

Report Number 37 A

Valuing the Reattributed Estate

A summary of Aviva's proposals in connection with the reattribution of the inherited estates of CGNU Life and CULAC with-profits funds

Norwich Union rebranded as Aviva in the UK on 1 June 2009. Where an historical position or events prior to 1 June 2009 are described in this appendix, 'Aviva' and associated naming conventions have been used. Financial information has not been updated and remains as at the time of the report date.

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Appendix by: Aviva UK Life – June 2009

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1.00 Context

Aviva is proposing to reorganise how the inherited estates in the CGNU Life With-Profits Fund and Commercial Union Life Assurance Company (CULAC) With-Profits Fund are used, whilst continuing to ensure that the funds remain financially secure.

The reorganisation, known as a reattribution, has to be agreed between Aviva and eligible policyholders in the relevant funds. In a reattribution, eligible policyholders can choose to receive a payment in return for giving up their interests in possible future payouts from the inherited estate.

Only policies invested in the with-profits funds of CGNU Life and CULAC are eligible (further details on eligibility for reattribution can be found in the appendix "Eligibility for Reattribution").

The reattribution is beneficial because:

- It offers a payment to eligible policyholders that would not be available under normal circumstances
- The payment is made from shareholder funds, not taken from the with-profits funds
- Security for investments is maintained

It provides cost-effective access to capital for Aviva that will support continued business growth and the financial strength of the company.

By doing this, both policyholders and shareholders will share in the benefits of the reattribution and benefit from the money being used more effectively, whilst making sure that the funds remain financially secure.

This appendix aims to explain Aviva's approach to assessing the fairness of the offer to both policyholders and shareholders.

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2.00 Aviva's Approach in Assessing a Fair Value for Policyholders

2.01 Value of Potential Distributions to Policyholder (VPDP)

Aviva developed a methodology to help assess whether the Policyholder Incentive Payment (PIP) offer is better value for particular groups of policyholders, than the alternative of waiting for possible future distributions. This methodology is described as the Value of Potential Distributions to Policyholders (VPDP).

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

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

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

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

2.02 PIP Breakeven Periods

The PIP breakeven period is the method used to assess the period over which the accumulated VPDP might be expected to exceed the value of the PIP offered.

Breakeven periods are expressed in five year bands: 0-5 years; 5-10 years; 10-15 years; 15-20 years; 20-25 years and over 25 years. The outcome of this analysis was used to assess for how many policyholders the reattribution offer might be good value or excellent value.

- The offer is considered “good value” if a policyholder would have to wait at least 10 years before the estimated VPDP could exceed the offer

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

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

As with VPDP, the breakeven periods are not a suitable basis for individual policyholder decisions. It gives a guide which has helped to inform our views on the fairness of the offer.

2.03 Inter-Generational Transfer

One of the features of with-profits is that the inherited estate capital supports the new business of subsequent generations of policyholders; through this approach value is effectively transferred from one generation of policyholders to the next. As part of the reattribution, the capital transfers to the shareholder and can be used, amongst other things, to write new business in the future. In order to be considered fair, the PIP offer must take into account that the inherited estate capital transfers to shareholders.

In their letter dated 1st February 2008 to the Policyholder Advocate, the Financial Services Authority (FSA) clarified that, “When we are considering an on-going fund, under business as usual we do not prohibit the use of the inherited estate to finance new business provided this is carried out in an appropriate way as we have discussed with you. This capital effectively passes from existing policyholders to future policyholders by way of a transfer between generations. In a reattribution the shareholder pays an amount for the inherited estate, including this tranche of capital. We have told you and Norwich Union Life that we do see a value attached to it and we expect the negotiations between you and the firm to consider how that might be reflected in an offer made to policyholders.”

As a result, in order to take account of this tranche of capital and to ensure that the offer could be considered fair in aggregate, Aviva’s PIP offer to eligible policyholders was in excess of the VPDP from the inherited estate.

