Office of the Policyholder Advocate

Report Number 36 A

The Pre-Reattribution Distribution

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

One of the key considerations in the scheme's design is that after the reattribution, the funds will be run in a way that is consistent with how they were run before the reattribution.

One of the ways of achieving this after the reattribution will be to continue to follow the preferred management approach and strategy that was used before the reattribution. In order to achieve this, the funds will hold an appropriate amount of capital.

One relevant factor in holding capital is that in certain scenarios there may be more capital than is needed to maintain the preferred management approach and strategy. This was the case when, in February 2008, Aviva announced that over the next three years they were awarding bonuses worth an estimated £2.1 billion to qualifying CGNU Life and Commercial Union Life Assurance Company (CULAC) policyholders.

The purpose of this appendix is to describe the circumstances and terms of the announced special bonus and the implications this has for Aviva's analysis of the likelihood of future special bonuses.

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2.00 Treating Customers Fairly

The key aim in our approach has been the importance of having due regard to customers and treating them fairly. This has been informed by the Conduct of Business Sourcebook (COBS) rules, which explains how this key aim could be evidenced when considering the management of excess surplus.

The description of the risk appetite describes the Board's approach to the management of the CGNU Life and CULAC funds in the past and articulates the basis for future management of these funds. It does not alter the basis on which the policy (and strength of the funds) was offered to customers when the policy was sold.

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3.00 The Risk Appetite Framework

As discussed in the appendix “Policyholders’ Future Security and Risk Appetite”, the Risk Appetite Framework (RAF) is a part of the with-profits governance framework for the CGNU Life and CULAC funds and operates with the full involvement of the With-Profits Committee (WPC).

The development of the RAF, and the concept of the preferred range of surplus, essentially represents a formalisation of the approach that has been followed by the Board in the running of the funds for many years.

3.01 Preferred Range of Surplus

The RAF expresses a preferred range of surplus within the fund with reference to the probability of ruin and expressed by reference to an AA and AAA rating. The board arrived at this level taking into account past representations to policyholders, in particular the strength of the funds, their high equity content, and the bonus and smoothing policy, as well as the funds capacity to withstand significant economic shock .

The Board is responsible for selecting the course of action to follow when surplus falls outside the preferred range (AA to AAA). In doing so, it will seek advice from the With-Profits Actuary (WPA) and take into account the views of the WPC.

The preferred range sits within a wider acceptable range of surplus. The boundaries for the acceptable range are the ICA at the lower level and the old with-profits sub-fund (OWPSF) mandatory distribution point at the upper level (120% of the AAA level). If surplus lies inside the acceptable range, but outside of the preferred range of surplus the Board is required to consider what reasonable actions it might take to restore surplus to preferred range. If surplus lies outside of the acceptable range the Board must take action to restore surplus to at least the acceptable range.

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4.00 The Announced Aviva Special Bonus

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

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

This allowed the Board to announce that about £2.1 billion (as at 1st January 2008) would be distributed to qualifying policyholder from the inherited estates of CGNU Life and CULAC over the next 3 years.

4.01 What are the with-profits fund assets?

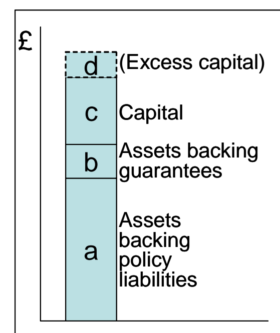
Fund assets comprise money / investments:

(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")[1] .



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.

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

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4.02 De-risking the Cost of Guarantees

The investment strategy for the CGNU Life and CULAC inherited estates was, on the whole, the same as that for the rest of the fund. This meant that the inherited estate was exposed to equity and property risk from three sources:

- Exposure from the equities and property held in the inherited estate
- Exposure from investing asset shares in equities and property
- Exposure from backing the liabilities for the cost of guarantees in equities / property

These (and other risks) are reflected in the calculation of the funds' capital requirements.

During 2006 the Financial Services Authority (FSA) advised Aviva that, for the purposes of assessing the fairness of the reattribution proposals, they would assume that the investment strategy for the assets backing the cost of guarantees (b) had been de-risked, regardless of whether the de-risking had actually taken place.

Having assessed the implications of this approach, during 2007 the CGNU Life and CULAC Boards took the decision to change the investment approach for the assets backing the cost of guarantees (b). In doing so they implemented a dynamic hedging strategy which reduced the funds exposure to losses that might arise from an increase in the cost of guarantees as a result of falls in the value of equities and property held as part of the asset shares.

