

## **Appendix 32 B**

### **The Position of Non-electing Policyholders**

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

If the reattribution proposal proceeds, only those who elect to receive the policyholder incentive payment (PIP) will have their policies transferred to the New With-Profits Sub Fund (NWPSF). Non-Electing Policyholders will have their policies transferred to the Old With-Profits Sub Fund (OWPSF). When, as in this case, a reattribution is proposed to be achieved in conjunction with an insurance business transfer scheme, governed by Part VII of the Financial Services Markets Act 2000, the FSA's conduct of business rules (COBS 20.2.51) require that with-profit policyholders are given the option individually to accept or reject a reattribution proposal. To ensure that policyholders are treated fairly, it is therefore important that the rights and interests of those policyholders who reject this reattribution proposal should to the greatest extent practicable remain as they were had the reattribution not taken place. The FSA supports this principle.

The policyholder advocate's role has included negotiating with Aviva to ensure that the non-electing policyholders' rights and interests are, so far as practicable, unaffected (as a minimum) or enhanced. She is satisfied that, with the possible exception of shareholders tax referred to below, this outcome has been achieved.

This appendix explains how the policyholder advocate has approached this issue, how her role in this respect and that of the independent expert inter-relate, and how she has reached the above conclusion. It takes into account (and constitutes where relevant a response from a legal and actuarial perspective to) the appendix of the same name prepared by Aviva.

Annexe 1 to Appendix 16B contains correspondence between the policyholder advocate and the FSA about certain aspects of the Scheme that are of concern to the policyholder advocate. The policyholder advocate's letter of the 13 March identified the relevant aspects of the Scheme and asked the FSA whether it considered that any of them merited further discussion as part of the FSA's fairness review. The FSA responded on the 25 March indicating that the FSA did not think there was anything in the policyholder advocate's letter which would cause the FSA to change their view of the Scheme.

## **2.00 The structure of the scheme**

Policyholders who do not elect for the Policyholder Incentive Payment (PIP) will have their policies transferred to the OWPSF, together with assets with a value sufficient to cover the realistic liabilities attributable to their policies and their attributable proportion of the inherited estates in the CGNU Life and CULAC with-profits funds (determined by reference to the proportion of the total PIP offered that was attributable to the non-electing policyholders, but subject to adjustment as explained further below).

Policyholders who do elect for the PIP will have their policies transferred to the NWPSF, together with assets with a value sufficient to cover the realistic liabilities attributable to their policies, and sufficient additional assets to ensure that the NWPSF is self-sufficient in terms of regulatory capital. The remainder of the inherited estates of the CGNU Life and CULAC with-profits funds (i.e. that which has not been allocated to the OWPSF or the NWPSF) will be transferred to the Reattributed Inherited Estate External Support Account (RIEESA), where it will continue (until distributed to shareholders in the future, under the terms of the Scheme) to be available to provide security for policies allocated to both the NWPSF and the OWPSF.

The Scheme contains detailed rules for the allocation of liabilities existing at the Effective Date of the reattribution and the transfer as between AVLAP's various funds (including the OWPSF and NWPSF) and for the allocation of assets and liabilities that arise in the future. It also contains detailed principles of financial management which govern the future management of the OWPSF, NWPSF and RIEESA (and in particular the writing and allocation of future new business, and future bonus and investment management policy), and rules for the calculation and distribution of future excess surplus from the inherited estates in the OWPSF and RIEESA.

### **3.00 Impact of the scheme on non-electing policyholders**

#### **3.01. How might a policy transfer to AVLAP be adverse for non-electors<sup>1</sup>?**

Under the Scheme, which covers both the reattribution and the fund transfer, all eligible policyholders, whether or not they elect to receive the PIP, will have their policies transferred to AVLAP, together with all of the with-profit fund assets. From a structural perspective, therefore, following the fund transfer all policyholders will have a change in the entity that insures their benefits, and this has the potential to change their position. However the significance of the change for policyholders who do not elect for the reattribution depends principally on the financial strength of AVLAP prior to the transfer, as compared with that of the CULAC and CGNU with-profits funds, and on how non-electing policies and their related assets are to be allocated and managed by AVLAP after the transfer.

