

Report Number 38 A

Aviva's New Business Forecasts

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

The levels of future new business assumed to be sold and the basis on which that business is sold have significant implications in the assessment of the fairness of the Policyholder Incentive Payment (PIP) offer. The effects of the assumptions made on new business impact the assessment in two ways:

- The value of potential distributions to policyholders in the future
- The size of the inter-generational transfer, for example as a result of the capital required to support the writing of that new business

The offer made by Aviva as part of the reattribution represents what the company believes to be a fair payment when taking these factors into account in a range of economic and new business scenarios over the next 25 years. The offer is based on the whole of the inherited estates of CGNU Life and the Commercial Union Life Assurance Company (CULAC).

This appendix aims to explain why Aviva has used certain new business assumptions, the implications of those assumptions, and why Aviva believes its approach to be fair.

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2.00 Background to With-Profits New Business

2.01 With-Profits: Inter-Generational Transfer

For many years inherited estates have been used to provide support for initial costs (commission and set up costs). In doing so the intention is that in the future this support will be fully repaid, along with the lost investment earnings, to the inherited estate over time through the charging structure of the product.

In effect the inherited estate is used to provide support for both new and existing policies. This is sometimes described using the term 'inter-generational support' as the security and support provided by the inherited estate is passed from one generation to the next.

All current with-profits policyholders in the CGNU Life and CULAC funds have already benefited from this type of support.

As confirmed by the Financial Services Authority (FSA) in their clarification letter dated 13th December 2007, this inter-generational transfer is deemed to be an intrinsic feature of with-profits business.

Their letter states "In general terms, we are content that the inherited estate can be used to provide capital to back new business in the with-profits fund. The writing of new business, even where that business is expected to be profitable, will usually be associated with relatively heavy administrative, commission and set-up costs in the initial period. We consider that it is acceptable to use the assets in the inherited estate to meet those initial costs, provided the business is managed with a view to recovering those costs, and repaying them to the inherited estate, over a reasonable period.

Where there is a reattribution, we will review the firm's assumptions for its new business flows post-reattribution. We will consider the significance of the assumptions about the volume and nature of the new business which the firm expects to undertake, and whether the firm's assumptions are reasonable in the context of the reattribution scheme.

One of the results of writing new business into the fund is that the fund, or the inherited estate, is then effectively supporting the new policies as well as the existing policies. This transfers the benefit of the inherited estate between the 'generations' of policyholders and is an intrinsic feature of with-profits business where a fund is open to new business."

2.02 With-Profits: Fund Structure

Under their product literature and articles of association companies writing with-profits new business set out the basis on which profits made by the with-profits fund which are available for distribution will be shared between policyholders and shareholders.

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The CGNU Life and CULAC funds are termed as 90:10 funds, meaning that at least 90% of the net distributable profits generated are awarded ('distributed') to policyholders in the form of bonuses. As with the inter-generational transfers, the term 'policyholders' is used to describe both existing and future policyholders.

As the inherited estate¹ is used (amongst other things) to provide security for existing business and support the writing of new business, it will only be distributed (90:10) when the Board, following advice from the With-Profits Committee and With-Profits Actuary reasonably expects that releasing the money will not jeopardise policyholders' expectations of benefit security; investment flexibility (high equity backing ratio); and smoothing. The risk appetite framework employed by the Aviva UK Life Board sets out the governance framework for this assessment.

It is therefore understood that policyholders (both present and in the future, if they are invested at the time) have a 90% interest in any distributions from the inherited estate if they are made. Again, as with the inter-generational transfers, the term 'policyholders' is used to describe both existing and future policyholders.

In practice, when either distributions of surplus or special distributions from the inherited estate are made, those eligible policies in force at the Effective Date set by the distribution announcement qualify.

2.03 Benefits of Continued New Business to Existing Policyholders

In exercising its discretion on using the inherited estate to provide the capital support for the writing of new business, the Board must ensure that the investment prospects of existing policyholders are not expected to be adversely affected.