2.04 Why is Our Approach Fair to Policyholders?

Aviva considers that the PIP offer fairly divides the value unlocked by the reattribution between policyholders and shareholders, taking reasonable account of the existing rights and interests of each party and of what might happen in future with or without a reattribution. Notwithstanding the inherent uncertainties of modelling the future, we are satisfied that the offer is fair when compared against a wide range of economic and new business scenarios.

One of our principles is that the PIP should be based on a sharing of unlocked value rather than merely compensating policyholders for distributions foregone, since the value of distributions foregone is so uncertain. We cannot reliably value future distributions, but VPDP could be considered a prudent, if limited, proxy.

Aviva has already committed to distribute more than 40% of the CGNU Life and CULAC 31st December 2007 inherited estate to policyholders through the special bonus.

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Making a fair offer has been at the heart of Aviva's decision making at all levels. The assumptions used and methodology employed are reasonable and, where considered to be prudent to do so, key aspects have been independently reviewed.

The company plans to continue to allow new generations of policyholders to benefit from the strength of the inherited estate, just as previous generations have. As a result, Aviva's assessment of the offer is against the strong open fund that it intends to run, rather than against a closed fund scenario (which it knows would otherwise bring most benefit to the current eligible policyholders in the form of future distributions). If Aviva intended to close the CGNU Life and CULAC with-profit funds to new business they would not be proposing a reattribution, since, in their opinion, it would not be possible to construct an offer under these circumstances which would be fair to both policyholders and shareholders.

In making its decisions the company has necessarily been required to balance a wide range of policyholders' interests. Sufficient account of factors such as the long term strength of the fund as a whole, the interests of future policyholders and the position of non-profit policies have been key to achieving a balanced and fair outcome for all.

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

Although not factored into our models, we note that many policyholders may value the option to choose certain tax-free cash now as opposed to uncertain future special distributions which may be taxable.

In determining our offer and recommendation guidance to policyholders, accuracy, tempered with an appropriate degree of prudence (if necessary), is of overriding importance. We have gone to great lengths to ensure that due account is taken in our analysis of the significant inherent uncertainties of predicting future events. Having said this, policyholders face a choice in this case between an actual value and a potential – but uncertain value. The industry has been strongly encouraged to invest in stochastic modelling and we have done this because it is acknowledged as better reflecting the full range of uncertainties in the inherent complexities of our business. The company is determined that its projections are based on maintaining policyholder security, and keeping to our risk appetite.

It is important that the risks of voting 'no' are as well understood as the risk of voting 'yes'. Recent market falls with the main equity indexes losing more than 35-40% of their value in the year and volatility running at levels not seen since the 1930s mean that the inherited estate's principal role - of providing benefit security - remains critical, and reduces the possibility of future distributions.

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3.00 Aviva's Approach in Assessing a Fair Value for Shareholders

Any offer needs to ensure an adequate return to the shareholder, taking into account:

- The cash and costs the shareholder pays now
- The capital that is reattributed to it
- The risks associated with the transaction and that continue to affect that capital
- The shareholders current rights and interests in the inherited estates

Sections below discuss each of these factors in more detail.

Section 4.00 summarises the estimated return to shareholders from this transaction and why it is considered fair.

3.01 The cash and costs the shareholder pays

3.01.01 Payment of the Policyholder Incentive Payment (PIP)

The full cost of the PIP will be met by shareholders from outside of the CGNU Life and CULAC with-profits funds (including the inherited estate).

There are a number of ways in which the shareholder can fund the payment of the PIP, each has implications for the Group's Insurance Groups Directive (IGD) valuation.

3.01.02 Payment of the reattribution and fund transfer project costs

The FSA Conduct of Business Sourcebook (COBS) rules set out specific guidelines for the treatment of project costs associated with a reattribution. These rules allow for the full costs of the Office of the Policyholder Advocate to be charged to either the inherited estate or relevant with-profits policyholders.

Aviva took the decision not to charge policyholders for the costs of the Office of the Policyholder Advocate, as a result all of the costs associated with the reattribution and fund transfer will be borne by the shareholder.

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3.02 The Capital that is Reattributed

The final value of the residual inherited estate will be based on the closing value of the CGNU Life and CULAC funds at the Effective Date.