Non-electing policyholders could in theory be adversely affected if either:

- (a) the financial condition of AVLAP after the transfer is such that the risk that AVLAP will not be able to meet guarantees in their policies is greater than the risk currently run with respect to CGNU Life or CULAC with-profits funds;
- (b) the financial condition of AVLAP, or of the sub-fund to which the relevant policies are allocated under the Scheme, is such that the AVLAP Board will be forced to adopt a less generous bonus policy, or a more constrained investment policy, than would have been the case in relation to CGNU Life or CULAC with-profits funds;
- (c) the effect of the transfer is that costs and expenses that can reduce transferring policyholders' benefits are increased, either because the cost base of the transferee group is inherently higher, or its ability to absorb cost-overruns without charging them to policy assets is lower, than is the case with CULAC

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<sup>1</sup> This appendix is focussed on the position of those who do not elect for the reattribution offer. But certain of the issues that may be adverse for non-electors will be of concern for electors too.

or CGNU Life with-profits funds, or the terms of the Scheme provide for a higher level of costs and expenses to be charged than is currently the case;

- (d) the terms of the fund transfer, and in particular the manner in which assets and liabilities are allocated within AVLAP are such that surpluses which policyholders might otherwise have expected to participate in (including distributions to non-electors from the inherited estates) will no longer be available to them, or the likelihood of their benefitting from such surpluses will be reduced; or
- (e) the AVLAP fund to which their policy is allocated carries a higher tax rate than has been applied in CULAC or CGNU Life with-profits funds.

These potential risks for transferring policyholders have been specifically investigated by the Independent Expert (see below). He has reported that transferring policyholders will not experience a significant reduction in the level of security for their guaranteed benefits and should not suffer any material reduction in reasonable benefit expectations, and that the Scheme provides appropriate protection for the interests of transferring policyholders. His report has considered the position of holders of electing policies and that of non-electing policies separately, and has not identified any difference in terms of security and reasonable expectations between transferring policyholders who elect and whose policies are allocated to the NWPSF and those who do not and whose policies are allocated to the OWPSF.

### **3.02. Scheme provisions**

The structure of the Scheme is designed to preserve, so far as possible, the status quo after the fund transfer as regards the management of the CULAC and CGNU Life with-profits funds.

The most important exceptions to this are (a) that as a result of the reattribution the electing policyholders' proportion of the inherited estates will be reattributed to a non-with-profits fund, and (while available to provide financial support for the electing and non-electing policies) will ultimately, subject to the provisions in the Scheme for the protection of policyholders, belong to shareholders; and (b) the remainder of the inherited estates will be

allocated to the OWPSF. This raises the question whether (see below) the amount of estate allocated to the OWPSF is an adequate reflection of the interests that non-electing policyholders would have had in special distributions from the inherited estates in the absence of a reattribution.

Otherwise bonus, investment allocation, charges and expenses and other relevant discretions that can affect the returns enjoyed by policyholders are intended to be unaffected by the transfer (and to remain consistent for electing and non-electing policies). Moreover, in some respects the current policyholders' position is improved, such as:

- (a) the Scheme strengthens the position of the With-Profits Committee (a majority of whose members are independent), containing a series of detailed principles and practices of financial management, and other restrictions (including a codification of the funds' risk appetite), exceptions or changes to which will require approval by that Committee. This governance structure will place significant restrictions on the ability of Aviva to make future changes in the management of the funds which might be adverse to policyholders' interests;
- (b) the affordability conditions to the mortgage endowment promise made to certain endowment policyholders will be removed, as referred to in Aviva's Appendix 32A on the position of non-electing policyholders (albeit that this increases the cost of this promise to the fund) ; and
- (c) the Scheme requires that, with the exception of certain development costs, only expenses or charges of a type that were being deducted prior to the effective date of the Scheme can be deducted from asset shares of transferring policies after the effective date. However the Scheme expressly provides for the possibility of industry levies being charged to policyholders' asset shares, if the Board considers it appropriate to do so, and subject to the overriding requirement to treat policyholders fairly. If inclusion of this item in the Scheme made it easier for the firm to prove that charging such levies was fair, this

would represent a worsening of the policyholders position by comparison with the status quo, and this would be of particular concern to non-electors. Aviva's stated intention in including the right to make this charge in the Scheme is that the analysis of fairness should remain as it would have been in the absence of the Scheme and that this ensures that policyholders' position in relation to this aspect is not made worse as a result of the Scheme. The policyholder advocate also considers that policyholders interests should be further safeguarded by requiring the WPC to approve such a charge

### **3.03. The Role and Conclusions of the Independent Expert**

While the purposes behind the structure of the Scheme are clear, this still leaves the question whether these are achieved, or whether the financial condition of AVLAP, the reattribution of the "electors' proportion" of the inherited estate in favour of the shareholders, or any other of the detailed provisions of the Scheme could result in any of the adverse effects identified in section 3.01.

