

Report Number 32 A

The Position of Non-Electing Policyholders

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

As part of the reattribution process, eligible policyholders are given a fully informed and free choice either to accept a policyholder incentive payment (PIP) or to retain their rights to participate in any special distributions from the inherited estates.

This appendix aims to explain how Aviva's approach for those eligible policyholders who do not elect to accept the PIP offer aims to maintain the status quo in relation to the inherited estates of CGNU Life and Commercial Union Life Assurance Company (CULAC) by leaving them in a broadly similar position as if the reattribution had not taken place.

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2.00 Philosophy of Aviva's approach towards Non-Electing Policyholders

Aviva's overriding aim is to ensure that all policyholders are treated fairly. The perfect solution would be to construct a scheme which meant that policyholders who do not accept the PIP offer are left in exactly the same position as if the reattribution had not taken place.

2.01 Principles

Aviva accepts that such perfection cannot be attained, since:

- It is not possible to accurately predict the future;
- The funds are different post reattribution and
- Their running is subject to continuous refinement and improvement.

As far as possible Aviva has sought to embody the principles it has adopted for managing the fund prior to the reattribution in how the funds will be run afterwards, and has sought to codify risk appetite and its practices in guidance documents.

As far as non-electors are concerned Aviva seeks to maintain their position in two major areas, reasonable expectations both as to normal bonus and as to possible future special distributions from the inherited estate, and benefit security. For benefit security we use a methodology called "effective date benefit security factor" and for reasonable expectations we employ both asset share techniques and a methodology called "Value of Potential Distributions" to Policyholders".

Since the primary purpose of the inherited estate (from the perspective of existing policyholders) is to provide security for policy benefits and investment freedom to policyholders, the allocation of the inherited estate is subject to a "true-up" adjustment which is designed to ensure that the financial strength of the Old With-Profits Sub Fund (OWPSF) and New With-Profits Sub Fund (NWPSF) (with the Reattributed Inherited Estate External Support Account (RIEESA)) are sufficiently similar. The measure of financial strength used for this purpose is the Effective Date Benefit Security Factor (BSF) which is the probability of the fund being able to meet its obligations to current policyholders when they fall due.

To ensure that electing policyholders benefit security is not unduly affected it is necessary for the BSF test to be applied after the safety net is calculated.

This BSF methodology has been reviewed by the independent expert. He concluded in his report that "Ignoring the scope for future special distributions from the inherited estates of the CGNU Life WPSF and/or the CULAC WPSF (see paragraph 9.8.3), on the basis of the governance arrangements set out in the Main Scheme, in my opinion there is no reason to believe that the benefit expectations of holders of with-profit policies to be (wholly or partly) allocated, or reassured, to the Old WPSF on the Effective Date will be materially adversely affected by the Proposed Schemes. I do not consider that

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there are any aspects of the Main Scheme which would be likely to result in material unfairness to any group of policyholders.”

2.01.02 Policyholders’ reasonable expectations

Policyholders’ reasonable expectations of future special distributions from the inherited estate are not straightforward. Individual policyholders in these funds have no expectation that their benefits will be boosted by special distributions from the CGNU Life and CULAC inherited estate. Policyholder literature, the companies’ Principles and Practices of Financial Management and the various representations we have made to policyholders and distributors make it clear that a decision to make a with-profits investment should never have been made in expectation of any bonus from the inherited estate.

None the less, it is clear that if any such distribution is made, then policyholders as a whole do have a right to 90% participation. Thus, policyholders have a right contingent on special distributions which may or may not occur. This uncertainty is deepened by a number of factors:

- Management is not under a duty to manage the inherited estate in a way that maximises special distributions from the inherited estate
- There is no need for a particular distribution to be made to any individual policyholder
- Changes in investment conditions
- The number, type and value of new policies being written
- The termination, alteration or exercise of policyholder options
- Changes in bonus rates
- Changes in the experience of funds
- Actions taken by an individual policyholder.

In addition, and perhaps surprisingly, the likelihood of a distribution is also governed by the decisions of other policyholders – so for example if actual experience deviates from planned performance in terms of particular surrenders of policy cohorts, this could lead to a change in the inherited estate, and thus of the chance of a special distribution.

