

Report Number 35 A

Size of the Inherited Estates

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

In assessing the aggregate Policyholder Incentive Payment (PIP) offer to be made to eligible policyholders one of the determining factors was the size of the inherited estate.

The size of the inherited estate for CGNU Life & Commercial Union Life Assurance Company (CULAC) is the starting point Aviva uses in considering two key aspects:

- The value of the potential future distributions that eligible policyholders are being asked to give up; and
- The value created by the transaction for shareholders.

With that in mind, both the Policyholder Advocate and Aviva want to understand the size of the inherited estate and how the value has changed during the course of the negotiations.

This appendix analyses the value Aviva placed on the inherited estate at 31st December 2008 and the factors which can, and have, caused it to change over time.

The appendix will also set out how the offer that Aviva intends to make to eligible CGNU Life and CULAC with-profits policyholders will be influenced by changes in the size of the inherited estate.

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2.00 Introduction

2.01 What is the Inherited Estate?

An inherited estate is money that has built up in a with-profits fund over many generations, which is over and above the amount that is expected to be needed to meet current and future policyholder commitments and other obligations of the with-profits fund.

The FSA describes¹ inherited estates as: "The 'inherited estate' is part of the with-profits fund. Generally, it is that part of the with-profits fund over and above the part required to meet realistic liabilities that the firm nevertheless retains for commercial reasons. For example, to ensure it has a strong capital base or to fund future growth plans. The inherited estate provides working capital for the with-profits fund in the longer term and supports its operation. In most with-profits firms, the inherited estate has built up over many years. It is usually made up of previous and current policyholders' premiums and investment returns, or past injections of capital from shareholders."

From both a legal and regulatory perspective it is clear that the inherited estate is an asset of the company and represents its working capital. However, the amount of this asset is by no means fixed. It is perhaps best described as the difference between two very large amounts, being the realistic assets and realistic liabilities of the with-profits company, both of which are highly volatile and susceptible to external influences such as interest rates, equity movements and property markets. The simplest practical description of the inherited estate is that it represents the assets in a with-profits fund over and above the money expected to be required to meet policyholder liabilities.

The primary purpose of the inherited estate is to support the features of with-profits business and provide security to policyholders. This manifests itself in how the inherited estate is used to support the investment strategy of the fund and to deliver flexibility in the smoothing of maturity payments. It also meets the excess between the cost of guarantees and asset share, and provides capital to support the writing of new business.

During periods of global economic volatility (such as now), the value of the inherited estate becomes more apparent. Aviva has determined that the funds whose inherited estates it is planning to reattribute should operate between AA and AAA strength to align with policyholder expectations. As a result of this approach these funds have continued to provide good returns to policyholders despite

¹ <http://www.fsa.gov.uk/pages/Doing/Regulated/newcob/faqs/estates.shtml>

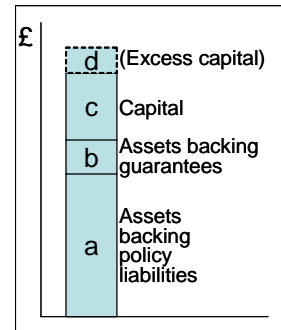
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many historic economic depressions, including World Wars, the 1929 Great Depression and the 1974 OPEC oil shock.

2.02 What makes up the inherited estate?

Fund assets comprise money / investments:

- (a) To back (or “equal”) policy liabilities; plus
- (b) To back guarantees attaching to those policies; plus
- (c) To mitigate risks to assets in (a) and (b) such as the risk of a stock market fall making asset values insufficient to back liabilities / guarantees (“capital”) in respect of existing and future new business; plus, potentially
- (d) If it exists, this is the amount in excess of what is needed, because there is no realistic prospect of there being insufficient capital to support the fund (“excess capital”) ².



All the fund assets are “at risk”, e.g. of values falling with stock markets, but when assets in (a) and (b) fall, their value is topped up from capital (c), so the capital changes to reflect the increase in the costs of guarantees. Broadly the inherited estate comprises the aggregate value of (c) and (d) from time to time.

The Financial Services Authority (FSA) requires Aviva to hold a particular minimum amount of capital (known as ICA), but requires Aviva’s management to determine the appropriate level of capital to be held in respect of each with-profits fund. As the largest UK provider of life insurance Aviva wants to maintain a high level of confidence in our funds and ensure that they will remain strong for the long term. Aviva therefore holds more capital than the minimum FSA requirement. The amount we hold is determined by our risk appetite, which is a measure of the fund strength we want to maintain. Aviva’s CGNU Life and CULAC with-profits funds were sold to policyholders as very strong funds with high equity backing ratios.

In February 2008, Aviva announced that about £2.1billion³ (as at 1st January 2008) would be distributed to qualifying policyholders from the inherited estates of CGNU Life and CULAC over the next 3 years. Additional surplus was created after we reduced the capital required to meet the guarantees within the funds through new de-risking techniques. This therefore represented a distribution of the available surplus.