In addition, by continuing to sell new with-profits business through the CGNU Life and CULAC funds existing policyholders benefit from:

- The equity backing ratio (EBR)² of the fund being maintained at a higher level, which over time is expected to result in higher returns
- The risks within the fund being reduced through diversification between existing and new business, with a positive consequent impact elsewhere e.g. EBR, regular bonus rates etc
- Lower expenses as the costs are spread over more policies

¹ N.B. the inherited estate is not a separate entity within the with-profits fund. It is the difference between the realistic assets and realistic liabilities of the with-profits company

² The level of assets invested in a suitable proportion of equity-type assets, consisting of stocks, company shares and property (as well as cash, corporate and government bonds) compared with the remaining asset mix.

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3.00 With-Profits New Business: Aviva's Perspective

3.01 The With-Profits Market

The image of with-profits has been tarnished and as a result no one expects the with-profits market to return to the boom levels of new business seen in the early 1990s in the foreseeable future.

Aviva continues to believe that with-profits products provide a valuable investment option and has been taking steps to support the product and reinvigorate the market over recent years.

Some of the reasons Aviva continues to have a presence in this market are:

- Requirements described by investors relating to equity exposure, lower volatility and guarantees closely match the features of with-profit investments – investors want this choice
- 42% of advisors believe with-profits has a role to play³ – advisers want this choice
- In 2007, the with-profits fund was still in the top 4 of best selling funds for Aviva across all of its sales channels – it's a profitable source of business for the company
- The characteristics of with-profits business bring significant benefits to savers:
 - Provision of investment guarantees
 - Lower volatility
 - Pooled savings in equity related funds

With-profits have provided Aviva with a profitable source of new business over the years and we see no evidence to suggest that this will not continue to be the case.

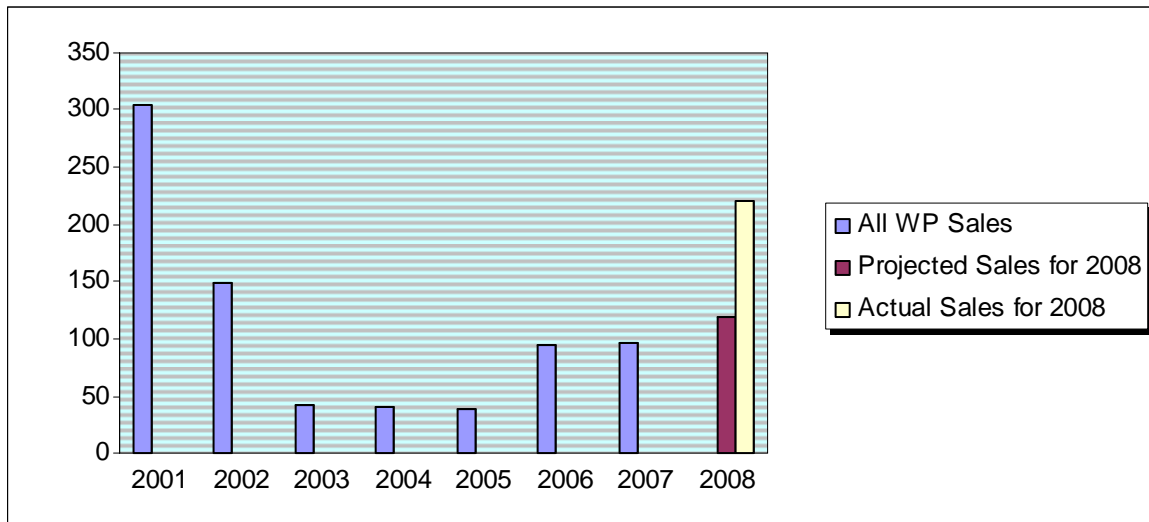
Aviva's historic volumes of new business are shown below. As can be seen from the illustration, the with-profits market has reduced considerably. The market contracted as a result of customer and distributor perception that performance was poor, mainly due to the:

- Stock market collapse in 2001/2003
- Equitable Life damaging the industry reputation
- Endowment mis-selling damaging the industry reputation
- Concepts such as market value reduction (MVR) and smoothing being poorly communicated, and as a result there being a mis-match with policyholder expectations
- Criticism over the transparency of the with-profits funds

³ Source: AIFA / ABI Stakes in the Ground (December 2006)

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With-Profits Investment Bond New Business Sales Annual Premium Equivalent (APE)



In reality, the actual performance of with-profits has been smoothed through a difficult set of circumstances. In doing so, with-profits have provided protection to the customer (enhanced by guarantees) and has out performed cash as illustrated below:

| Investment period at 1/9/08 (based on a £10,000 investment) | Annualised growth | | | |
|---|-------------------|--------------------------------------|----------------------|-------------------------------------|
| | With-Profit Fund | Average savings account ⁴ | Consumer Price Index | FTSE All Share (total return basis) |
| 3 years | 6.61% (5.35%) | 3.10% | 2.77% | 5.65% |
| 5 years | 7.56% (6.80%) | 2.87% | 2.40% | 10.05% |
| 10 years | 4.19% (3.82%) | 2.83% | 1.80% | 4.90% |

Source: Lipper Hindsight, £10,000 investment, net of income tax for a basic rate taxpayer.

Fund value figures are provided by Aviva and are based on a £10,000 initial investment into Portfolio Level Option or equivalent product prior to 07/07/2003

⁴ Moneyfacts average savings account up to 90 days' notice

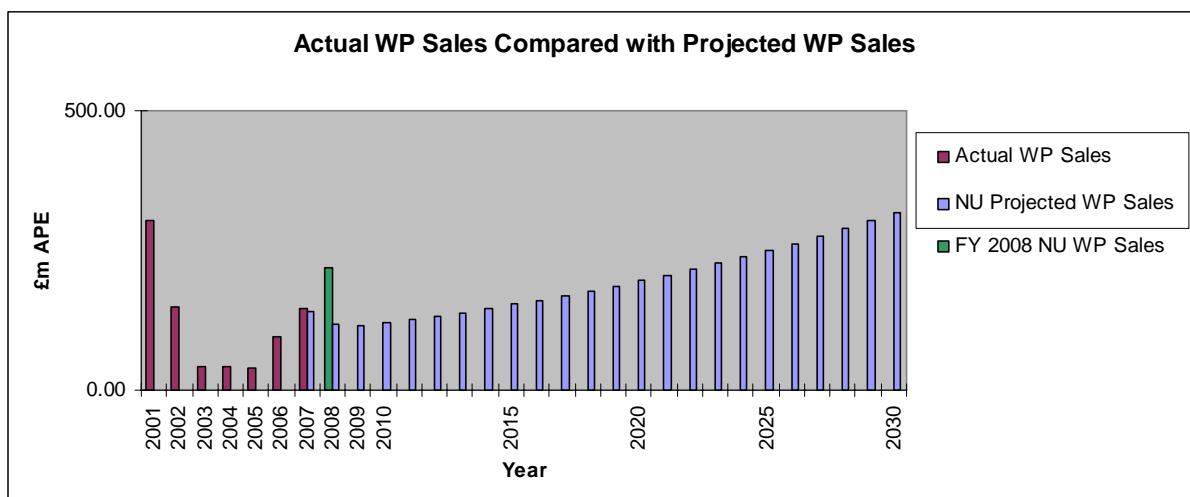
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3.02 Future New Business Volumes

As part of its normal business planning cycle, Aviva has set prudent assumptions for future with-profit business sales, and the mix of that business, which make allowance for some market growth.

These future sales assumptions make provisions for the continuation of the capital support (inter-generational transfer) both before and after reattribution.

For the purposes of evaluating the fairness of the PIP offer, Aviva has used lower new business assumptions than those shown in their current business plan. The new business assumptions used are represented in the graph below..