In this respect it is important to note the role of the Independent Expert. His detailed terms of reference are set out in his report, and it is clear that his role requires him to consider whether any of the adverse effects identified above are likely to occur.

As noted above, the Independent Expert has concluded that transferring policyholders will not suffer a material reduction in the level of security for their guaranteed benefits and should not suffer a material reduction in reasonable benefit expectations, and that the Scheme provides appropriate protection for the interests of transferring policyholders..

His report has considered the position of holders of electing policies and that of non-electing policies separately, and has not identified any difference in terms of security and reasonable expectations between transferring policyholders who elect and whose policies are allocated to the NWPSF and those who do not and whose policies are allocated to the OWPSF.

The Independent Expert has also looked specifically at the question whether the Scheme could have a material adverse effect on non-electors' interests in future distributions from the

inherited estates, as compared to the position in the absence of a reattribution. He has concluded that there could potentially be such effects, but that given the level of uncertainty surrounding such distributions in the absence of a reattribution, and having considered the circumstances in which such adverse effects may arise, he does not consider that they are likely to result in material unfairness to any group of non-electing policyholders.

The role of the Independent Expert potentially duplicates that of the policyholder advocate to some extent. Although he has no mandate to negotiate the terms of the reattribution on behalf of policyholders, his expert review of the Scheme for purposes of his report covers some ground that the policyholder advocate would otherwise have to cover herself in order to inform policyholders whether the firm's proposals are in their interests (COBS 20.2.44). In giving her guidance to policyholders the policyholder advocate has adopted the conclusions of the Independent Expert as regards the impact of the Scheme on security of policy benefits and normal bonus expectations.

In this connection, KPMG has reviewed and commented on the report of the Independent Expert, (see Appendix 19) and has had a number of discussions with him and his team, and KPMG has examined in particular the effect of the Scheme on Investment Policy and Smoothing and Bonus Policy, (see Appendix 29B). However, it is important to note that KPMG has not duplicated the detailed investigation carried out by the Independent Expert which would have been necessary in order independently to confirm his conclusions.

## **4.00 Particular issues for non-electors**

The policyholder advocate has reviewed certain aspects of the Scheme in particular, as they had potential to be adverse to the interests of non-electing policyholders. These are as follows.

### **4.01. The amount of Inherited Estates allocated to the OWPSF**

The Scheme divides the inherited estates of the two funds in the same proportions as the aggregate amount of PIP that is accepted by electing policyholders bears to the aggregate amount of PIP that is rejected by non-electors. The proportion attributable to the non-electors

is allocated to the OWPSF, and is potentially distributable in the future in the form of special distributions for the benefit of policies allocated to that fund.

This is a logical way of dividing the estates in a context where the PIP offer is broadly formulated to purchase the interests which electing policyholders have in the inherited estates.

However, in normal circumstances, any special distributions from the estates would not arise immediately and in a single lump sum. They would be likely instead to arise over a period of years, and be distributed over that period to the policyholders who were then eligible to share in them, probably on the basis of their respective asset shares or possibly on the basis of their sums assured and attaching bonuses. Appendix 43 (Allocation of the aggregate PIP between policyholders) explores in more detail the extent to which the way in which the PIP offer is allocated among eligible policyholders differs from the way in which the inherited estates would be likely to be distributed between policyholders in various scenarios, in the absence of a reattribution.

It follows that policyholders with longer maturities might legitimately argue that were the inherited estates in CGNU Life and CULAC allocated to the NWPSF and OWPSF in a fashion that reflected only a “non-reattribution” distribution pattern, rather than the one-off 100% distribution implied by the allocation methodology under the reattribution, a larger proportion of it would be allocated to the OWPSF than under the allocation method contained in the Scheme. Policyholders with longer terms to maturity could also in theory argue that the allocation of the inherited estates between the OWPSF and NWPSF does not fully allow for the fact that after the pre-reattribution special bonus distribution taking place in 2008, 2009 and 2010, Aviva has said that no further distributions of the inherited estates can be expected in the medium term. If there were no reattribution, those policies with shorter terms to maturity would be very unlikely to receive any further distributions of inherited estates, and their share of the estates would therefore remain in an enlarged with-profits funds “pot” potentially increasing future special distributions for policyholders with longer maturities.