² Amounts falling into this category would be considered for distribution by the Board in line with the risk appetite framework for the funds

³ Based on the funds’ financial position at end 2007

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The remaining amount within the inherited estate continues to be required to support the strength of the funds within the preferred AA to AAA range. At the end of 2007 fund strength was in the middle of AA and AAA, whereas at the end 2008 valuation it was outside the preferred range of surplus but comfortably within the acceptable range of surplus following significant market falls and increases in market volatility in 2008.⁴

Our aim is for the funds' strength to remain within the range of AA to AAA and the CGNU life and CULAC with-profits funds continue to be managed to achieve this.

⁴ The negotiated reattribution offer announced on 30th July 2008 was based on the financial position of the CGNU Life and CULAC funds at 30th June 2008. Since then, as a result of continued market falls, the offer has been restructured using a scaled approach which allows the value of the inherited estate to be assessed nearer to the Effective Date.

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3.00 Realistic Balance Sheet

The realistic balance sheet (RBS) forms part of Aviva's annual returns to the FSA. It sets out the best estimate of the assets and liabilities of the fund based on a set of assumptions about the future. Stochastic modelling techniques are used in order to determine the effects of the assumptions on the valuations.

The key reference points for determining the size of the inherited estate are the realistic balance sheets for the CGNU Life and CULAC with-profits funds (the "RBSs").

These RBSs have been audited, shared with the FSA and are in the public domain.

In line with normal business practices, the RBS, giving the financial position at 31st December 2008, was reviewed by Ernst & Young.

3.01 The Approach to the RBS

In order to assess the size of the funds and their assets and liabilities, Aviva uses a market consistent approach, rather than a "real world" approach. This allows market pricing to be used, as far as possible and so allows the valuations to be less influenced by assumptions.

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4.00 Size of the Inherited Estate at 31st December 2008

The summary RBS results for CGNU Life and CULAC for end December 2008 which were included in the FSA returns are shown in the tables below:

RBS Mid-2008						
Interim Results	000	000	000	000	000	000
						G'tees
	Assets	Liabilities				Options
	for WP	for WP	Estate	RCM	Surplus above RCM	Promises
CGNU	14,228	13,463	765	392	371	1,405
CULAC	13,608	12,844	764	376	387	1,509
Total			1,529			

Since finalising the RBS for the Aviva Group Results Announcement further analysis of the end 2008 cost of guarantees has been undertaken. The results of this analysis have been reflected in the FSA returns (shown above) for end 2008 as an increase to the inherited estate valuation of £89 million.

A full breakdown of the RBS results and FSA Reporting for CGNU Life and CULAC over recent years has been shared with the Policyholder Advocate and her advisors.

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4.01 Changes in the Size of the Estate

RBS Results Summary	End 2006	Mid 2007	End 2007	Mid 2008	End 2008
CGNU	2,549	2,711	2,609	1,115	765
CULAC	2,480	2,638	2,393	960	764
Total	5,029	5,349	5,002	2,115	1,529

The backdating of the Special Distribution announced by Aviva in February 2008 altered the RBS results as follows:

End 2007	Assets	Liabilities	
Pre-Distribution	for WP	for WP	Estate
CGNU	14,475	11,866	2,609
CULAC	13,926	11,532	2,393
Total			5,002
Distribution			
Tax			(18)
Policyholder (90%)			(2,111)
Shareholder (10%)			(234)
Post-distribution			2,639

4.01.01 De-risking of the Cost of Guarantees

In February 2008 Aviva announced that it had changed the way that it manages the with-profits funds of CGNU Life and CULAC by reducing some of the investment risk.

As a result, less money needed to be set aside to cover the cost of the guarantees offered under with-profits policies invested in the CGNU Life and CULAC funds.

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This allowed the Board to announce that about £2.4 billion would be distributed from the inherited estates of CGNU Life and CULAC over the next 3 years. This payment is made on a 90/10 basis as shown in the table in section 4.01 above.

For the purposes of the reattribution, this reduced the size of the inherited estate by approximately £2.4 billion at 31st December 2007, to £2.6 billion.

4.01.02 Market falls

At the end of 2007 fund strength was in the middle of the AA and AAA preferred range of the risk appetite framework, whereas at the end 2008 valuation it was outside the preferred range of surplus but comfortably within the acceptable range of surplus following significant market falls and increases in market volatility in the year.

The key market drivers for this are set out below:

Economic data	Dec-07	Jun-08	Sep-08	Dec-08	Change Dec07- Dec08
FTSE 100	6,457	5,626	4,902	4,434	-31.33%
15 yr gilt	4.55%	5.18%	4.68%	3.74%	-81 bps
Equity vol – 5 yr term	23.6%	25.1%	27.5%	34.4%	+1080 bps
Equity vol – 10 yr term	24.5%	25.8%	27.7%	34.6%	+1010 bps

Over this period equity performance has been very adverse. Although hedging of assets is in place against the impact of equity movement on guarantees in CGNU Life and CULAC, the hedges are not perfect (particularly where markets move very quickly). Since October 2008, steps have been taken to further reduce the direct and indirect exposure to equity risk in the inherited estate.