Actual sales volume reported against target have been strong and show a healthy growth in the market which supports our view that the with-profits market is sustainable and will continue to provide a profitable source of income:

- At the end of 2007, the with-profits sales annual premium equivalent (APE) reported by Aviva for the year was 121.5% of the business plan target
- At the end of December 2008, the with-profits sales APE reported by Aviva for the year was more than 220% of the projected sales target for the year

A key fact to note is that Aviva has not experienced a reduction in with-profit sales after the reattribution announcement even though new customers have not been eligible to participate in the reattribution.

For the purposes of the reattribution Aviva carried out stochastic modelling in a large number of economic scenarios testing the effects of differing levels of new business on the fairness of the outcome for both electors and non-electors.

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Aviva has not attempted to revise its new business assumptions that were used for the negotiations to take account of the increased with-profits sales volumes in 2008. As a result, in simple terms, the offer may be even better value for policyholders than indicated by Aviva's assessment.

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 potential new business scenarios.

The approach to with-profits new business post reattribution and the effects of future new business volumes on the fairness of the outcome for both electors and non-electors is outlined below.

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4.00 With-Profits New Business Post-Reattribution

Having taken into account current sales performance against target, the potential benefits of investment in new with-profits business and the terms of the reattribution scheme, the Board considers that new business plans will be unaffected by the reattribution; being written both on the same basis and volumes as those included in the companies business plans before reattribution.

This section therefore aims to clarify how the capital support provided to new with-profits business will be managed and how new with-profits business will be allocated between the old and new with-profit sub-funds if the reattribution of the inherited estates of CGNU Life and CULAC goes ahead.

When the Scheme becomes effective the Reattributed Inherited Estate (RIE) will be represented by the value of the Reattributed Inherited Estate External Support Account (RIEESA). The RIEESA is a separately identifiable account to be maintained within the non-profit funds of AVLAP. The purpose of retaining the RIEESA is to provide capital support to the Old With-Profits Sub Fund (OWPSF) and the New With-Profits Sub Fund (NWPSF) if this is required.

4.01 Principles

Generally speaking, policyholder investments in new with-profits business will be split pro-rata to the policyholder incentive payment (PIP) proportions of eligible policyholders who elect / do not elect to accept the reattribution offer.⁵

The capital support required for this new business is also split proportionately, but between the RIEESA and the OWPSF pro-rata to the proportions of eligible policyholders who elect / do not elect to accept the reattribution offer.

This approach ensures that the benefits of continuing to write new business (as described in section 2.03) continue to be shared with the non-electors in the OWPSF.

New policyholders will also receive a pro-rata interest in possible future special distributions from the OWPSF inherited estate – thereby continuing the inter-generational transfer as before reattribution.

These principles are further explained and illustrated below.

4.01.01 Scenario – 100% of eligible policyholders elect

In this first scenario we assume that 100% of eligible policyholders accept the reattribution offer – as a result the whole of the inherited estate will be reattributed and transfer to the RIEESA.

⁵ Full details of the mechanics that will be used to split the CGNU Life and CULAC inherited estate is provided in the Scheme Summary

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The Reattributed Inherited Estate (RIE) will remain in the support account until prudent trigger points are reached, meaning that the shareholders cannot gain immediate cash benefits. The RIE will remain in the fund and continue to provide security for existing business and support the writing of new business until such time as the Board (following consultation with the With-Profits Committee and With-Profits Actuary) believe that it is no longer needed.

The RIE remains locked in until tests prescribed in the Scheme demonstrate that releasing some of it to shareholders will not jeopardise policyholders' security.

In this way the previous inter-generational transfer to new policyholders continues, only now the new business support comes from the RIEESA. The net effect of this is that shareholders will have to wait longer before releases from the RIEESA can start taking place, however in writing new business shareholders will of course benefit from the value of that new business.

4.01.02 Scenario – 80% of eligible policyholders elect

In this second scenario we assume that 20% of eligible policyholders choose not to accept the reattribution offer – as a result (in simplified terms) 80% of the inherited estate will be reattributed and transfer to the RIEESA; the remaining 20% is moved to the OWPSF.