This change in approach did not affect or remove investment in equity and property for the assets backing policy liabilities.

As a result of the change in investment strategy, less money needed to be held to back the guarantees attaching to policies in the CGNU Life and CULAC with-profits fund. This enabled a distribution of surplus from the inherited estate to be made, on a 90:10 basis (90% to policyholders, 10% to shareholders), as a special bonus for qualifying policyholders.

4.03 The Form of the Special Bonus

The special bonus will be added to qualifying with-profits policies in addition to any other standard bonuses over 3 years.

Qualification dates for the special bonus are:

- 1st special bonus – 1st January 2008
- 2nd special bonus – 1st January 2009
- 3rd special bonus – 1st January 2010

Further detail can be found in the leaflet "Special bonus – your questions answered" which was sent to qualifying policyholders in March / April 2008.

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4.04 Why is the special bonus spread over three years?

The WPC supported the approach of spreading the special bonus over three years to ensure that the stability of the fund is maintained for all investors (including those who did not qualify for the special bonus).

The Board and the WPC considered a range of options from an immediate single distribution to one spread over 10 years.

The Board and WPC concluded it was fair to distribute over three years because:

- It rewards the vast majority of policyholders (around 96% will receive all three special bonuses)
- It reduces the risk of de-stabilising the funds, and thus rewards loyalty
- It does not disproportionately reward a policy which has just been taken out, especially substantial single premium investments

The Board and WPC were concerned that a single large special bonus could result in policyholders concluding that they should now withdraw their investments from the fund (having achieved a significant uplift in value). Whilst policyholders would be free to do this, such an action, if taken by a large number of policyholders, could de-stabilise the funds, to the detriment of the remaining and future policyholders.

Spreading the bonus over three years was seen as a way of reducing the risk of de-stabilising the fund and protecting the interests of current and future policyholders.

4.05 Why was the special bonus not backdated to the Reattribution Announcement Date?

On 21st November 2006 Aviva announced that it was planning to make changes to the CGNU Life and CULAC with-profits funds, including a reattribution of their inherited estates.

At the time of the announcement the CGNU Life and CULAC funds were not considered to have sufficient surplus to allow a distribution to be made. Three key factors relevant to the later decision to distribute had not yet taken place:

- The formal articulation of the risk appetite framework, and its agreement with the FSA: the concept of the preferred range of surplus and its impact on the company's approach to their requirements under COBS was still in development. Whilst the formal articulation happened in 2006 it did represent the management of the fund over many years, in particular the level of financial strength;
- The de-risking of the cost of guarantees: the FSA had only recently told us that in assessing the fairness of the offer they would assume that de-risking of the cost of guarantees had taken place;

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- At that time the Boards had not yet worked through the implications of de-risking the cost of guarantees for the management of the funds or the methodology for implementation.

As an illustration building on the explanation given in section 4.01:

- In 2002/2003 there was significant market volatility which led to a sharp decrease in the value of the funds. This led to more working capital being required to cover policy liabilities and guarantees – therefore reducing the value of the inherited estate.
- In the period 2004/2006 markets improved, the value of the funds increased and therefore the size of the inherited estates steadily grew – although not reaching their pre-2002 levels.
- 2007 / 2008 has seen further market volatility, a consequent reduction in the value of the funds and inherited estate as more of the working capital is again required to cover policy liabilities and guarantees.

At the time of the reattribution announcement and de-risking (and likewise in the immediately preceding years) economic conditions were not as favourable as they had once been, as a consequence in the period prior to de-risking there was no excess surplus in the funds.

The timing of the implementation of the de-risking decision was therefore a key driver of when excess surplus emerged in the funds. Since the implementation involved selling both equities and property held as assets to cover the cost of guarantees, this was not something that could be rushed or backdated.

As a result of the de-risking of guarantees carried out in 2007, additional surplus was generated in that year and this enabled a distribution of surplus to be made over the subsequent three year period. Special bonuses are added to policies, and any tax payable determined as part of policy proceeds in line with the tax treatment of the particular policy.

Unlike the reattribution (where the policyholder incentive payment (PIP) is made from shareholders' funds) the special bonus payments are being made from the CGNU Life and CULAC with-profits funds.

For both legal and tax reasons it is not possible to make special bonus payments to policies which are not in force (as a result of maturity, lapse, transfer or surrender) in the funds on the qualifying dates announced for the special bonus. Accordingly special bonus payments cannot be backdated to a point before the additional surplus for distribution arose.