Aviva considers that it is impossible to value any individual’s right to a special bonus. It is accepted that for current with-profits policyholders in aggregate, their expectation of a special distribution over the lifetime of their policies is not zero, but there is no accurate method to value that expectation since it is dependent on a number of factors over which Aviva has little or no control. However for the purposes of the reattribution, Aviva has constructed a model to attempt to estimate the value of these future special distributions as described further below.

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2.01.03 Value of Potential Distributions to Policyholders (VPDP)

Aviva developed a methodology to help assess whether the PIP offer is better value for particular groups of policyholders than the alternative of waiting for possible future special distributions. This methodology is described as the Value of Potential Distributions to Policyholders “VPDP”.

As future distributions depend on a range of factors¹ that interrelate and are hard to predict, consequently the methodology has significant inherent limitations and therefore cannot be viewed as the definitive answer – there is no such thing.

As a result, VPDP is viewed as giving an estimate of the amount which groups of customers might potentially receive as future special bonuses. It is calculated using assumptions that we consider to be reasonable assessments of what might happen over the next 25 years, although inevitably unforeseen circumstance (both beneficial and detrimental) in the future could, with the benefit of hindsight, make these assumptions look unrealistic.

As VPDP is an average of values determined across a wide range of possible scenarios it is not a suitable basis for individual customer decisions or for individual PIP allocation. Its value is in providing management with a useful tool to help them – as part of a range of considerations – to ensure that their proposals and recommendations are fair.

In summary, VPDP gives a reasonable guide to which groups of policyholders seem likely to be better off by electing to accept the reattribution offer.

2.02 Independent Expert’s Conclusions

Section 9.0 of the Independent Expert’s report addresses “With-profit benefit expectations of holders of policies to be allocated to the Old WPSF”.

A summary of his conclusions follow, a copy of the full report from the Independent Expert is available to policyholders on request.

The Independent Expert concluded:

“In arriving at the conclusions set out below I have placed reliance upon the effective operation of the governance arrangement set out in the Main Scheme, the Actuarial Function Holder’s report and the With-Profits Actuary’s report.

I am satisfied that the proposed allocation of transferring policies and transferring long term insurance liabilities between the Old WPSF, the New WPSF and the RIEESA is reasonable. I am also satisfied that the allocation of transferring long term insurance assets as between the Old WPSF on the one hand, and the New WPSF and RIEESA on the other hand, is fair. In the light of the current role of the inherited estates of the CGNU Life WPSF and the CULAC WPSF, I consider the requirements under the Main Scheme regarding the provision of capital support by RIEESA to the Old WPSF to be appropriate.”

¹ These factors include, for example, new business volumes, market performance, management actions, and the pattern of individual policyholders’ own decisions

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“Having regard to the current management of the CGNU Life WPSF and the CULAC WPSF, I consider that the principles and practices set out in the Main Scheme, the Actuarial Function Holder’s report and the With-Profits Actuary’s report applicable to transferring policies to be allocated, or reassured, to the Old WPSF regarding the future determination of asset shares, Equity Backing Ratios (EBR) for asset shares, regular bonuses, final bonuses, smoothing and other aspects of the determination of payouts from asset shares and payouts for with-profit policies for which asset shares are not calculated, are capable of providing adequate protection for the interests of holders of those policies. To the extent that these principles and practices change past or present practice as a result of the Main Scheme I consider these changes to be appropriate. I also consider that the changes necessary to give effect to the Main Scheme are included.”

“I consider the applicable governance should in principle be sufficient to ensure that such changes will not adversely affect the security or benefit expectations of holders of policies allocated, or reassured, to the Old WPSF.”

“Ignoring the scope for future special distributions from the inherited estates of the CGNU Life WPSF and/or the CULAC WPSF (see paragraph 9.8.3), on the basis of the governance arrangements set out in the Main Scheme, in my opinion there is no reason to believe that the benefit expectations of holders of with-profit policies to be (wholly or partly) allocated, or reassured, to the Old WPSF on the Effective Date will be materially adversely affected by the Proposed Schemes. I do not consider that there are any aspects of the Main Scheme which would be likely to result in material unfairness to any group of policyholders.”

