

## **Appendix 36 B**

### **The pre-retribution distribution**

A report for the policyholder advocate in connection  
with the retribution of the inherited estates  
of the CGNU Life and CULAC with-profits funds

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## **1.00 Introduction and Summary**

### **1.01 Context**

This appendix has been prepared by KPMG LLP for the policyholder advocate, and is a response to Aviva's paper on the same aspect of the proposals. Whilst we have done our best within this appendix to explain technical terms and concepts, it remains the case that this is a technical report intended for readers who have some familiarity with the concepts involved.

### **1.02 Background**

The purpose of this paper is to respond to Aviva's appendix 36 A ("The pre-retribution distribution") on the circumstances and terms of the announced special bonus and the implications this has for the likelihood of future special bonuses.

We note that although the special bonus has already been announced, consideration of this special bonus has very much been part of the overall process to consider the inherited estates of the CGNU Life and CULAC with-profits funds.

### **1.03 Summary of Aviva's view**

By de-risking (see section 3 of this report) the assets backing the guarantees, Aviva has reduced the capital requirements of CULAC and CGNU Life funds and in doing so has been able to make a special distribution to policyholders. In its appendix Aviva describes the background for the special bonus announced during February 2008, and the rationale for spreading this bonus over three years. This is covered in more detail in section 2 of this report.

### **1.04 Summary of our view**

We welcome the special bonus distribution announcement by Aviva, and we agree that the amount of the bonus distribution is appropriate. However we do not agree that the bonus should be spread over three years. The risk appetite framework is a key factor in deciding on the size of the special bonus now and any future special distributions and, while our thoughts on the risk appetite are covered in detail in a separate report, we note here that we believe that

some aspects of Aviva's risk appetite could be considered prudent, which is clearly in the interests of benefit security, but could be to the detriment of policyholders when considering how much surplus is available to be distributed. This is not an issue for the pre-retribution distribution since the level of capital now currently in the funds is below the preferred range of surplus (albeit still comfortably within the acceptable range of surplus), but we consider that the potential for future distributions in the old with-profits sub-fund (Old WPSF) could be delayed due to this prudent risk appetite framework.

### **1.05 Structure of this chapter**

In section 2 we summarise Aviva's position without comment, and our views on their position are then described in section 3.

## **2.00 Aviva's Approach**

### **2.01 Treating Customers Fairly**

Aviva has stated that the key aim in their approach has been to have due regard to customers and treating them fairly. This has been informed by the FSA's Conduct of Business Sourcebook Rules, which explains how this key aim could be evidenced when considering the management of excess surplus.

### **2.02 The Risk Appetite Framework (RAF)**

Aviva refers to its appendix 28 A ("Risk appetite and policyholders' future security") and states that the risk appetite framework (RAF) formalises the approach that was followed by the Board in the running of the funds for many years.

#### **Preferred Range of Surplus**

Aviva states that its 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 statements made to policyholders, in particular the strength of the funds, their high equity content, and the bonus and smoothing policy, as well as the fund's capacity to withstand significant economic shocks.

If the surplus lies outside the preferred range but within the acceptable range of surplus, the Board is required to consider what actions it might take to restore the surplus to the preferred range. However, if the surplus is outside the acceptable range the Board is required to take action to bring the surplus to at least within the range.

### **2.03 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 1 January 2008) would be distributed to qualifying policyholders from the inherited estates of CGNU Life and CULAC over the next three years.

Aviva states that during 2006 the 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 had been de-risked. 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 guarantee reserves. In doing so the CGNU Life and CULAC Boards 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.

Aviva states that as a result of the change in investment strategy, less capital was needed to back the guarantees attaching to policies in the CGNU Life and CULAC with-profits fund. This enabled a distribution of surplus from the estate to be made on a 90/10 basis as a special bonus for qualifying policyholders.

Aviva states that this distribution is to be added to qualifying policies over three years. There are three qualification dates and policies are required to be in force at these dates to qualify for the bonus.

Aviva states that the spreading of the distribution is to ensure stability of the fund for all investors. The Board concluded that it was fair to distribute the funds over three years because:

- It rewards the vast majority of policyholders (around 96% of qualifying policyholders 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 was concerned that a large number of policies might suddenly withdraw following a single large uplift in value which could de-stabilise the funds. Aviva believes that spreading the distribution over three years reduces the risk of this happening.