This differs from the eligibility criteria for the reattribution where greater flexibility can be applied because the PIP comes from shareholders' funds and not from the with-profits funds.

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5.00 Prospects of a Special Distribution in the Future

As part of the operation of the risk appetite framework (RAF) for the CGNU Life and CULAC funds, the Boards periodically considers whether there is excess capital in the funds, by reference to the RAF. If there is, it then considers what actions it should take with the excess capital in the circumstances. One of those actions could be a Special Distribution to policyholders and shareholders.

A combination of the announced special bonus, the recent significant market falls and increases in market volatility in 2008 has taken the fund strength outside the preferred range of surplus but comfortably within the acceptable range of surplus. Our aim is to remain within the range of AA to AAA because this is not only prudent in fluctuating economic conditions but is also the basis upon which the with-profits policies were sold to our customers.

At this point, the Board (in consultation with the With-Profits Committee) considers that further sizable special distributions from the inherited estates are unlikely in the short to medium term.

5.01 Implications for the Reattribution

Aviva has undertaken extensive stochastic modelling in order to assess the impact of a wide range of possible economic scenarios over the next 25 years.

The outcome of this analysis leads Aviva to believe that the reattribution offer is good value for almost all eligible customers (99%), and represents excellent value for at least 95%.

- The offer is considered “good value” if a policyholder would have to wait at least 10 years before the estimated value of any future distributions could exceed the offer.
- The offer is considered “excellent value” if a policyholder would have to wait at least 25 years before the estimated value of any future distributions could exceed the offer, or if the offer will always exceed the estimated future distributions.

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

6.01 Risk appetite

Aviva notes that, in the Policyholder Advocate view, the risk appetite mandatory distribution levels for the CGNU Life and CULAC funds is considered too prudent. We do not agree with this view, and believe that the Policyholder Advocate's approach to risk appetite would introduce far too much risk to the security of policyholder benefits (particularly apparent in the current turbulent economic conditions). Our detailed thoughts on this topic are covered in the appendix "Policyholders' Future Security and Risk Appetite" and therefore not repeated here.

6.02 Phasing of the special bonus payments

The Policyholder Advocate has made it clear that she does not agree with the Board's decision to spread the special bonus over three years.

In their response, "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" dated 22nd October 2008, the FSA stated that "Considering the possible phasing of any special distribution, our rules do not include any requirements as we believe this should be assessed in the light of the particular circumstances of the firm at the time. It would be for firms, having taken advice from their With-Profits Committee (or similar arrangement), to determine a fair basis for the distribution."

Aviva's decision to spread the special bonus over three years was taken with the full support of the With-Profits Committee and is intended to ensure that the stability of the fund is maintained for all investors (including those who did not qualify for the special bonus).

If the Board had taken the decision to make a single large special bonus payment and this had led to a 'run on the fund' (through a large number of policyholders leaving early), there could have been a number of implications, principally:

- A need to quickly sell equity and property assets in order to meet the claims;

  There are a number of areas to consider:

  - There is a back-drop of highly volatile markets
  - In carrying out the de-risking of the guarantees for the CGNU Life and CULAC funds significant equity and property investments had already been sold.

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- To meet the claims further sale of equity and property may have been necessary and there was a significant risk that the markets would have moved against us – meaning that a lower price would have been achieved for the sale.

In reality (given the escalating economic problems), this could have been a vicious cycle which would have de-stabilised the funds and probably have led to more stringent MVR adjustments being necessary for early surrender and in addition to falling returns.

- There could have been a knock on reduction in equity exposure for assets backing asset shares which would have led to reduced returns on investment for remaining and new policyholders;
- The surrender service delivered could have unacceptably deteriorated as a result of unplanned boost in volumes of requests;
- Maintaining higher Equity backing Ratio (EBR) should mean that policyholders are well placed to benefit from the upside when markets recover.

The approach taken by the Board in spreading the special bonus over three years has endeavoured to treat customers fairly. It is regrettable that in protecting the interests of the majority it is inevitable that a minority will be unhappy with the decision. With the benefit of hindsight it can also be seen that the decision to spread the special bonus has not worsened the position of the funds (or threatened their stability) in the recent extremely volatile market conditions.

As can be seen it is not as simple as the fund just becoming a smaller fund as KPMG has suggested in their appendix.

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