It is worth noting that if the mix of business for electing and for non- electing policyholders is the same in terms of outstanding terms to maturity and levels of asset shares etc, then the

position of non-electing policyholders with regards to possible future distribution of the inherited estates would be unchanged, as there would be a strictly proportionate allocation of the estates between the two new sub-funds.

The policyholder advocate however believes that it is unlikely that the mix of policyholders not electing and whose policies are then allocated to the OWPSF will be the same as those electing to go into the NWPSF; in particular she would expect those whose policies have shorter outstanding periods to be particularly motivated to elect for the PIP offer, whilst those with longer to wait until maturity may be tempted to “wait and see”. Hence it is unlikely that the expectations of the policyholders in the OWPSF with respect to future distributions of the estates will be precisely the same as they would have been absent the reattribution.

Aviva’s offer has acknowledged these issues by adjusting the PIP allocation basis (which will also affect the estate allocation basis) to give more weight to policies with longer maturities. However, it is true that no single method of PIP allocation (and hence of estate allocation) can correctly reflect the entire range of possible future non-reattribution outcomes. A reattribution inherently involves the once-and-for-all division of the pre-existing inherited estates between those who do wish to elect for the reattribution offer and those who do not, and there is no basis of division that can be certain to replicate for each relevant policyholder the value of the special distributions from those estates that the policyholder might otherwise have received in every conceivable future scenario. A degree of approximation is inevitable and there is a clear possibility, even probability, that the reattribution will result in some policyholders doing somewhat worse than they might otherwise have done, while others do rather better.

The policyholder advocate has had detailed discussions on this aspect with Aviva, who recognised the need to be able to assure those who do not accept the reattribution offer that their interests in future special distributions have been properly protected. To this end the Scheme includes what is called the VPDP (Value of Potential Distributions to Policyholders) Adjustment. Once it is clear who has and who has not elected for the PIP, and what proportion of the inherited estates will be allocated to the OWPSF under the basic allocation method described above, the present value of non-electors’ future special distributions will be

estimated (using the average level of projected distributions from stochastic projections of the development of the relevant business over a period of 25 years by reference to a number of assumptions as to the level of claims, level of new business, investment returns and other matters as further described in the Actuarial Function Holder's Report). If these projected distributions are less than it is forecast that they would have been in the absence of the reattribution, then the inherited estates in the OWPSF will be topped up by shareholders (subject to a maximum of £100 million) as necessary to maintain that estimated present value.

Also under the Scheme, if there is more than a certain difference between the financial strength of the OWPSF on the one hand, and the NWPSF and RIEESA taken together, on the other, a payment has to be made from the stronger to the weaker. Clearly, if the result of this benefit security adjustment could be that the VPDP Adjustment is reversed, then the necessary protection for non-electing policies' future special distributions would not be achieved. However, Aviva has agreed both that the benefit security adjustment will not reverse or trigger the VPDP Adjustment and that the adjusting benefit security payment (if any) should be made by way of contingent loan, which means that if the adjustment is not in the event required to be paid out to policyholders allocated to the NWPSF, the amounts will revert to the OWPSF. This ameliorates the essential potential unfairness of an adjustment that can structurally only be in favour of the NWPSF, given that in measuring benefit security the OWPSF has the advantage of the RIEESA if necessary.

LECG has studied Aviva's VPDP Adjustment proposals and the detailed financial modelling that underlies Aviva's proposal in this regard, and its conclusions can be found in Appendix 44 (The Position of Non-Electing Policyholders). LECG's overall conclusion is that Aviva's proposals will provide adequate protection for non-electing policyholders.