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Other factors we consider include:

- Fixed interest yields have significantly reduced
- Widening credit spreads
- Significant rise in equity volatility⁵
- Falling property prices

The effect of this market downturn has been to reduce the size of the inherited estate by £1110m (or 42%) in 2008.

⁵ Increased equity volatility tends to reduce expected returns over a period

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5.00 Inherited Estate Valuation for the Restructured Offer

5.01 Response to Market Volatility

In response to the continued market volatility, the negotiated offer has been restructured so that the inherited estate valuation can be based on the size of the inherited estate closer to the Effective Date.

The PIP offer is dependent on the size of the Reattribution Estate, as illustrated by the table below:

Reattribution Estate (£m)	PIP (£m)	Minimum PIP per eligible policy
2,500	1,215	486
2,400	1,160	464
2,300	1,105	442
2,200	1,050	420
2,100	995	398
2,000	940	376
1,900	885	354
1,800	830	332
1,700	775	310
1,600	720	288
1,500	665	266
1,400	610	244
1,300	555	222
1,200	500	200

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5.02 Valuation of Inherited Estate for Calculation of the PIP Offer

For the purposes of the offer on which eligible policyholders will make their election decisions, the aggregate PIP is £500 million. This has been calculated using an assumed Reattribution Estate value of £1,200 million at 1st October 2009 (“the Effective Date”). This restructured PIP is directly proportional to the originally proposed PIP of £1 billion for an inherited estate valued at £2.115 billion at 30th June 2008.

Individual PIP offers will be determined based on this aggregate PIP amount and will represent the lowest payment that electing policyholders could receive in exchange for giving up their rights to any future special distributions of the inherited estates if the reattribution proceeds.

As described below, the actual amount payable may be higher than this figure.

5.03 Valuation of the Inherited Estate for Calculation of the PIP Payment

The valuation of the inherited estate on which payment of the Policyholder Incentive Payment (PIP) is made to eligible policyholders who elect to accept the offer will be calculated using an unweighted average valuation of the CGNU Life and CULAC inherited estates at 30th June 2009, 31st July 2009 and 28th August 2009 the (“Reattribution Estate”).

In practice these valuations will be performed using the methodology Aviva employs for its interim valuation reports each year – which means that a realistic balance sheet calculation for CGNU Life and CULAC will be performed as at 31st May 2009 and then an agreed balance sheet economic impact projection applied.

For PIP payments this methodology will be used to derive the Reattribution Estate. The Reattribution Estate figure will be increased by two months interest using the London Interbank Offered rate (LIBOR) to allow for the period to the Effective Date.

In agreeing the dates for the 3 valuations an appropriate balance between a desire to make payments as speedily as possible to electing policyholders and the necessity to ensure that the figures calculated are properly assessed by our auditors needed to be achieved. The policyholder advocate’s views were sought in this decision making process.

Ernst and Young have reviewed the balance sheet economic impact projection and concluded that the proposed methodology is consistent with the introduction and purpose as described and that they had

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found nothing to suggest that it was inherently biased when approximations to economic movements were applied.

Details of the methodology and the Ernst and Young review have been shared with the Office of the Policyholder Advocate, the Independent Expert and FSA.

In addition, when calculated the values will be reviewed by Ernst and Young.

5.04 Valuation of Inherited Estate for Allocation at the Effective Date

The basis for the allocation of the inherited estate between the Old With-Profits Sub-Fund (OWPSF) and Reattributed Inherited Estate External Support Account (RIEESA) uses a realistic balance sheet calculation as at 30th September 2009.

The value calculated will be reviewed by Ernst & Young before being apportioned between RIEESA and OWPSF based on the proportion of eligible policyholders who elect / do not elect to accept the offer.

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

The Policyholder Advocate has suggested how, for the purposes of the reattribution, the value of the inherited estate should be adjusted. In this section Aviva appraises the Policyholder Advocate's suggested changes and commentary.

In preparing their realistic balance sheets insurance companies have to make careful assumptions about what might happen in the future (many of the policies could be in existence for more than 25 years). Inevitably there will always be differences of opinion on whether the assumptions made are prudent or optimistic, the key 'check and balance' for Aviva is to take a collective look at all of the assumptions and ensure that they are reasonable as a whole.

Individual assessment of selective assumptions to test whether they are considered optimistic or pessimistic could produce differences of opinion, however if changes are made on such a piecemeal basis they are likely to unbalance the overall reasonableness of the assumptions as a whole, which could in turn have a negative impact on the long-term security of policyholder benefits.

For the purposes of the reattribution negotiations, Aviva has agreed to make allowance for a notional adjustment to the value of the inherited estate which recognises the inherent uncertainty involved in assessing possible future events.

For the purpose of assessment of the merits of the offer, Aviva agreed to a notional adjustment to the RBS valuation of the inherited estate at end 2008 of £100 million; while the Policyholder Advocate has allowed for an adjustment of £177 million. The adjustment principally relates to differences in approach with regard to the reserves in the realistic balance sheet.

6.01.01 Impact on the Assessment of the Offer

The Office of the Policyholder Advocate used their valuation of the size of the inherited estate in their assessment of the offer, and in reaching their conclusions.