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3.00 Basis for Allocation of the Inherited Estates of CGNU Life and CULAC

From a policyholder perspective, the inherited estate allocation basis should aim to:

- Broadly maintain equivalent security of policyholder benefits between the OWPSF and NWPSF (considered together with the RIEESA) on a standalone basis;
- Maintain the aggregate VPDP for non electors as a whole at the point of transfer;
- Ensure that the OWPSF and the NWPSF can be run in a manner consistent with the operation of the with-profits funds of CGNU Life and CULAC prior to the reattribution, for example in terms of EBR and bonus setting, and in a consistent way with how the CGNU Life and CULAC funds were operated prior to the reattribution.

It is imperative that the basis for allocating the inherited estates between the OWPSF and NWPSF reflects the primary purposes of the inherited estate (from the perspective of existing policyholders) namely providing security for policy benefits and investment freedom. Any other basis that did not achieve this outcome would be considered unfair.

Having said this, it is reasonable to expect that the VPDP for non-electors as a whole should be broadly preserved by the reattribution when tested under a wide range of take-up scenarios. The inherited estate allocation will accommodate both factors.

3.02 Inherited Estate Allocation Basis

Broadly speaking, the allocation of the CGNU Life and CULAC inherited estates between the RIEESA and the Old WPSF will be pro rata to PIP paid to electors and PIP declined by non-electors.

This works as follows, firstly:

- If the aggregate cost of the PIP paid to electing policyholders is X; and
- The aggregate amount of the PIP which would have been paid to non electors whose policies are allocated to the OWPSF is Y; then
- $100 \times X / (X + Y)$ % of the estate will be allocated to the RIE; and
- $100 \times Y / (X + Y)$ % of the estate will be allocated to the OWPSF.

This calculation will be based on the size of the inherited estate at the Effective Date and valued in accordance with the basis used to determine Aviva UK Life's published realistic balance sheet.

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Initial scenario testing and analysis of this basis showed us that it was not possible to confidently confirm that VPDP for non-electors as a group had been preserved in a sufficiently wide range of voting patterns. The safety net mechanism was therefore developed to mitigate this risk.

Secondly the “safety net” mechanism described below is applied.

3.03 Safety Net Mechanism for Non-Electors

The safety net mechanism is designed to ensure that VPDP for non electors and the ‘Old WPSF Proportion’ of the VPDP determined for transferring ineligible with-profits policies, determined as a whole is maintained at the point of transfer (the Effective Date).

The safety net mechanism is designed to broadly work as follows:

- The VPDP is determined for with-profits policies of the Old WPSF as a class immediately before and immediately after the effective date of the scheme.
- Calculations of VPDP will be based on Aviva’s view of:
 - The size of the inherited estate on the Effective Date valued in accordance with the basis used to determine Aviva UK Life’s published realistic balance sheet
 - Assumed future new business based on the average of the 3 years new business immediately prior to the effective date, with projected growth at -10% p.a.² after the first year.

If, as a result of performing these calculations, the VPDP for with-profits policies of the Old WPSF is reduced by the reattribution, then the OWPSF inherited estate will be increased (via a transfer of assets from the RIEESA) by the amount required to bring the with-profits policies of the Old WPSF VPDP up to 100% of the pre-effective date VPDP (subject to a maximum transfer of £100m).

In the vast majority of the scenarios tested the aggregate VPDP for non-electors is higher than it would be without the reattribution. This testing has also highlighted that as the mechanism is based on assessment of cash flows, in some circumstances it is possible that the addition of the safety net mechanism payment could in itself drive the size of the OWPSF inherited estate to exceed the upper end of the risk appetite preferred range of surplus.

Immediate distribution of such amounts would unfairly treat those longer term policyholders that the safety net is designed to protect and therefore a mechanism to defer any such distributions is required in order to address this issue.

3.04 Effective Date Benefit Security Factor (BSF)

Since the primary purpose of the inherited estate (from the perspective of existing policyholders) is to provide security for policy benefits and investment freedom to policyholders, the allocation of the inherited estate is subject to a “true-up” adjustment which is designed to ensure that the financial strength of the OWPSF and NWPSF (considered together with the RIEESA) are sufficiently similar.

