

Appendix 38B

Aviva's New With-Profits Business Assumptions

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

June 2009

Report by: LECG Ltd

Contents

1.00	Introduction and Summary	3
2.00	History of with-profits products in the UK savings market	6
3.00	Aviva's new with-profits business assumptions	13
4.00	The policyholder advocate's new with-profits business assumptions	17
5.00	Conclusions	25

1.00 Introduction and Summary

This appendix has been prepared by LECG Ltd. for the policyholder advocate, and is a response to Aviva's appendix on the same topic. While care has been taken to explain the technical terms and concepts contained in this appendix, the complex issues involved will be better understood by readers with some familiarity of the concepts involved.

This appendix describes the assumptions of Aviva and the policyholder advocate about future trends of new with-profits business. It also sets out the basis of reasoning underpinning each party's assumptions.

- Section 2 describes the history of with-profits products in the UK savings market;
- Section 3 summarises Aviva's new with-profits business projections;
- Section 4 describes the policyholder advocate's new with-profits business assumptions; and
- Section 5 sets out LECG's conclusions.

1.01 Context

The CGNU Life and CULAC with-profits funds are insurance funds for long-term savings. In total, the two funds hold around a million eligible life and pension policies, but the number and nature of the policies in the funds are not static. New policies are continually written into the funds; at the same time, old policies leave for reasons of maturity, surrender or death.

As analysed in *Appendix 39: The Impact of FSA Guidance on Policyholders*, the expected value and timing of new with-profits business forecasts are important to any evaluation of Aviva's reattribution proposals. This is because they affect the value of potential special

distributions, that current policyholders might receive if a reattribution did not occur, against which the firm's PIP offer needs to be compared.¹

In the extreme, if no new with-profits business were written, over time current policyholders would receive 100 per cent of the policyholders' 90 per cent share of any such special distributions from the inherited estates. However, to the extent that new business is written, it **dilutes** potential future special distributions to current policyholders, as they will be shared with future policyholders. Moreover, the use of capital to support new business **defers** any potential future special distributions from the inherited estates, all else being equal, thereby skewing the division of such distributions from current policyholders to future policyholders, because at the date when such distributions may be made, fewer current policyholders will remain in the funds (that is, there will be an 'intergenerational transfer' of special distributions from the estate to future policyholders).

All else being equal, therefore, a higher amount of new business serves to reduce the value of future special distributions from the inherited estates to current policyholders, absent a reattribution, to which Aviva's offer to policyholders is compared. The impact of new business on the value of potential future special distributions to current policyholders is set out in *Appendix 40: Analysis of Potential Future Special Distributions for Policyholders & Shareholders*. The policyholder advocate challenged the FSA rules which allow an inherited estate to be used to provide capital support to new with-profits business in this way. However, the FSA confirmed that it did not expect to change its guidance which permits this use of inherited estates (for more details see *Appendix 26: FSA Guidance Letters and Responses* and *Appendix 39: The Impact of FSA Guidance on Policyholders*).

The level of new with-profits business also affects the position of current policyholders who choose not to accept Aviva's offer. Following a reattribution, Aviva proposes to reinsure a portion of new business into the old with-profits sub-fund (Old WPSF) into which the

¹ It is not, however, the only factor affecting potential special distributions. Investment returns, FSA regulations and the insurer's risk appetite, among other things, will also affect the value and timing of potential special distributions.

inherited estate of non-electing policyholders will be transferred². The consequence of that reinsurance is that new policyholders will have access to special distributions from the inherited estate of the Old WPSF, as they do to the inherited estates of the funds today. The effects of new with-profits business on current policyholders, absent a reattribution, will therefore continue to affect policyholders who do not accept the offer after a reattribution.

1.02 Summary of conclusions

Aviva's new with-profits business projections assume the firm will maintain a constant share of a growing market for with-profits products. The policyholder advocate and her advisers believe that Aviva's projections could lie towards the upper end of the range of potential outcomes. This, in part, is because in LECG's 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.

The inherited estate currently bears some of the costs of writing new business, in particular non-market risk. The company also receives higher returns than the fund from new business since it continues to receive 10 per cent of special distributions from the inherited estate even though it is, on average, writing 98:2 business. Post-reattribution, the company will therefore either have to accept lower levels of profitability than it does today for writing new business, or increase the charges for new business. In addition, new policyholders will no longer receive special distributions from the electing policyholders' proportion of the estate. This will instead be reattributed to shareholders, potentially reducing the attractiveness of the products.