In a similar way to the previous example, the RIE will still remain locked-in and continues to provide security for existing business which chose to accept the reattribution offer (the '80%').

In exactly the same way as if the reattribution hadn't taken place, the OWPSF inherited estate is used to provide security for the existing business which chose not to accept the offer (the '20%')

In this scenario, both the RIEESA and the OWPSF inherited estate are used to support the writing of new business. The proportion of support provided by each of these is determined by the proportion of policyholders that accept the reattribution offer – in this example 80% would come from the RIEESA and 20% from the OWPSF inherited estate

In this way the previous inter-generational transfer to new policyholders continues, only now the new business support comes from both the RIEESA and the inherited estate. The net effect of this is that:

- Shareholders will still have to wait longer before releases from the RIEESA can start taking place, and
- Those existing policyholders who chose not to accept the offer (the 20%) plus the (20%) proportion of new business for each future policyholder continues to have a 90% interest in future special distributions from the OWPSF inherited estate if they are made. Therefore maintaining the situation in similar circumstances before the reattribution, except that the Scheme now defines the risk appetite and the point at which distributions of excess surplus have to be made (i.e. 120% of AAA).

In summary, in this scenario the inherited estate in the OWPSF will support 20% of future new business and maintain the situation before the reattribution. Existing non-electing eligible policyholders and 20% of future new with-profits business will have a 90% interest in special distributions from the OWPSF inherited estate if they are made.

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4.01.03 Incentives for the Board to continue to write new with-profits business

The Boards have an incentive to continue to write new with-profits business post-retribution – namely, the expected profitability of future new business exceeds the additional benefits that could be gained from accelerating releases from the RIEESA by not writing this business.

Aviva consider any additional benefit gained from attempting to accelerate release from the RIEESA (by intentionally reducing new business levels) to be exceptionally fragile.

This conclusion has been reached because the benefits actually achieved through such action will depend heavily on factors which are outside of the Board's control, such as stock markets and changes in regulatory requirements. The Board would therefore be giving up a 'relatively' secure new business profit stream for a possible acceleration in an uncertain amount of RIEESA benefits.

The sort of circumstances in which with-profits business becomes less attractive to customers (and therefore less profitable to shareholders) have historically been associated with falling stock markets causing a loss of confidence. These circumstances would reduce the value of accelerating releases from the RIEESA and therefore any perceived incentives to reduce new business levels substantially from those planned for after the retribution. Such circumstances are again outside of the Board's control.

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5.00 The Effect of Future New Business Assumptions on the Reattribution Offer

5.01 What Part do Assumptions on New Business Play in the Reattribution Offer?

The level of new business assumed for the future and its profitability play a key part in assessing whether the PIP offer made represents a fair value to policyholders relative to their contingent right to a 90:10 distribution of any excess surplus in the inherited estate in the future. Simply explained, the more new business assumed to be sold the longer it is likely to take to make releases from the RIEESA or special distributions from the OWPSF inherited estate and the more those distributions would be shared with future policyholders, and vice versa.

Since the amount of new business assumed delays when distributions could be made, the new business assumptions necessarily need some scrutiny to ensure that we continue to treat customers fairly.

There is a fine balancing act to perform here, since:

- If new business volumes are assumed to be too high, in hind-sight the offer could look to have been of less value for policyholders since shareholders may have paid too little for the rights given up by policyholders (although, shareholders will also have lost planned new business profit)
- Alternatively, if new business volumes are assumed to be too low, in hind-sight the offer could look as if shareholders paid too much for the rights given up by policyholders.

5.02 Levels of New Business Assumed for the Future

The levels of new business assumed are discussed in section 3.02.

Aviva has provided the Policyholder Advocate with information demonstrating that it is able to continue to write profitable new business in the future and that the value of this business is expected to exceed the additional value shareholders could create by shutting the funds to new business.

Aviva's future new business plans assume that capital support for the writing of new business will continue as before, with it being split proportionally between the RIEESA and the OWPSF inherited estate as described in the scenarios in section 4.00.