² N.B. this is not Aviva’s best estimate forecast of new business, it is the rate selected to ensure that we could confidently predict that the mechanism was robust enough to preserve VPDP across a wide range of voting patterns

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The measure of financial strength used for this purpose is the Effective Date Benefit Security Factor (BSF) which is the probability of the fund being able to meet its obligations to current policyholders when they fall due.

To ensure that electing policyholders benefit security is not unduly affected it is necessary for the BSF test to be applied after the safety net is calculated.

The BSF test specified in the Scheme requires the Old WPSF to provide a contingent loan (the “BSF Loan”) to the RIEESA if the benefit security factor (BSF) determined for the OWPSF on the Effective Date exceeds that of the NWPSF (considered together with the RIEESA) by more than 0.5%. The market value of the assets loaned will be that which will result in the BSF of the OWPSF being exactly 0.5% higher than that of the NWPSF. However, the amount loaned will be further restricted to the extent that the VPDP calculated for OWPSF with-profits policies immediately after the Effective Date excluding the amount to be loaned would otherwise be lower than the VPDP determined for such policies immediately prior to the Effective Date. In particular, if the VPDP safety net results in a transfer of assets from the RIEESA to the Old WPSF then no such contingent loan will be provided.

In addition, if the OWPSF Bonus Amount (see below) determined as at the Effective Date is non-zero then the amount of any such loan will be recalculated after excluding assets of the inherited estate of the OWPSF with market value equal to the OWPSF Bonus Amount (which will reduce the BSF of the OWPSF on the Effective Date, and hence the amount of any such loan).

Any such loan will be contingent in the sense that repayments must be made if the financial strength of the NWPSF (considered together with the RIEESA) (determined as specified in the Scheme) exceeds ‘AAA’.

Releases from the RIEESA to the AVLAP shareholder are not permitted if the loan (if made) has not been repaid in full.

3.05 OWPSF Bonus Amount

The mechanism to avoid the possibility of potential immediate distributions from the OWPSF as a result of the application of the safety net (and after the BSF test) will broadly operate as follows:

- Following any safety net addition (and after the BSF test), should the OWPSF estate exceed 100% of the funds’ AAA Capital Requirement then the excess (the “OWPSF Bonus Amount” or “OBA”) will be set aside in a separate account in the OWPSF to distribute to policyholders at a future date, the effect of which will be to reduce surplus to 100% of the AAA Capital Requirement;
- Eligibility to participate in distribution(s) of the OBA is restricted to those with-profits policyholders transferring to the OWPSF at the effective date and which are still in force at the date(s) of distribution, i.e. the post-effective date new business allocated to the OWPSF will not benefit from the OBA;
- The OBA cannot be distributed for at least 3 years after the Effective Date. After this period, the OBA will be paid-out through one or more distributions, the timing and allocation of

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which, in accordance with the normal operation of the funds, will be decided by the Boards of AVLAP after taking into account the views of the With-Profits Committee.

- The With-Profits Committee will be obliged to consider on an annual basis (after the 3 year initial period) whether a distribution of all or some of the OBA should be made and advise the AVLAP Board accordingly. The Board will decide whether or not a distribution will be made.

We consider this mechanism to be fair since, absent a reattribution, the prospect of a distribution from the inherited estates of CGNU Life and CULAC in the next few years would be extremely unlikely (given the recently announced special bonus and the current poor market conditions).

In the event that the inherited estate allocation basis inadvertently took the fund strength over AAA, the mechanism could be considered to have artificially generated a distribution that would otherwise not have been possible.

Immediate distribution of such amounts would unfairly treat those longer term policyholders that the safety net is designed to protect and therefore a mechanism to defer such distributions is required in order to address this issue.

When looking at whether to make a distribution, the Board is required to take account of:

- the reason the OBA is there (including those policyholders who should benefit),
- the current fund strength and
- prevailing market conditions

All of which will be crucial factors in deciding when to actually distribute the OBA. It is therefore not possible at this stage to be more precise about exactly when the distributions will occur, save to say that the With-Profits Committee will be required to regularly consider whether it is appropriate to distribute.