This is not the value attributable to shareholders since there are a number of other costs, benefits and other factors to consider, such as:

- The number of eligible policyholders who accept the PIP offer
- Costs
- Policyholder incentive payment
- Continued market fluctuation and volatility

3.03 Additional Risks Associated with the Transaction

In assessing the potential return to shareholder for their investment (through the PIP); additional risks, which arise as a result of the transaction, need to be considered. These include:

3.03.01 Lock-in of the reattributed inherited estate (RIE)

Both the security of policyholders' benefits and ability to run the funds using the preferred management approach and strategy are key principles underpinning the running of the funds after the reattribution.

With these principles in mind, the RIE will be used to provide capital support for the newly created with-profits sub funds in AVLAP (New With-Profits Sub Fund (NWPSF) & Old With-Profits Sub-Fund (OWPSF)). In effect, following the reattribution the shareholder will take on the full risk that the RIE will be needed to 'make good' guarantees given to policyholders.

In order to provide capital support, all of the RIE will be locked in to provide security until the combined strength of the NWPSF and the RIE allows some of the RIE to be released to shareholders.² The earliest this can occur is 6 years after the reattribution.

Aviva has prepared projections which indicate that it will be necessary for the RIE to be locked in for many years beyond the 6 year minimum, although depending on a number of factors, such as:

- The mix of business that elects to accept the offer
- Run-off profile of policies
- Levels and mix of new business sold in the future

it may be possible to release some of the RIE shortly after the six year period has expired.

² See Chapter 6 of the Scheme

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3.03.02 Tax on investment earnings

Tax payable on investment earnings of a life company represents an additional tax burden for shareholders relative to holding the underlying assets directly. Therefore, any tax payable on the earnings on the inherited estate, whilst they are locked in, is an additional cost which otherwise would not have been incurred pre-retribution.

The factors underpinning the estimate of the investment earnings tax costs are:

- the investment mix between UK/non-UK equities, bonds, property and cash
- the assumed investment return on those assets, including (for equities and property) the relative contribution of income and capital growth
- the rate of inflation for assessing indexation relief on equities and property, and of overseas withholding tax suffered in relation to overseas equity income
- the average proportion of investment return attributed to life (as opposed to pensions) business and thus taxed at 20%

The average tax cost would then be calculated by determining an effective tax rate on investment return (allowing for indexation and double tax relief) for each asset class and weighting that effective rate according to the investment mix.

3.03.03 Tax on releases of the RIE

This will be the cost of any additional tax incurred if there is a release of the RIE from the long term fund to shareholders. This cost will depend upon the proportion of non-linked life and pensions business in the non-profit sub-fund at the time of the release, the underlying asset mix of the fund at the time and the amount of surplus release itself.

The factors underpinning the estimate of the tax charge on release are:

- the estimated time of release of the RIE
- the projected mix of non-linked business in the non-profit sub-fund at that time.

3.03.04 Tax asymmetries and uncertainty

There are asymmetries in the tax system, in particular where there are mismatches in treatment between gains and losses. For example, realised gains are taxed immediately but losses have to be carried forward for deferred relief. Such relief may never be received if future gains do not emerge. Similarly, there can be different categories of gains and losses which are not fungible in terms of being capable of offset against each other.

There will also be uncertainty in the tax rates and methodology that will apply. This is a risk that increases the longer the RIE is locked in

3.03.05 Investment expenses

Investment expenses will be incurred, as a result of the investment of the RIE, whilst it is locked in. These costs will be based on the actual expenses incurred, which in turn could depend on the asset mix of the RIE.

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Investment management costs will be incurred in respect of the investment of the RIE over the period until it is released into surplus. These costs will be based on the actual expenses incurred, which will in turn depend on the asset mix of the RIE.

3.03.06 Non market risks

The overall value calculation will include an allowance for all risks associated with the with-profits and non-profits business being transferred to the NWPSF, to the extent such risks may fall upon the RIE.

Market and credit risks associated with guarantees and options need to be considered.