From Aviva's perspective prudent assumptions for future with-profit business sales have been used in our assessment of the fairness of the reattribution offer to policyholders and shareholders; we do

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however recognise that it is inherently difficult to accurately predict the levels of new business which will be written in the future. Some additional safeguards have been written into the Scheme to protect policyholder interests in the event that new business levels reduce following the reattribution:

- The AVLAP Board (following the approval of the WPC) can reduce the levels of new business reinsured to the OWPSF below the “Old WPSF Proportion” if the OWPSF becomes significantly weaker than the NWPSF after the Effective Date.
- Broadly, on or prior to 31st December 2013 should the AVLAP board decide to stop writing new business in the NWPSF and OWPSF; or if the amount of new business written is significantly below the amounts assumed by Aviva in our negotiation projection an amount will be transferred from the RIEESA to the NWPSF and applied to increase the asset shares of Elected Policies.

The full details of both of these safeguards can be found in the Scheme and the Actuarial Function Holders’ (AFH) report.

5.03 Conclusion

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 potential new business scenarios.

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

6.01 Market Context for With-Profits

As noted in section 3.01, Aviva agrees with the Office of the Policyholder Advocate that the with-profits market has contracted since the boom period of the 1990's, and the number of insurance providers offering new with-profit products has reduced.

It can also be seen that key characteristics of with-profits business (such as provision of investment guarantees; lower volatility and pooled savings in equity related funds) have become of higher value to savers during periods of significant market falls and increased market volatility (such as now).

Volumes of new with-profits business sold in the UK industry have grown in both 2007 and 2008 with (amongst others) Aviva, Prudential and Legal and General reporting healthy, above target growth in new business APE.

In their appendix the Office of the Policyholder Advocate has suggested that the ability to use an inherited estate to provide capital support for the writing of new business may provide a barrier to new entry into the with-profits market.

This aspect has been considered by the Office of Fair Trading (OFT)⁶ when they concluded "First, there are FSA rules on the terms in which new business can be written in a with-profits fund, which raise the cost of using the inherited estate and suggest that the cost of capital to with-profits firms from this source is not significantly different from, at least, the cost of capital to non-with-profits companies, some of which have also retained funds for working capital purposes.

Second, there is evidence that non-with-profits companies have been able to obtain a large share of new business being written despite not having an inherited estate.

The evidence on entry also does not suggest that it is the inherited estates that are inhibiting entry to the relevant markets: twenty or so years ago, when with-profits business had a much larger market share than it has now, and inherited estates were already substantial, entry did occur. Nothing material seems to have changed since and, if anything, inherited estates have shrunk relative to realistic liabilities.

While there may have been very few entrants in the last 10 – 15 years, this appears to be due to other factors."

⁶ Office of Fair Trading submission to the Treasury Committee inquiry into inherited estates, April 2008

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6.02 The Policyholder Advocate's View of the Outlook for the With-Profits Market

The Office of the Policyholder Advocate disagrees with our assessment of the future of the with-profits market. In their paper they suggest that Aviva's projections could lie towards the upper end of the range of potential outcomes and that this, in part, is because in their view, the reattribution itself may affect three aspects of Aviva's writing of new with-profits business:

- the terms on which Aviva writes new with-profits business;
- Aviva's willingness to write new with-profits business; and
- consumers' willingness to purchase Aviva's with-profits products.

Whilst we agree that the number of insurance providers offering new with-profit products has reduced, this has meant a larger market share for the remaining providers. Recently Aviva, Prudential and Legal and General have all reported significant growth in sales of new business with-profits products during 2008 – this runs contrary to the Office of the Policyholder Advocate's views.

We fundamentally disagree with the Office of the Policyholder Advocate's views that shareholders will have less incentive to write new business following the reattribution and that it will attract lower returns – our experience, assessment of the future management of the funds and business plans suggests otherwise.

In conclusion, we consider the Office of the Policyholder Advocate's alternative scenario views of the future of the with-profits market to be at an extreme which is not necessarily supported by recent evidence across the insurance industry.