3.06 Why is this approach fair to non-electing policyholders?

If the take-up of the PIP is close to being uniform, i.e. limited difference between the mix of electors and non-electors then there would be little, if any, effect on non-electing policyholders from employing an alternative to a liability or PIP based allocation. As a consequence, our analysis focused on the effects of the “pro rata to PIP” basis in several scenarios where take-up is non uniform.

The range of assumptions tested against each of these scenarios which have helped in the assessment of the fairness of the inherited estate allocation mechanism to non-electing policyholder gave 110 possible outcomes. A proportion of these scenarios were selected to be deliberately extreme in order to stress test the approach.

The analysis results showed that in the vast majority of situations the aggregate VPDP for non-electors as a group has been adequately protected. In addition the analysis showed that benefit security of non-electors is also protected across all our tested scenarios. Aviva therefore concludes this offer to be fair to non-electors.

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All eligible with-profits policyholders will have the opportunity to vote no and retain their current rights. The Scheme aims to ensure that all policyholders will retain the benefit security offered by the inherited estate regardless of whether they elect. The basis proposed for the allocation of the inherited estate ensures that, regardless of the mix of non-electors and electors, the VPDP for non-electors as a whole will be broadly preserved.

The full analysis results have been shared with the Office of the Policyholder Advocate and the Financial Services Authority (FSA).

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

4.01 Potential Adverse Effects of the Reattribution Proposals

4.01.01 The Amount of Inherited Estate Allocated to the OWPSF

It is agreed that the PIP offer is sufficient to cover the estimated aggregate value of potential special distributions for all eligible policyholders across a wide range of economic and new business scenarios. The question then is whether the allocation basis used to allocate the aggregate PIP is fair.

Aviva considers that it is impossible to value any individual's right to a special bonus and therefore the allocation basis adopted will always involve some approximations – the Policyholder Advocate also acknowledges that this is the case in her appendix.

VPDP has continued to fall as a result of the falling markets, highlighting the uncertainty of the value of current policyholders' potential interest in the inherited estate – this fact is again acknowledged by the Policyholder Advocate in her appendix on this topic.

We note that the Office of the Policyholder Advocate has stated that they agree with the concept of the OBA; however they have some reservations with the three year deferral period applied to the OBA. From our perspective the eventual distribution of the OBA is not simply a matter of process and prevailing economic conditions at the time (amongst other things) will need to be considered. If the Policyholder Advocate's view was accepted, it would result in a worrying loss of flexibility to react to the then current market conditions.

Protections have been provided to policyholders through the With-Profits Committee's (WPC) obligation to consider its recommendations to the Board on an annual basis (after the 3 year initial period) about whether a distribution of all or some of the OBA should be made and the Board's duties to consider why the OBA was originally set up in making its decision on whether to distribute or not.

4.01.02 Management of the OWPSF

The Office of the Policyholder Advocate's paper has acknowledged that there are some valuable protections for policyholders written into the Scheme, they also go on to highlight some instances where the treatment of the OWPSF and NWPSF (plus RIEESA) differs from the general principle of a single fund approach.

The difference in treatment between the OWPSF and the NWPSF in this respect comes first from the principle that Aviva should be able to carry on managing the funds in the way it would have done in the absence of the Scheme and thus if it could effect internal reinsurance from the CGNU Life and CULAC WPSFs before the reattribution, it should be able to do so after the implementation of the Scheme.

Specific protections have been introduced for the NWPSF since this is in a different position with the greater potential for conflict between shareholders and policyholders because of its structure. Nevertheless, there are provisions in the Scheme that provide sufficient additional protection to the

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OWPSF (which complement the existing protections provided under Conduct of Business Sourcebook (COBS) rules and Treating Customers Fairly (TCF)):

- reinsurance to the OWPSF shall be approved by the WPC
- reinsurance between an Aviva Group Company and the OWPSF is subject to the prior approval of the WPC.