² Policyholder investments in new with-profits business will be split between the Old WPSF and the New With Profits Sub-Fund (New WPSF) pro rata to the policyholder incentive payment (PIP) of those who accept/do not accept the reattribution offer. Capital support will be provided, split between the Reattributed Inherited Estate External Support Account (RIEESA) and the Old WPSF, but pro rata to the proportions of policyholders who accept/do not accept the reattribution offer.

In addition, for a variety of reasons, demand for, and supply of, with-profits products have both been in long-term decline, notwithstanding Aviva's recent high sales of new with-profits bonds or the growth in 2008 of sales by Prudential and Legal & General.

In combination, the above factors suggest that the with-profits market is not likely to grow significantly and that Aviva's shareholders may have less incentive to write new with-profits business after a reattribution, both in comparison to Aviva's competitors and to the incentives that they would have to write such business, absent a reattribution. In addition, the actual values of any new business written will be heavily dependent on factors outside the company's control, suggesting that any projection can be only indicative.

Accordingly, new with-profits business forecasts are necessarily uncertain; especially since with-profits is a small segment of the savings market. Small changes in its relative attractiveness can be expected to have large volume impacts, as has been evidenced in the past. The policyholder advocate has taken this into account by assessing the reattribution offer against a range of new business projections that include Aviva's assumptions as well as more conservative assumptions than those used by Aviva.

2.00 History of with-profits products in the UK savings market

This section describes the context for with-profits products in the UK savings market. In particular, it describes the recent history of the with-profits market, including the current structure of the market and our view of Aviva's position in that market.

2.01 Background

With-profits funds are among the oldest types of savings vehicles in the UK. With-profits policies have traditionally been purchased by conservative savers seeking higher returns than are available from a bank or building society, but without high risk. With-profits policies reduce the impact of volatility of financial market returns (i.e. their risk) through the presence of guarantees and smoothing features that are supported by a broad range of investment classes besides equities alone. In effect, with-profits policies miss out on the crest of market

peaks but use the returns forgone at the market peak to provide support to policy value in market troughs.

Historically, policyholders have paid for these features of with-profits policies through reduced investment returns rather than through higher charges. Aviva aims to ensure that over time, any payments made to policyholders which are greater than the returns experienced by the fund are matched at other times by underpayments, so that over a cycle the payments made match the returns on the fund. The cost of guarantees and smoothing is wrapped up in the funds' overall returns to policyholders, rather than made explicit through direct charges to policyholders.³

With-profits products have been considered appropriate to support the writing of endowment policies (especially linked to mortgages), investment bonds (especially for higher-rate tax payers, when there were tax advantages in these products) and pension saving. In the 1980s, and most of the 1990s, with-profits products offered investors good returns and were seen as a safe long-term saving vehicle. In recent times, the with-profits market has come under pressure from:

- the reduction in tax advantages for long-term insurance products (including with-profits policies) in comparison to other forms of long-term saving;
- a reduction in the number of with-profits providers competing for new business. The fall in short- and long-term interest rates between 1998 and 2003 caused significant stress on many with-profits funds. The fall in long-term interest rates increased the present value of the funds' liabilities, leading to the

³ We understand that some with-profits funds do levy explicit charges for smoothing, although the CULAC and CGNU Life with-profits funds do not.

closure of many funds to new business.⁴ At the same time, there has been no new entry into the market for a considerable period of time;⁵

- the financial difficulties of certain funds, such as Equitable Life, may have reduced consumer confidence in with-profits products;
- recent periods of poor investment returns. The simultaneous fall in stock markets and interest rates between 2000 and 2003 reduced investment returns at the same time as the funds' future liabilities were increasing. In the years to 2008, returns on many policies experienced an almost continuous decline in their compounded average rates of return.⁶ Many policyholders have therefore received poor returns on their investment for much of the current decade compared to what might have been achieved through other investment products or during earlier periods. As a result, many with-profits mortgage endowments will not mature with a sufficient value to pay off mortgages. Recent market conditions have also obliged customers to appreciate the limitations of smoothing by inherited estates. We note, however, that with-profits funds are not unique in having been affected by market volatility and low returns, either since the late 1990s or during the recent market turbulence; and
- the rise of alternative savings products, such as Open-Ended Investment Companies ("OEICs") or Exchange Traded Funds ("ETFs") that offer lower charges and increased transparency of investment strategy and returns.⁷

⁴ Between 1994 and 2004, the number of open life insurance firms fell from 197 to 134. Over the same period, the assets of closed firms increased from £39bn to £139bn, accounting for 13% of the industry total in 2004. (source: O'Brien, C. & Diacon, S. (2005). Closed life funds: causes, consequences and issues, University of Nottingham, Centre for Risk and Insurance Studies, Report 2005-II). Of the 45 life offices for which FSA Form 59 section returns were available in 2007, only 18 are open to new business (source: Money Management, December 2008).