Another feature of the VPDP adjustment is that this one-off transfer might in and of itself result in the OWPSF becoming sufficiently strong that the obligation to make a compulsory special distribution is triggered earlier than would have been the case if the reattribution and the one-off VPDP adjustment had not occurred. The policyholder advocate agrees with Aviva's view that this would not be appropriate, and she therefore has no objection to

provisions in the Scheme that allocate the amount of any excess that would otherwise be distributable to a separate account known as the OWPSF Bonus Amount (OBA). This amount is to be distributed to non-electing policyholders in the future, on a basis determined by Aviva in consultation with the With-Profits Committee. As referred to in Appendix 16 B, however, the terms of the Scheme also apply the OBA approach even if there has been no VPDP adjustment, and the policyholder advocate sees no justification for this.

Aviva has proposed that no distributions at all should be made from the OBA until the third anniversary of the reattribution. Although this is not a material reservation on her part, the policyholder advocate would prefer that there be no arbitrary restrictions on distribution of any OBA and that instead a specific programme be agreed for the distribution of the OBA in the Scheme.

Nevertheless, based on the review carried out by LECG, and recognising that it is not in fact possible to devise a basis on which the inherited estates can be shared that maintains all policyholders' present value of future estate distributions in all conceivable circumstances, the policyholder advocate is in general content that the Scheme now provides proper protection, as regards the opening size of the inherited estates in the OWPSF, for those who choose not to accept the PIP offer. Although she has reservations (as described above) on the manner in which Aviva plans to restrict the distribution in early years of the OBA, and on the application of the OBA approach even if there is no VPDP adjustment, those reservations do not materially affect her views on the protection the Scheme provides to non-electors.

#### **4.02. Management of the Old With-Profits Sub Fund**

The OWPSF having had allocated to it the appropriate amount of the inherited estates, the non-electors' remaining concern is that the management of the OWPSF will be such as to maintain their interest in the funds, including their interest in possible future special distributions from the inherited estates.

The rules for the management of both the OWPSF and the NWPSF are set out in Schedule 4 to the Scheme, the "Scheme Principles of Financial Management". These broadly provide for the With-Profits sub funds (WPSFs) to be operated as if they were a single fund as regards

new business (in particular, with-profits business), bonuses (except special distributions) charges and expenses, and investment policy.

The policyholder advocate considers that this is a valuable protection for non-electing policyholders because policyholders would expect continuity of the previous pre-retribution management approach for these aspects. Also non-electing policyholders can take comfort from the fact that Aviva, having paid for the inherited estates attributable to the electing policyholders, will be keen to safeguard its investment. It follows that if all the significant discretionary decisions in with-profit fund management must be exercised as if the OWPSF, the NWPSF and the RIEESA were a single fund, this will generally ensure that the shareholders' interest to minimise inadequately remunerated risk to its investment in the RIEESA (and to achieve access to it as soon as possible) will be aligned with the non-electing policyholders' interest to maximise and accelerate special distributions from the inherited estates in the OWPSF.

There are certain exceptions to the "single fund" approach referred to above, and some circumstances where this approach may not, in the policyholder advocate's opinion, provide appropriate protection for non-electing policyholders. These are not in the aggregate sufficient to displace the policyholder advocate's overall conclusion that the non-electing policyholders' rights and interests are, so far as practicable, unaffected (as a minimum) or enhanced as a result of the Scheme, but they nevertheless merit comment. In particular:

- (a) the policyholder advocate has pressed, unsuccessfully, for the rules in the Scheme which allow the OWPSF and NWPSF to be reinsured by other funds within Aviva or the Aviva group, to provide both the WPSFs with the protection of With-Profits Committee approval of such reinsurance arrangements. At present only the NWPSF has this protection. Most forms of "connected party" reinsurance are required to be approved by the With-Profits Committee so it is odd that an exception has been made for reinsurance out by the OWPSF alone. Aviva's response to this point is that it is consistent with the

position prior to the reattribution, and that it would in any event be bound by the obligation to treat customers fairly in relation to any such reinsurance;