The PHA welcomes the establishment of the WPC under the Scheme although there are some differences between the parties on the extent of the WPC's role. Aviva's views on the extent of the powers for the WPC proposed by the Policyholder Advocate have been covered in the appendix "With-Profits Governance Arrangements" and are therefore not repeated in detail here. In summary, the role of the WPC is to provide independent oversight and challenge to the management of the with-profits funds, if additional powers were granted to the WPC there is a danger that the committee could effectively become part of the company's management of the funds and thus the committee would no longer be independent in nature.

Under the provisions of the Scheme, AVLAP remains in a position to comply with contractual terms and use the benefit of any options etc it has in place before the reattribution without requiring additional WPC approval. The Management Services Agreement, the IMAs and any rights or options arising in respect of investments are examples of contracts that will be in force on the Effective Date. Arrangements existing prior to the Effective Date cover internal reinsurance arrangements between funds and the terms of those - which will not affect the OWPSF since it was not in existence prior to the Effective Date and reinsurances in respect of the OWPSF are specifically covered in the Scheme. Given these facts, we are unclear why the Policyholder Advocate objects to these provisions.

We disagree with the Policyholder Advocate that the WPC should be required to provide approval to changes which the Board wishes to make and which it considers are required to continue to treat customers fairly. Aviva firmly believes that it is the responsibility of the Board to determine whether customers are being treated fairly. If the Board needs to take a course of action for TCF purposes, it is not felt to be acceptable for the WPC to have the power to veto this.

Ultimately, under their terms of reference the WPC can raise any concerns with the Board and if necessary whistle blow to the FSA.

4.01.03 Uses of the Inherited Estate in the OWPSF

Whilst we accept that the Policyholder Advocate views certain uses of the inherited estate as unfair, her views do run contrary to industry practice, current FSA rules and guidance (as set out in COBS) which were developed following an extensive With-Profits Review. During the negotiation process the Policyholder Advocate was able to challenge the FSA on these points and they have provided her with detailed clarification which shows that all of the practices and uses which Aviva applies to the inherited estates comply with COBS.

The Office of the Policyholder Advocate's suggestion that the NWPSF/RIEESA will not be making this intergenerational transfer and so it does not affect shareholders' profit on new business appears to overlook the fact that by providing capital support from the RIEESA for the writing of new business, shareholders are effectively delaying the period when releases of RIEESA could take place. So in effect there is a time cost to shareholders.

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The Policyholder Advocate's arguments also appear to overlook the benefits to existing policyholders of the funds continuing to write new business. These are discussed in the appendix "Aviva's New Business Forecasts" and so not repeated here.

4.01.04 Distribution of Excess Surplus

As set out in the appendix "Policyholders' Future Security and Risk Appetite" we fundamentally disagree with the Policyholder Advocates desire to weaken the mandatory levels at which distributions should be made through making changes to the risk appetite.

Aviva accepts that the Office of the Policyholder Advocate has sought to challenge the level of the risk appetite for the purposes of the PIP negotiations, but finds it surprising (particularly in the current turbulent economic circumstances) that they appear to be suggesting that a weakening of the mandatory levels at which distributions should be made is desirable.

One of the factors that has attracted investment in the CGNU Life and CULAC funds is their long-term financial strength. The risk appetite framework formalises the approach that has been followed by the Board in the running of the funds for many years. Indeed, if the Board were to increase the risk in the funds following the reattribution they would arguably not be treating customers fairly (by not keeping their promises) and fall foul of one of the key outcomes used by the FSA to judge the appropriateness of reattribution transactions – "Ignoring the scope for future distributions, policyholders' benefit expectations are no worse under the proposals than if the reattribution does not take place"³. Given the current economic volatility (and the failure of a large number of financial institutions) the Boards can see no justification for the suggestion that the management of the funds should be changed in this respect.

³ House of Commons Treasury Committee. Inherited Estates: Financial Services Authority and Office of Fair Trading Responses to the Committee's Twelfth Report of Session 2007-08

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5.00 References

- Investment Policy, Smoothing and Bonus policy
- Principles and Practices of Financial Management (PPFM) for CGNU Life Assurance Limited & Commercial Union Life Assurance Limited (CGNU/CULAC)