⁵ The last recorded entry into the with-profits market was in 1995. See *Appendix 11: The UK With-Profits Life Insurance Industry, A Market Review* by C.O'Brien, University of Nottingham.

⁶ Source: Money Management, December 2008, page 41. Returns are measured by comparing the initial investment to the "cash-in" value of policies, net of any applicable exit charges. The best-performing fund in the ten years to 2008 returned 5.9% p.a. on average. Over the same period, the average fund returned 3.3% p.a. and the worst performing fund 0.2% p.a. All three 10-year return figures are the lowest since Money Management started compiling 10-year returns for with-profits bonds in 2003.

⁷ Stephen Haddrill, Director General of Association of British Insurers in Financial Times, article 18, January 2008. An "OEIC" is an exchange-traded investment fund in which private investors may purchase shares.

In combination, the cumulative effect of these factors has been a generally falling trend of new with-profits business values being written. With-profits products have also been the subject of regulatory investigation by the Sandler report into the UK long-term savings industry, the FSA and in the Treasury Select Committee on a number of occasions. Certain of these investigations raised concern about the management of with-profits funds in the regulatory environment, prevailing at the time.

Regulatory comment and concern may have contributed to increasing uncertainty about with-profits products in recent years. It seems likely that new with-profits business levels declined in response to that uncertainty, either because of increased consumer resistance or because independent financial advisers (“IFAs”) are more reluctant to recommend them. Surveys indicate that IFAs consider the basic principles of with-profits funds (pooled risk, smoothed returns and guaranteed minimum bonuses) to be sound and that many would recommend them as part of a balanced portfolio of investments.⁸ At the same time, many IFAs have also expressed concern over the products’ lack of transparency, lack of tax advantages and relatively high mis-selling risk when compared to other products.

Whatever the reasons for the long-term decline in sales of with-profits policies, there is no contesting that it has occurred. From 1985 to 2007, new business Annual Premium Equivalent (APE - defined as 100 per cent of new regular premium business and 10 per cent of new single premium business), in all UK with-profits funds, not just Aviva’s with-profit funds, declined from £1,129m to £643m in nominal terms; over the same period, new business APE in non-profit funds increased from £349m to £3,260m. The rise in linked business was even steeper, from £1,132 million in 1985 to £13,555 million in 2007. In real terms, new with-profits APE has declined by 73 per cent from 1985 to 2007: having accounted for 42.6 per cent of new business in 1985, by 2007 it accounted for 3.7 per cent.⁹

We note, however, that new with-profits business APE increased from £566m in 2005 to £611m in 2006 and £643m in 2007. It remains to be seen if this reversal of the long-standing

⁸ NMG Financial Service Consulting. “Stakes in the Ground. With Profits.” AIFA/ABI. December 2006

⁹ See *Appendix 11*, The UK With-Profits Life Insurance Industry: A Market Review, Section 2, for a detailed analysis of the market for with-profits products.

decline of the market segment will be permanent or only temporary. However, it does serve as a reminder that new business levels are very uncertain.

A significant portion of the recent growth in new with-profits business sales has been made by funds owned by Aviva plc. For instance, in the first ten months of 2008, Aviva accounted for around two-thirds of all sales of new with-profits bonds, with a majority of the remaining third being accounted for by Prudential.¹⁰ We understand that Aviva has been selling subsidised products, since 2006, which have offered policyholders either a high guaranteed return relative to market rates or lower charges than are available on competing products.¹¹ In the absence of these subsidies, whether for guarantees or expenses, it is possible that Aviva's new business values would have continued to decline as the segment has over many years. Further comments on Aviva's recent performance in the with-profits segment are in Section 3.02 below.

2.02 Structure of the market for with-profits products

The closure of 42 per cent of large funds between 1998 and 2004 has led to a rise in concentration among providers of with-profits products.¹² Between 2000 and 2007, the share of new with-profits business, written by the top four firms in the segment, rose from 42 per cent to 65 per cent (Table 1). The top four firms by new business APE in 2007 were Prudential (32.7 per cent), Aviva (20.6 per cent), Aegon (5.8 per cent) and Legal & General (5.4 per cent%)¹³.

The asymmetry between the costs and risks of the larger incumbents, and those of potential entrants or firms with small inherited estates may represent a barrier to new entry into the

¹⁰ Source: Money Management, December 2008. We note from the same source that Aviva's commissions are currently among the highest in the marketplace, up to 4.5% of the amount invested.