- (b) the policyholder advocate considers that in all circumstances where either the NWPSF or the OWPSF invests in loans to or securities of any Aviva group company, or when any policy or other liability, or any asset is transferred from another Aviva fund or Aviva group company there should be a requirement that such investment or transfer is on arms'-length terms and that the With-Profits Committee should in all circumstance be required to give its approval. However, Aviva has not agreed to this proposal. The policyholder advocate has been assured by Aviva that this reflects the current position pre-reattribution, but she would nevertheless prefer to see stronger safeguards;
- (c) more generally, as explained in Appendix 30B (With-Profits Governance Arrangements), the policyholder advocate has reservations about some aspects of the governance arrangements for the new sub-funds, and would have preferred that certain of the With-Profits Committee's rights as set out in their terms of reference from Aviva had been entrenched in the Scheme. She also believes (and intends to address this further in her supplemental report) that further disclosure on the change in the inherited estate over the year, over and above that already disclosed in FSA returns, should be made available to policyholders. Specifically she believes that there should be a flow of funds report which details movements in the estate which would explicitly include uses of the estate over the year and that the With-Profits Committee should assure policyholders that the flow of funds report fully reflects how the estate has been used during the year
- (d) there is a provision in the Scheme Principles of Financial Management which allows, without With-Profits Committee approval, the adoption of policies which bring a material benefit to shareholders which would not have been derived in the absence of the Scheme, provided that the board considers that

this is necessary in order to treat customers fairly. The policyholder advocate considers that the possibility of material benefit to shareholders creates an obvious potential conflict of interest, and so makes it important that the With-Profits Committee should be required to approve any such policy, even if the board judges that its adoption is necessary to achieve fairness.

- (e) As referred to in Appendix 16B, the policyholder advocate has concerns about a general provision that allows the continuation of pre-existing practices that would otherwise be a breach of the Scheme. Some acceptable examples of this have been provided. The policyholder advocate is not, as Aviva suggests, objecting to these practices. However, she does object to the open-ended nature of the provision that would also allow the continuation of any other practices that Aviva cannot currently bring to mind but may remember later. The policyholder advocate considers that if Aviva cannot recall any others, only the acceptable examples it has provided should be permitted as exceptions.
- (f) Aviva wrote a significant amount of subsidised business in 2007, and the inherited estate is less than it would otherwise have been but for this. This has been taken into account by Aviva in the aggregate PIP offer and by the policyholder advocate in her evaluation of the offer. However, the policyholder advocate understands from Aviva that the FSA would have required this subsidy to have been made good by Aviva increasing the size of the inherited estates had the reattribution not taken place. It follows that the inherited estate in the OWPSF should also be enhanced by its pro rata share of this shortfall, to ensure that non-electors are no worse off than they would have been had there been no reattribution. At the time of writing, Aviva has accepted this in principle, but there is continuing discussion with the policyholder advocate and the FSA as to precisely how this should be achieved

#### **4.03. Uses of the inherited estates in the OWPSF**

Clearly, the ultimate distribution of the inherited estates in the OWPSF is critically dependent on the extent of AVLAP's discretion as to the use and the retention of those estates. In Appendix 25B (Legal issues relating to the rights and interests in, and uses of the inherited estates) the policyholder advocate's legal advisers express the opinion that it is difficult to justify some of the current uses as a legal matter or as a matter of fair treatment for policyholders.

The policyholder advocate recognises that the approach proposed to be adopted to the estates in the OWPSF is in accordance with the rules, guidance and current practice of the FSA. She recognises that unless the FSA can be persuaded to adjust its position on these matters, policyholders must realistically assume that the OWPSF will be managed in a manner consistent with such rules and guidance, and should therefore discount the scale of possible future special distributions from the inherited estates in the OWPSF accordingly.

The policyholder advocate notes in this respect that one of the most significant uses (in terms of the likelihood of future distributions to non-electing policyholders from the estates) is the provision of capital support (or, as the policyholder advocate sees it, the permitted subsidy) for new with-profits business. (See Appendix 39: Impact of FSA Guidance on Policyholders) In this connection non-electing policyholders can take some comfort from the fact that new business can only be written in the OWPSF by way of pro rata reinsurance from the NWPSF, and that the shareholders will be anxious not to put the RIEESA at undue risk by selling new business which is expected to be unprofitable to shareholders.