The policyholder advocate does go on to acknowledge that new with-profits business forecasts are uncertain and that small changes in its relative attractiveness can be expected to have large volume impacts, as has been evidenced in the past.

Aviva considers the approach taken in assessing the reattribution offer against a range of new business projections is a pragmatic way forwards as long as policyholders are not misled by the guidance given to them into believing that future projections of possible outcomes are more certain than in reality they can be.

6.03 The Effects of a Reattribution on New Business Incentives

In their appendix the Office of the Policyholder Advocate has suggested that whilst other companies, such as Prudential, continue to write new business on terms that offer policyholders an interest in the inherited estates of their funds, following the reattribution Aviva's with-profit products will be less attractive to investors.

Aviva disagrees with this view for a number of reasons, primarily:

- The Office of the Policyholder Advocate's view is predicated on the assumption that an investors' sole reason for taking out a new with-profits policy is the potential for receiving distributions from the inherited estate. In reality, since the value of such distributions is so

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uncertain, we believe that there are many other factors which an investor (and their advisors) are likely to take into account first (such as the funds performance, security etc); and not with-standing this

- New Aviva with-profits policyholders will have a proportionate interest in any future distributions from the OWPSF inherited estate.

In the two years since the reattribution was announced Aviva has reported marked increases in their levels of new with-profits business (121.5% of the 2007 sales target and 220% of the 2008 sales target). Which supports Aviva's view that sales will be unaffected by the reattribution – as in effect those new customers are in the same position now as new with-profits policyholders after the reattribution, in that they have no eligibility to participate in the reattribution and will have only a proportionate interest in any future special distributions from the OPWSF inherited estate.

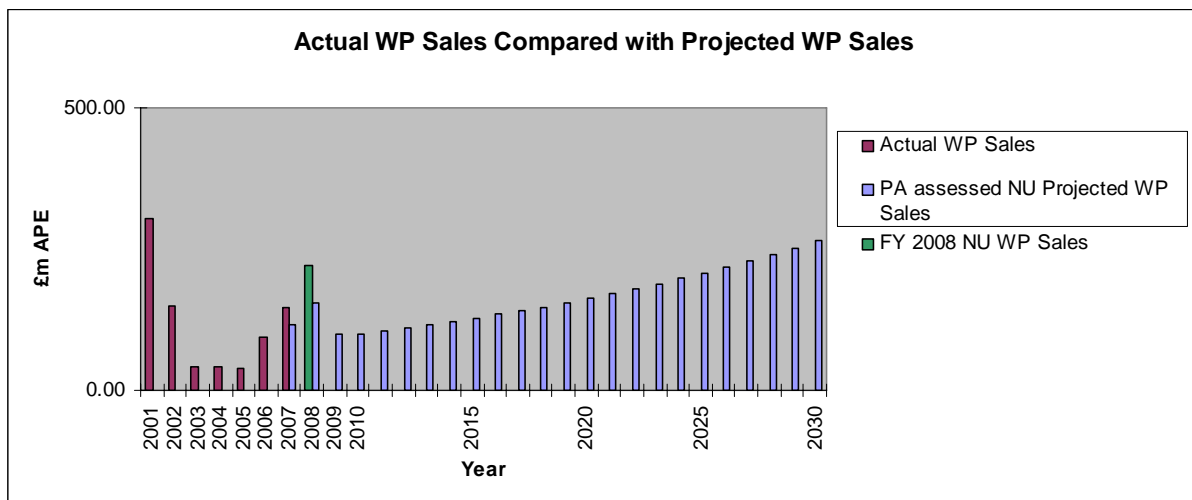
6.04 The Policyholder Advocate's New Business Scenarios

The Office of the Policyholder Advocate have analysed three new business scenarios:

- 5% growth from 2011
- 5% decline from 2011
- 15% decline from 2011

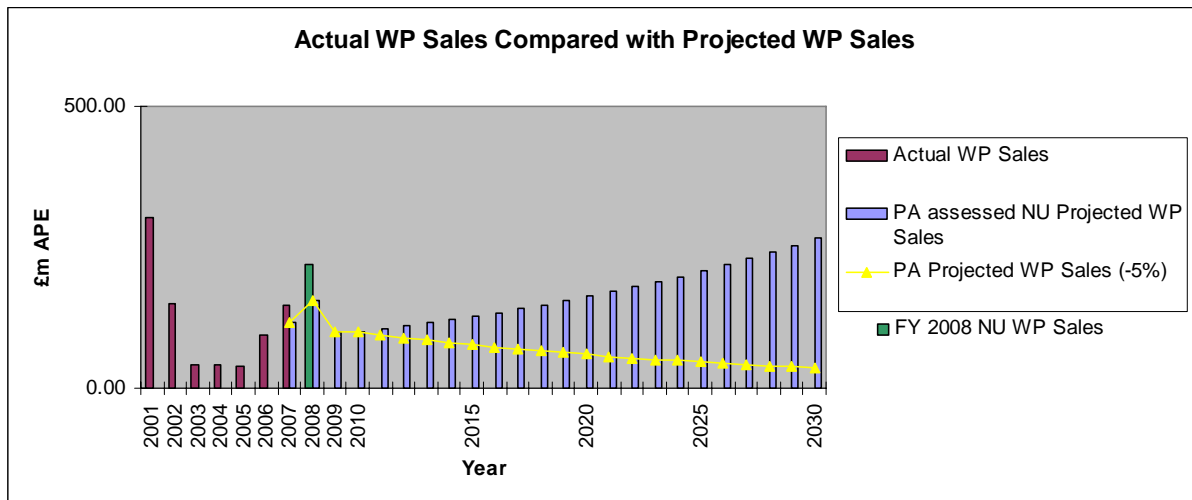
The graphs below illustrate the extent of the differences in new business assumptions used in the assessment of the reattribution offer.

6.04.02 Scenario 1: 5% growth

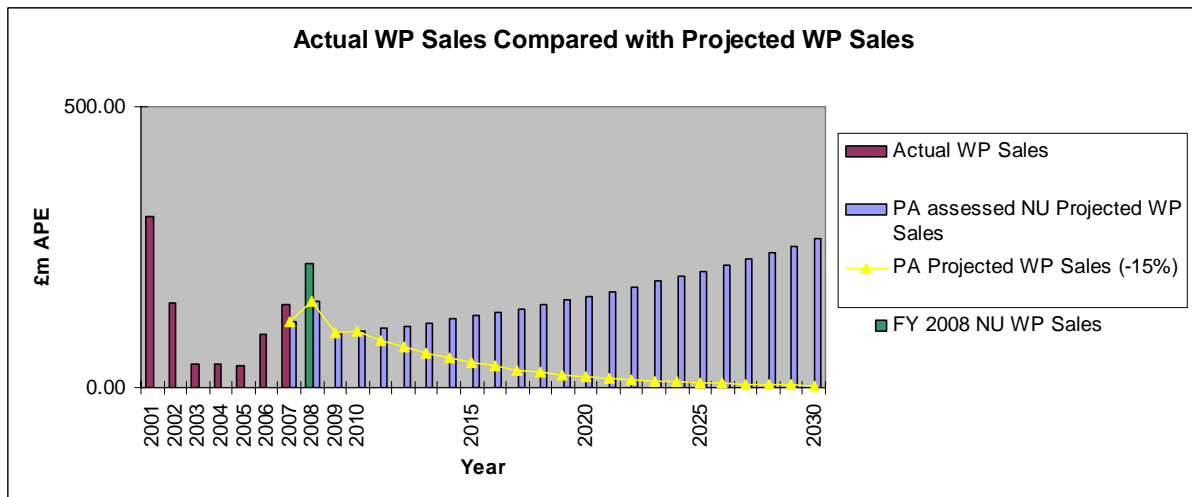


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6.04.03 Scenario 2: 5% decline



6.04.04 Scenario 3: 15% decline



6.04.05 Conclusions

Notwithstanding any 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 potential new business scenarios.