Types of non-market risk considered:

- Controllable risks
 - Operational
 - Expense
- Non-controllable risks
 - Tax
 - Mortgage promise
 - Legal
 - Pension fund
 - Regulator's Actions
 - Insurance

3.04 The Shareholders Current Rights and Interests

FSA COBS rules set the regulatory framework which determines permitted uses of inherited estates. The management and uses of the CGNU Life and CULAC inherited estates is explained in Section 6 of the CGNU Life and CULAC Principles and Practices of Financial Management (PPFM).

In summary, the PPFM states that the inherited estate can be used at the board's discretion to:

- Provide investment flexibility. This means a higher proportion of the assets that back with-profits policies can be invested in potentially higher rewarding but higher risk investments, such as equities, than would otherwise be the case
- Provide a cushion of additional security for policyholder benefits against unexpected adverse events such as substantial falls in stock-market values
- Allow flexibility in the smoothing of maturity and surrender payouts for with-profit policies
- Provide the finance that is needed to support the continued writing of new business in the with-profits fund

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- Meet other purposes permitted by law and consistent with the Company's duty to maintain adequate financial resources

The Board manages bonus rates and investment policy in order to keep the inherited estate at levels which is in line with the risk appetite of the business and maintains solvency. This and the other uses of the inherited estate are overseen by the With-Profits Committee and the With-Profits Actuary.

The Policyholder Advocate has challenged a number of uses of the inherited estates, these are discussed in more detail in the appendix "Policyholders' and Shareholders' Rights and Interests in the Inherited Estates & Uses of the Inherited Estates".

Nevertheless, prior to the reattribution, shareholders already have a 10% interest in distributions from the inherited estate and could already use the inherited estate for specified purposes (in line with COBS rules) and established industry practice.

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4.00 Return to Shareholders

As mentioned in Section 2, the PIP offer is based on the principle that value unlocked by the reattribution should be shared fairly between policyholders and shareholders.

There are a number of measures that can be used to estimate what the return to shareholders might be from the unlocking of the reattributed capital:

- Internal Rate of Return (IRR)
- International Financial Reporting Standards (IFRS) Profit
- Market Consistent Embedded Value (MCEV)

The main benefits to shareholders from the reattribution can be summarised as:

- Shareholders receive all of the investment return on the reattributed inherited estate (RIE) and would be eligible to receive 100% of future releases of the RIE (where they are able to be made under the terms of the Scheme)
- Subject to some Scheme limitations, the RIE can finance new business with 100% of the new business profits from this business accruing to shareholders
- Dividend capacity will be increased
- Improved capital efficiency within the company

The eventual economic value created for shareholders will depend on a large number of factors, and will be affected by factors such as:

- The economic situation prevailing at the time the transaction is finalised and in the periods until the RIE is available for release
- Investment returns on the RIE
- The validity of the assumptions made when reviewed in hind-sight (actual policyholder behaviour, new business volumes, economic conditions etc.)

It is for these reasons that the measures used provide an indication of the possible returns rather than a definitive view.

4.01 Why Should Shareholders get a Return From the Transaction?

Prior to the reattribution, shareholders already have a 10% interest in distributions from the inherited estate and could already use the inherited estate for specified purposes (in line with COBS rules).

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As part of the reattribution process, the shareholder provides new money, up front to pay for the PIP and pays all of the costs associated with the transaction in return for the policyholders giving up their rights to any future special distributions from the inherited estate. They also take on the entire risk that some or all of the reattributed inherited estate may be needed now and in the future to make payments guaranteed to policyholders as well as to maintain the investment flexibility and security of the with-profits funds.

In order to make the transaction economically viable, shareholders expect to receive a fair return on their investment.

4.02 How Quickly Could Shareholders get Releases From the RIE?

It may be many years before the RIE could start to be released to shareholders. There are a number of factors which affect this, one being the amount of new business that is sold in these funds in the future – simplistically the more new business sold, the longer the shareholders may have to wait for releases from the RIE as the money is likely to be required to mitigate risks to policyholder benefits, such as the risk of stock market falls making asset values insufficient to back liabilities / guarantees in respect that new business (and also existing and future new business); some of the other factors include economic conditions and policyholder surrender and lapse behavior.