¹¹ We understand that Aviva has ceased to subsidise products with high guaranteed values, but that it continues to offer products with subsidised expenses.

¹² A large fund is used here to mean one with more than £500 million assets.

¹³ Market share of companies now forming Aviva Plc has varied significantly. It was 5.76% in 1995, 2.73% in 2001, 6.20% in 2003, 7.60% in 2004 and 13.62% in 2005. See *Appendix 11: The UK With-Profits Life Insurance Industry: A Market Review*.

with-profits market.¹⁴ The positive correlation between insurers' market shares and the sizes of their inherited estates is evident from Table 1 below.

Table 1 Market shares and inherited estates of top four with-profits insurers, 2007¹⁵

With-profits (WP) provider	Market share of direct new WP business (2007)	Adjusted inherited estates ¹⁶	Estate as percentage of liabilities	New business APE as percentage of estate
Prudential	32.7%	£9,251m	10.6%	3.3%
Aviva plc	20.6%	£4,453m	7.7%	3.0%
AEGON NV	5.8%	£953m	8.6%	3.9%
Legal & General	5.4%	£1,047m	5.7%	3.3%

Source: *Appendix 11: The UK With-Profits Life Insurance Industry: A Market Review*. Figures include NULAP, CGNU Life and CULAC funds.

The importance of inherited estates to the writing of new business might also be supported by Aviva's published figures. These show that in 2007, the company wrote £79.3 million APE of new business in the CGNU Life fund and £67.4 million in the CULAC fund. In contrast, the company wrote £2.3 million of new business into the NULAP fund that has a small inherited estate in relation to the value of the fund's liabilities. (These new business figures differ slightly from those in *Appendix 11: The UK With-Profits Life Insurance Industry: A Market Review* but Aviva have not been able to explain the difference). In 2008, the company wrote £117 million APE of new business into the CGNU Life fund, and £103 million into the CULAC fund.

Outside of the four companies shown above, the proprietary insurer with the largest inherited estate is AXA (today AXA Sun Life), which performed its own reattribution in 2001. At the end of 2007, AXA Sun Life's inherited estate was £692 million, representing around 8.6 per

¹⁴ Aviva points out that a larger inherited estate, all else being equal, helps to deliver higher returns to policyholders as the fund is able to support a higher ratio of equities backing liabilities. There is some evidence to suggest that financial strength and investment returns are linked. Source: Money Management, December 2008, page 47.

¹⁵ Liabilities have been calculated simplistically as assets less the value of the adjusted inherited estate. Source: *Appendix 11: The UK With-Profits Life Insurance Industry: A Market Review*.

¹⁶ Adjusted inherited estates adjust the 'realistic balance sheets' of insurers to exclude, from the liabilities, the planned enhancements to asset shares in closed funds or sub-funds that arise as a result of the planned distribution of the inherited estate such as the special distribution announced by Aviva in February 2008.

cent of liabilities. In 2007, however, AXA wrote new business with an APE of only £17 million, representing a 2.6 per cent market share, or 1 per cent of the size of its inherited estate (compared to more than 3 per cent for the leading funds shown in Table 1 above).¹⁷ Prima facie, therefore, it might appear that shareholder ownership of the inherited estate may affect incentives to write new business.

It is true that, in recent years, profits on writing new with-profits business have been low, despite the use of inherited estates to support expenses and the cost of guarantees. The low profitability is evident from movements in companies' inherited estates reported in FSA returns. In 2006, new business reduced Prudential's inherited estate by £49 million. Aviva's inherited estates fell by £105 million in the same year. In 2007, the reductions associated with new business were £94 million and £59 million respectively. Over 2008, the global economic crisis has meant that Aviva's inherited estate has fallen sharply, from £2,115 million to £1,570 million.¹⁸ If new with-profits business were priced to reflect market costs of capital, it is possible that the profitability of new business would be further reduced.¹⁹

In light of the evidence set out above, we believe that Aviva's view of the outlook for new with-profits business in general, and for Aviva's with-profits business in particular following a reattribution, could lie towards the upper end of potential outcomes. Our view is based primarily on the continuing decline of aggregate amounts of new with-profits business from market players other than Aviva and Prudential. That decline is partly driven by falling supply, as with-profits funds close to new business, and by falling demand, as investors choose to save through other products. Today, with-profits products have become but a small part of the overall market for long-term savings.

Notwithstanding past trends, future new with-profits business levels are impossible to forecast accurately, partly because it is a relatively small segment of the savings market. Aviva has

¹⁷ Figures for AXA Sun Life exclude Winterthur Life UK, subsequently merged with AXA Sun Life.

