to maintain adequate financial resource.

6.2.5.2 The **inherited estates** represent the **working capital** of the respective funds. To the extent that the size of the **inherited estates** exceeds the levels that the [NUL&P] Board considers to be necessary for their current and future use, distributions may be made from the Old WPSF **inherited estate** and releases may be made from the **RIEESA**. The Scheme imposes restrictions on the circumstances in which releases can be made from the **RIEESA** to

the shareholders and it specifies circumstances in which distributions must be made from the Old WPSF **inherited estate**.

6.2.5.3 The Scheme does not prevent the [NUL&P] Board from making discretionary distributions from the Old WPSF **inherited estate** in circumstances where the Scheme does not require distributions to be made, nor does it prevent the [NUL&P] Board from making discretionary distributions from the Old WPSF **inherited estate** in excess of those required by the Scheme. The scope for discretionary distributions from the Old WPSF **inherited estate** will be established having regard to the [NUL&P] Board's **Risk Appetite Framework**. Although the [NUL&P] Board's **Risk Appetite Framework** may be changed from time to time, such changes will not override the Scheme requirements governing distributions from the Old WPSF **inherited estate** and releases from the **RIEESA**”

“6.2.6.6 Where the **inherited estate** rises above the top end of the preferred range, the actions that might be taken include:

- a discretionary distribution from the **inherited estate**;
- changing the investment strategy of the **inherited estate** in a way which increases the potential risks and rewards (where the existing strategy was considered to be too cautious and the increase in risk was considered to be acceptable);
- increasing new business volumes or offering higher guarantees on new products;
- increasing **regular bonus** levels;
- increasing the EBR for the **Return Assets** within the constraints referred to in section 3.

The [NUL&P] Board would be under no obligation to carry out any of these actions.

6.2.6.7 Where the **inherited estate** falls below the bottom end of the preferred range, the actions that might be taken include:

- adopting a more cautious investment strategy for the **inherited estate**;
- reducing the EBR for the **Return Assets** within the constraints referred to in section 3;
- reducing **regular bonus** levels (but still in accordance with the PPFM);
- reducing new business volumes or reducing the guarantees on new products;
- reviewing the proposed management actions in the event of further adverse experience.

6.2.6.8 In some adverse circumstances it may be necessary to change the PPFM Practices.

6.2.6.9 One of the management actions that may be taken is a discretionary distribution. Provided that the Old WPSF **inherited estate** lies within the preferred range, the [NUL&P] Board considers that the level of security for policyholder benefits is satisfactory and in this event it is unlikely that a distribution will be made from the Old WPSF **inherited estate** except in response to specific circumstances.”

“6.3.2 Uses of the inherited estates

6.3.2.1 In managing the Old WPSF **inherited estate**, current practice is to use it to pay the costs of the following items where they arise in connection with policies that are allocated to the Old WPSF:

- 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 respect of contracts under which the principle policy benefit is expressed in terms of a cash sum at retirement 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).

6.3.2.2 Similarly, current practice is to use the **Reattributed Inherited Estate** to pay the above costs where they arise in connection with policies that are allocated to the New WPSF.

6.3.2.3 In addition, the **inherited estates** may be used to pay other costs as agreed by the Board, having regard to the advice of the **With-Profits Actuary**. The approval of the **With-Profits Committee** will be required prior to any changes to the type of expenses or charges that are deducted from the **inherited estates**, or the basis of their calculation, from those which were being deducted from the **With-profits funds** of CGNU Life and CULAC immediately prior to [1 October 2009].

6.3.2.4 In the case of unitised contracts with investments in a **unitised with-profits fund**, expected profits on new policies are compared with the projected shareholders' transfers at the point of sale (currently 10% of surplus available for distribution). On the basis of this comparison, the Board, having regard to the advice of the **With-Profits Actuary**, may restrict future shareholders' transfers in respect of such business to a lower percentage than 10% rather than charge the difference to the **inherited estates** as is currently the case."

"7.1.1 The company will set planned volumes of new business by determining a level and mix of new business which meets the Company's business objectives and which is unlikely to have a material adverse effect on the interests of the existing policyholders."

“7.2.1 The approach the Company takes in setting a maximum volume of new business each year and any limits on classes written is as follows:

- a marketing plan is determined which meets the business objectives of [NUL&P];
- a number of projections of the Company’s financial position over a period of years are then carried out under a range of future economic scenarios. In each case it is assumed that new business is in accordance with the plan;
- further projections are carried out assuming new business differs from the plan in defined ways, e.g. that higher levels of new business are achieved;
- the results of these projections are then studied to determine a level and mix of new business which meets the Company’s business objectives and to which the Company’s future financial development and regulatory position is resilient under a wide range of economic scenarios.

7.2.2 The Company does not set a specific minimum proportion or scale of new **with-profits business** to justify the Fund staying open to new business. Decisions on the future of the Funds will be taken in the light of the circumstances at the time. The **Risk Appetite Framework** will also be considered.

7.2.3 The Company may choose to cease to write new business for particular product groups either because of lack of demand or unacceptable terms to secure new business.

7.2.4 The company manages the Funds on the basis they remain open to new business....”