However, there is some imbalance in the respective interests of OWPSF policyholders and shareholders in this connection. First, because the shareholders make profit on new business not just through the terms on which it is written in the NWPSF/RIEESA, but also through its ability to extract value from the charges that it levies through its investment management and service companies and also from using inherited estate capital, rather than shareholders capital to write this business. This extra profit may incline it to take more risk with the RIEESA (and, with the estates in the OWPSF), at a lower reward for the relevant funds, than would

otherwise be the case. Second, since the shareholders' 10 per cent interest in any special distributions from the inherited estates in the OWPSF is permanent (while policyholders' interests subsist only so long as their policies are in force and invested in with-profits), shareholders are less concerned about the timing of any future special distributions than individual policyholders, whose policies may mature before any distribution is made. Third, new with-profits business will also benefit from the "intergenerational transfer" of estate from the OWPSF. This has the effect of deferring (and diluting) any future special distributions to current policyholders. However, the NWPSF/RIEESA will not be making this intergenerational transfer and so it does not affect shareholders' profit on new business; it is only a cost to current policyholders. Aviva suggests that the cost arising from delayed distributions from the inherited estate to shareholders associated with retaining funds in the RIEESA as capital to support new with-profits business has a cost equivalent to that which the intergenerational transfer represents for the current policyholders. In making her assessment of Aviva's aggregate PIP offer, the policyholder advocate's assumption is that Aviva will always price new business so that this capital cost is fully recovered. Aviva is not forced to write new business if it would be unprofitable to do so

Another potential use of the estates is to pay mis-selling and other regulatory costs arising as a result of the mis-management of the funds. The Scheme contains provisions which allocate such costs for which the liability has already been incurred prior to the effective date between the OWPSF and the RIEESA pro rata to the original allocation of the inherited estates between them. The concept of allocating such costs to the inherited estates is considered inherently questionable by the policyholder advocate as referred to above. However, the allocation itself as between the sub-funds is acceptable to the policyholder advocate.

Finally and as referred to in detail in Appendix 16B (The Scheme) currently, the FSA rules permit tax on distributions to shareholders from the WPSFs to be borne by the inherited estates. It is conceivable that the FSA rules could change so that shareholders would have to bear this cost. The policyholder advocate is concerned that under the Scheme the Old WPSF policyholders could not be sure that they would benefit from such a change. Although the

possibility that FSA would not insist on this is remote, the policyholder advocate considers that the Scheme should be changed to put this beyond doubt.

#### **4.04. Distribution of excess surplus from the inherited estates**

A key aspect of the Scheme from the non-electors' perspective is Schedule 8 which contains the rules governing the calculation and distribution of excess surplus from the inherited estates.

These rules formalise Aviva's chosen approach to risk appetite for the OWPSF and NWPSF, and provide for annual investigations to establish whether there are excess assets above two thresholds:-

- (a) the Capital Release Point (or **CRP**), above which Aviva may if it wishes extract assets from the RIEESA; and
- (b) the Maximum Permitted Coverage (or **MPC**), above which Aviva must make distributions from the OWPSF.

These thresholds are required to be maintained for three successive years before a distribution can be (in the case of the CRP), or must be made (in the case of the MPC). The thresholds are 110 % (for the CRP) and 120% (for the MPC) of the market value of assets required to ensure that the fund has sufficient assets at the end of each year during the next 25 years to cover its realistic liabilities with a probability that is at least equal to 1 minus the cumulative rate of historic default for the period concerned, where the default rates are those published by Moody's for Aaa corporate bonds.

The policyholder advocate is in general comfortable with these provisions, subject only to the question (discussed in Appendix 28B Policyholder's Future Security and Risk Appetite) whether the financial strength threshold in respect of the mandatory distribution point is set too prudently, giving insufficient weight to policyholders' interest in future special distributions from the OWPSF estates.

Additional explanatory material about how the CRP and the MPC are determined is contained in the Actuarial Function Holder's report. This and the relevant provisions of the Scheme have been reviewed by KPMG, and its views can be found in Appendix 28B: Policyholders' Future Security and Risk Appetite, and Appendix 17B which provides comments on the Actuarial Function Holder's Report. In summary, KPMG considers that the manner in which the mandatory distribution point is determined could be considered prudent. It points in particular at the assumption that Aviva's desired management strategy (in particular as regards the equity backing ratio in the funds) will be maintained in all but the most extreme scenarios, which greatly increases the capital required. KPMG considers that it would be more reasonable to assume more flexibility with regard to the strategy, with a subsequent reduction in capital requirements, and accelerated distribution of excess surplus..

## **5.00 Conclusion**

With the possible exception as regards future rule changes on shareholder tax, the policyholder advocate's overall conclusion is that the non-electors' rights and interests are as far as practicable unaffected or enhanced as a result of the Scheme