Aviva has also explained why the distribution was not backdated to the reattribution announcement date. Aviva states that at the time of the announcement the CGNU Life and CULAC funds were not considered to have sufficient surplus to allow a special 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 the 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;

- 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.”

Aviva states that immediately prior to de-risking there was no excess surplus in the funds and, likewise in the immediately preceding years, the economic conditions were not as favourable as they had once been which as a result meant that no excess surplus existed.

The timing of the implementation of the de-risking decision was therefore a key driver of when excess surplus emerged in the funds.

Aviva states that for both legal and tax reasons it is not possible to make special bonus payments to with-profits 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.

## **2.04 Prospects for a Special Distribution in the Future**

Aviva states that a combination of the announced special bonus, the recent significant market falls and increases in market volatility in 2008 has taken the financial strength of the fund at the end of 2008 to below the preferred range of surplus, but comfortably within the acceptable range of surplus. The Board considers that further special distributions from the inherited estate are unlikely in the short to medium term.

## **3.00 KPMG’s Comments on Aviva’s Approach**

This section sets out our comments on Aviva’s appendix 36 A (“The pre-retribution distribution”).

### **3.01 Treating Customers Fairly**

We are in agreement with Aviva’s statement.

### **3.02 The Risk Appetite Framework (RAF)**

Aviva has formulated a risk appetite framework to guide it in deciding on the appropriate level of capital to hold above the requirement regulatory minimum. Our comments regarding the RAF are discussed in detail in appendix 28 B (“Policyholders’ future security and risk appetite”), but we note here that, although some aspects of Aviva’s RAF could be considered prudent (potentially delaying distributions of the inherited estates), we believe that the amount of pre-retribution distribution that was announced is appropriate.

### **3.03 The Announced Aviva Special Bonus**

We understand that the FSA’s reason for assuming that the funds were de-risked for the purposes of assessing the fairness of the retribution proposals was in part influenced by the fact that such de-risking had already been carried out within the AVLAP with-profits fund. Essentially, Aviva has put in place an internal hedging strategy which involves selling some equities and buying fixed interest assets. The amount sold is such that, broadly, any increase or decrease in the reserve for the cost of guarantees is offset by the fact that there is a deliberate mismatch in the assets held to back asset shares and those assumed to be held for the purpose of determining the returns to credit to asset shares. The de-risking strategy does not affect the returns credited to asset shares and largely removes the exposure of the inherited estate to changes in the guarantee reserves as a result of changes in equity values (the estate remains exposed to changes in those equities and properties in which it is invested). A simple example to illustrate the mechanics is set out below:

Asset shares = 1000, cost of guarantee reserve = 200, total reserves = 1200

Assets backing asset shares = 1000 (all equities), assets backing guarantees = 200 (Gilts), total assets = 1200

Sell 100 equities and buy 100 Gilts

Assets notionally backing asset shares = 1000 (all equities), actual assets = 900 equities, 100 Gilts

Assets backing guarantees = 200 (Gilts)

### ***Scenario 1***

If equities increase by 10%, the notional return to asset shares (all else being equal) is 100, ie 10% of 1000, but assets held in equities have only increased by 90, ie 10% of 900, so there is a shortfall of 10. However, the de-risking has been implemented such that the guarantee reserve will have decreased because the guarantees are less likely to bite if asset shares have increased and this offsets the shortfall of 10..

Asset shares = 1100 (1000 + 100), cost of guarantee reserve = 190 (200 less 10) total = 1290

Amount of equities held = 990 (900+90), Gilts = 300 (unchanged), total = 1290

### ***Scenario 2***

If equities decrease by 10%, the notional return to asset shares (all else being equal) is -100 ie -10% of 1000, but assets have decreased by 90 ie -10% of 900, so there is a 10 surplus. However, the de-risking has been implemented such that the guarantee reserve will have increased by 10 because the guarantees are more likely to bite if asset shares have decreased and the offsets the surplus of 10.