A minimum period of 6 years has been set (in the Scheme) as a 'back-stop' safeguard before any releases of the RIE to shareholders can take place. In effect this means that there is little or no incentive for the Board to reduce its planned levels of new business during this period since no release of the RIE to shareholders can take place.

Aviva has prepared projections which indicate that it will be necessary for the RIE to be locked in for many years beyond the 6 year minimum, although depending on a number of factors, such as:

- Take up rate and the mix of business that elects to accept the offer
- Run-off profile of policies
- Levels and mix of new business sold in the future

it may be possible to release some of the RIE shortly after the six year period has expired.

4.03 Why is our Offer not Excessive to Shareholders?

Shareholders will be taking on considerable extra risk relating to capital which is heavily locked-in. When these are all discounted, our approach targets an estimated IRR range of between 8.9% and 10.6% which is lower than would be expected from other group investments.

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5.00 Aviva's Conclusions at 31st December 2008

The implementation of the approach described above, leads Aviva to conclude that the offer is fair.

An offer of £500 million³ at 1st October 2009 equates to around 41% of the face value of the inherited estate. Combined with the £2.1 billion⁴ special distribution to qualifying policyholders (announced in February 2008), which released around 42% of the inherited estate value at that time. The offer represents a significant combined payment to existing with-profit policyholders.

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 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 future distributions could exceed the offer, or if the offer will always exceed the estimated future distributions

The shareholder return represents a fair return when both compared with other (global) investments the shareholder could make and when taking into account:

- That the shareholder provides all of the money to pay for the PIP
- Pays all of the costs associated with the transaction
- Takes on the risk that some or all of the reattributed inherited estate will be needed now and in the future to make payments guaranteed to policyholders

³ For a Reattribution Estate value of £1,200 million

⁴ As at the valuation date of 1st January 2008

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6.00 Alternative Approaches to Valuing the Reattributed Estate

In this section we explore the factors which could be considered when using alternative approaches to assess the fairness of the offer to both policyholders and shareholders.

These look at:

- Adjustments to the 'face value' of the inherited estate
- Costs that could be attributed to the inherited estate in the normal course of business
- Additional costs and risks as a result of the reattribution
- Existing interests of policyholders and shareholders in the inherited estate

6.01 Adjustments to the 'Face Value' of the Inherited Estate

In assessing the aggregate PIP offer to be made to policyholders one of the determining factors is the size of the inherited estate.

The size of the inherited estate for CGNU Life and CULAC is the starting point Aviva uses in considering two key aspects:

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

The appendix "Size of the Inherited Estates" provides details of our thinking on this topic.

6.02 Costs that Could be Attributed to the Inherited Estate in the Normal Course of Business

In this section Aviva assesses the impact of costs that could be attributed to the inherited estate in the normal course of business, and as a result are areas that could be considered by the shareholders when they assess the gross value created by the transaction.

6.02.01 Present value of tax on shareholder transfers on future new business

The realistic balance sheet (RBS) includes an allowance for costs in relation to the tax payable on shareholder transfers arising from existing business, but does not include an allowance for the tax payable on shareholder transfers arising from future new business.

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The current and past practice in the management of the inherited estate has been to include an allocation to the inherited estate for tax payable on shareholder transfers arising from both existing and new business transfers.

One way of allowing for this in the reattribution could be to make an appropriate deduction from the size of the estate.

Charging of the marginal tax on shareholder transfers to the inherited estate is consistent with distributing profits 90/10 after allowing for tax charges generated by the operation of the Fund. Surplus is determined after allowing for tax generated on the earnings of the fund (i.e. principally earnings on policyholder funds) and it is therefore fair for surplus to be determined after allowing for tax to be generated after allowing for shareholder transfers.