Asset shares = 900 (1000 – 100), cost of guarantee reserve = 210 (200 + 10) total = 1110

Amount of equities held = 810 (900-90), Gilts = 300 (unchanged), total = 1110

As a result of this change in the investment strategy, the risk-based capital required under the RAF decreased, and there was a significant excess surplus. We are in agreement with this change in the investment strategy because we believe that investment techniques such as hedging should be utilised to reduce exposure to market risk. We note that Aviva has confirmed that this change does not affect or remove investment returns credited to the asset shares due to equity and property returns, and we agree that this approach is appropriate as it ensures that the returns on policyholders' asset shares remain unaffected.

Aviva has told us that the special distribution brought the surplus available to towards the middle of the preferred range. Since then, significant market falls and increases in volatility

have taken the valuation below of the preferred range, but within the acceptable range of surplus.

The pre-retribution distribution will be spread over three years. We note that the realistic balance sheets at the end of 2007 included a provision for the full special bonus.

We do not believe that it is appropriate to spread the distribution over three years and believe that any distribution where there is an excess surplus should be carried out immediately as it introduces a source of inequity where policyholders exit before the end of the three years. In this case they will not receive all of the distribution which they might otherwise have received. Aviva states that it wants to reward loyalty, and suggests that the fund could be destabilised if a large proportion of policyholders lapsed in a short space of time. We challenge Aviva's reasoning for spreading the special distribution over three years because:

- there is still the risk that policyholders will lapse anyway after three years when the full special bonus has been granted, and so spreading the payment over three years does not really mitigate the risk of the policyholders lapsing after the payment is made, rather it delays the effect;
- we do not agree with Aviva's reasoning that the spreading avoids disproportionately rewarding a policy which has just been taken out. We take the comment to mean that a policy will have had to have been in force for at least three years to receive the full benefit as opposed to having potentially been in force for less than one year. However, policies which have recently been taken out will not mature in the next three years, and will therefore benefit from the fact that policies which have been in force longer may mature before the three distributions are made leaving more for the newer policies;
- we note Aviva's explanation regarding the potential for the funds to be destabilised if there were to be a "run on the fund" after the full distribution had been made in one go. However, we note that on most products Aviva would be able to adjust surrender values to reflect the costs of selling underlying assets,

which provides protection for the fund. In addition, the spreading of the distribution simply delays any potential increases in surrenders.

We also note that in response to this last point, the Treasury Committee<sup>1</sup> (before which Aviva argued that the phasing was fair) said:

*“The suggestion that a single payment would seriously destabilise a fund making a special distribution would appear to suggest that policyholders were desperate to leave that fund, and continued as policyholders only to receive their special distribution payouts. If so, the phasing of payouts, in our view, must be considered an unreasonable barrier to exit.”*

Aviva has also explained why the distribution was not backdated to the reattribution announcement date. The policyholder advocate has commented generally on this in appendix 22 B (“Qualification for pre-reattribution distribution”). However, in relation to Aviva’s specific comments on surplus, we concur that pre de-risking the level of surplus capital available was significantly less than post de-risking. We note that at the end of 2006 the funds were in a strong financial position, but that Aviva’s RAF would have prevented any excess surplus from being available. No detailed analysis of the surplus levels of the funds prior to 2006 was provided to us. However, we performed a high level comparison of Aviva’s 2005 individual capital assessment (ICA), a capital requirement driven by the FSA, with the total surplus available. Given that the ICA is an FSA requirement (since 2005), we would expect companies to hold capital over and above the ICA to mitigate against the risk of becoming insolvent if the market fell. We concluded that we would not have expected any excess surplus to be available at the end of 2005.

We have not had access to any stressed capital calculations (such as the ICA) for years prior to 2005 (when the calculation of the ICA became a requirement). However, we note that Aviva has stated that the funds’ strength had reduced post 2002, only recovering again in 2005 and 2006 from which we conclude that it is unlikely that there would have been any excess surplus available post 2002 given the current RAF and lack of de-risking.

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<sup>1</sup> Report of House of Commons Treasury Committee, Inherited Estates, 12th Report of Session 2007-08.

Aviva states that a combination of the announced special bonus, the recent significant market falls and increases in market volatility in 2008 has taken the fund strength at the end of 2008 to outside the preferred range of surplus, but comfortably within the acceptable range of surplus, and that the Board considers that further special distributions from the inherited estate are unlikely in the short to medium term. We would agree that, given the current RAF, the expectation for a further special distribution from the inherited estate in the short to medium term is unlikely. However, the prospect very much depends on the market and on new business volumes.