6.02.02 Tax on distribution of the inherited estate

The reattributed inherited estate will be transferred for tax and regulatory purposes to the Non Profit Sub Fund (NPSF) of AVLAP. Tax will be payable on any distribution of surplus made from the reattributed inherited estate. Based on current law, the tax rate payable will be based on the proportion of non-linked life and pensions business in the NPSF at the time of the distribution which will be at least six years after the Effective Date of the reattribution.

This charge could be increased or decreased or accelerated depending on changes to tax law between now and the time of release

6.03 Additional Costs and Risks as a Result of the Reattribution

In this section Aviva assesses the impact of additional costs that will be borne by shareholders as a result of the reattribution. In the normal course of business, these costs are not deducted from the inherited estate; they will however be taken into account by the shareholders when they assess the gross value created by the transaction.

6.03.01 Payment of the policyholder incentive payment (PIP)

The full cost of the PIP will be met by shareholders from outside of the CGNU Life and CULAC with-profits funds (including the inherited estate).

There are a number of ways in which the shareholder can fund the payment of the PIP, each has implications for the Groups IGD valuation.

The cost of raising the capital to fund the PIP is therefore a factor for consideration.

6.03.02 Lock-in of the reattributed inherited estate

Both the security of policyholders' benefits and ability to run the funds using the preferred management approach and strategy are key principles underpinning the running of the funds after the reattribution.

With these principles in mind, the RIE will be used to provide capital support for the new with-profits sub funds in AVLAP (NWPSF & OWPSF). In effect, following the reattribution the shareholder will

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take on the full risk that the reattributed inherited estate (RIE) will be needed to 'make good' guarantees given to policyholders.

In order to provide capital support, all of the RIE will be locked in to provide security until the combined strength of the NWPSF and the RIE allows some of the RIE to be released to shareholders.⁵ The earliest this can occur is 6 years after the reattribution.

Aviva has prepared projections which indicate that it will be necessary for the RIE to be locked in for many years beyond the 6 year minimum, although depending on a number of factors, such as:

- The mix of business that elects to accept the offer
- Run-off profile of policies
- Levels and mix of new business sold in the future

it may be possible to release some of the RIE shortly after the six year period has expired.

6.03.03 Tax on investment earnings

Tax payable on investment earnings of a life company represents an additional tax burden for shareholders relative to holding the underlying assets directly. As a result any tax payable on the earnings on the inherited estate whilst it is in the non-profit fund, is an additional cost which otherwise would not have been incurred pre-reattribution.

The tax charged to the reattributed inherited estate will be calculated under the tax calculation provisions of the Scheme as if it forms part of the NWPSF. The tax charged will depend upon the assets held in the reattributed inherited estate.

6.03.04 Tax on distribution of the RIE

The reattributed inherited estate will be transferred for tax and regulatory purposes to the Non Profit Sub Fund (NPSF) of AVLAP. Tax will be payable on any distribution of surplus made from the reattributed inherited estate. Based on current law, the tax rate payable will be based on the proportion of non-linked life and pensions business in the NPSF at the time of the distribution which will be at least six years the Effective Date of the reattribution.

This charge could be increased or decreased or accelerated depending on changes to tax law or to the mix of business between now and the time of release.

6.03.05 Tax asymmetries and uncertainty

There are asymmetries in the tax system, in particular where there are mismatches in treatment between gains and losses. For example, realised gains are taxed immediately but losses have to be carried forward for deferred relief. Such relief may never be received if future gains do not emerge. Similarly, there can be different categories of gains and losses which are not fungible in terms of being capable of offset against each other.

⁵ See Chapter 6 of the Scheme

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There will also be uncertainty in the tax rates and methodology that will apply. This is a risk that increases the longer the RIE is locked in

6.03.06 Investment expenses

Investment expenses will be incurred, as a result of the investment of the RIE, whilst it is locked in. These costs will be based on the actual expenses incurred, which in turn could depend on the asset mix of the RIE.

Investment management costs will be incurred in respect of the investment of the RIE over the period until it is released into surplus. These costs will be based on the actual expenses incurred, which will in turn depend on the asset mix of the RIE.

6.03.07 Non market risks

The overall value calculation will include an allowance for all risks associated with the with-profits and non-profits business being transferred to the NWPSF, to the extent such risks may fall upon the RIE.

Market and credit risks associated with guarantees and options need to be considered.

Types of non-market risk considered:

- Controllable risks
 - Operational
 - Expense
- Non-controllable risks
 - Tax
 - Mortgage promise
 - Legal
 - Pension fund
 - Regulator's Actions
 - Insurance

6.03.08 Payment of project costs

The FSA COBS rules set out specific guidelines for the treatment of project costs associated with a reattribution. COBS 20.2.52 state that the shareholder should pay a reasonable proportion of the Office of the Policyholder Advocate costs and that the remainder can be charged to either the inherited estate or relevant with-profits policyholders.

Aviva took the decision not to charge policyholders for the costs of the Office of the Policyholder Advocate, as a result all of the costs associated with the reattribution and fund transfer will be borne by the shareholder.

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6.04 Existing Interests of Policyholders and Shareholders in the Inherited Estate

The funds as a whole, including their inherited estates, are legally owned by the respective companies. From both a legal and regulatory perspective the inherited estate is an asset of the company and represents its working capital.

6.04.01 Policyholders existing interests in the inherited estate

Policyholders have a contingent interest in possible special distributions from the inherited estate which, in the case of CGNU Life and CULAC, would normally be paid in the proportions of 90% to policyholders and 10% to shareholders. From a legal perspective, a policyholder has no contractual right to expect such distributions during the lifetime of their policy.

6.04.02 Shareholders existing interests in the inherited estate

The shareholders' existing interest in the inherited estate is valued as 9.8% of the inherited estate before allowing for the same lock-in and tax inefficiency costs as applied to the reattributed inherited estate described above.

This allows for the fact that the additional tax payable on shareholder transfers is met by the inherited estate and hence the shareholder interest in the tax costs is only 10% (hence the 0.2% tax allowance).

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7.00 Assessing Whether Aviva's Offer Fairly Shares the Value Created between Policyholders and Shareholders

7.01 FSA Guidance

In their letter dated 1st February 2008 the FSA confirmed in a reattribution the shareholder pays an amount for the inherited estate including the tranche of capital which, absent a reattribution, would have transferred to future policyholders by way of intergenerational transfer. They went on to acknowledge that they do see a value attaching to this tranche of capital and expected the negotiations between the policyholder advocate and Aviva to consider how it might be reflected in the offer made to policyholders.

In considering whether a fair division of this tranche of capital had been achieved, The Office of the Policyholder Advocate assessed the residual value of the inherited estate after the existing interests and costs (as described above) are taken into account.

7.02 Summary of results using Policyholder Advocate approach (incl. size of estate) and Aviva assumptions

This information is summarised from the Office of the Policyholder Advocate's 8th April 2009 response to the Aviva plc proposed offer.

It should be stressed that these results are indicative, since projections of future events and economic circumstances are uncertain.

Reattribution Estate Value	£1.2bn	£1.57bn	£1.8bn
Value after reattribution costs, taxes & allowances	904	1,197	1,380
Shareholders' future distributions from whole estate	-130	-167	-189
Current policyholders' expected future special distributions	-83	-197	-292
Residual value after interests and costs	690	834	899
PIP based on 50/50 split of residual value ⁶	428	614	741

⁶ Calculated as "current policyholders' 90% future distributions" plus 50% of residual value

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Reattribution Estate Value	£1.2bn	£1.57bn	£1.8bn
Aviva plc PIP Offer	500	704	830
Policyholder share of residual value and PIP	60.4%	60.8%	59.9%

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

In her letter to John Lister dated 8th April 2009, the policyholder advocate concluded that "Overall therefore, under the current FSA rules, I am of the view that Aviva's PIP offer is in the interests of eligible policyholders. It is for the FSA to decide if the offer is fair and appropriately balances the interests of policyholders and shareholders."

Notwithstanding any approach and assumption differences, the Office of the Policyholder Advocate and Aviva are satisfied that the offer is in the interests of the vast majority of policyholders when compared against a wide range of scenarios.