¹⁸ The end-2008 figure of £1,570 million is made up of the £1,529 million published value plus a £41 million post year-end adjustment, and includes a repayment by shareholders of £100m for capital support of new business in 2008. (Aviva has required that this figure be blanked out on the basis that it is commercially sensitive. The policyholder advocate believes this figure is not commercially sensitive and should be disclosed.)

¹⁹ We note, however, that the capital subsidy for new business provided by the inherited estate is not the only factor influencing the value of the inherited estate.

explicitly projected new business levels up to 2010 and from 2011 onwards assumed new business growth, in nominal terms, to be 5 per cent per annum (see section 3). Due to the uncertainty in accurately predicting new business levels, the policyholder advocate has considered sensitivities of a 5 per cent per annum decline in new business from 2011, and a 15 per cent per annum decline in new business from 2011 (see section 4.02 below).

3.00 Aviva's new with-profits business assumptions

This section describes Aviva's assumptions about the terms on which its future new with-profits business will be written and the forecasts for new with-profits business values that are associated with those assumptions. FSA regulations have historically permitted insurers to subsidise new business from the inherited estates of their funds. Following recent FSA guidance, new business must be written on terms that are not expected to erode the inherited estate over the life of the policy (with the exception of the cost of non-market risk). However, as noted above, the FSA continues to permit inherited estates to be used to provide capital support for new with-profits business.

Aviva's most recent new business projections date from the end of 2007 and have been modified to incorporate the FSA's regulatory guidance. Since that time, Aviva has also provided updated figures for actual new business written in 2008. Our description of Aviva's new business projections is based on Aviva's projections made at the end of 2007, updated to include values to the end of 2008. Aviva has not updated its projections to take account of full-year 2008 new business sales.

3.01 Aviva's assumptions about future new business values

Aviva has put forward two sets of assumptions for future new business values. The first, a "low subsidy scenario" assumes that new business products are written on terms under which the new business expense subsidy reduces over the period from 2008 to 2013 to a level that is

considered “sustainable” over the long term. The second scenario assumes that there is no subsidy to new business from the inherited estate.²⁰

As set out in the Principles and Practices of Financial Management (PPFMs) of the CGNU Life and CULAC funds, all bonuses from the funds (reversionary, terminal and special) are currently distributed to policyholders and shareholders in a ratio of 90:10. Under the low subsidy scenario, shareholders would be required to support new business to some degree themselves. The effect of those costs to shareholders would be to modify the expected division of benefits from non-special distributions (that is, reversionary and terminal bonuses) on new business over a period of years to a ratio of around 95:5 instead of the customary 90:10. Under the no subsidy scenario, new business would effectively be written on 98:2 terms (i.e. policyholders would receive 98 per cent of the regular benefits under the policies and shareholders 2 per cent).

Aviva says that its calculations, in respect of the no subsidy scenario, demonstrate that new business is profitable in the absence of subsidies from the inherited estate and, therefore, that writing new with-profits business is in the interests of shareholders because its value exceeds that of a scenario under which the funds were closed to new business.

Aviva expects to write the same value of new business under either subsidy assumption. The company’s new business projections are also the same following a reattribution as absent a reattribution. Aviva notes, however, that its assumptions in respect of new business terms do not necessarily represent the terms that Aviva will use in the future.

3.02 Aviva’s recent new business performance and market outlook

Aviva has grown its share of new with-profits business in recent years. The market share of with-profits business of the companies held by Aviva Plc has grown from 2.73 per cent in 2001 to 7.60 per cent in 2004, 13.62 per cent in 2005, 19.98 per cent in 2006 and 20.60 per cent in 2007. New with-profits business values for the CULAC and CGNU Life funds in

²⁰ The FSA permits the cost of non-market risk on new business to be charged to the estate and any such charges made are a subsidy.

2006 were £95 million Annual Premium Equivalent (APE), rising to £147 million in 2007 (Table 2). In 2008, Aviva wrote new with-profits business into these funds with an APE of approximately £220 million, suggesting that the recent growth in values has continued despite the withdrawal of high guaranteed values previously offered to new business and supported from the inherited estates. Aviva has confirmed that with effect from 17 April 2009, the Inflation Protected Guarantee (IPG) option has been withdrawn from its investment bond for sale to new customers. As shown in Table 2 below, savings and bonds products have dominated recent new with-profits business values.

Table 2 Aviva's recent new with-profits business values, CULAC and CGNU Life funds, APE, £ million

	2006	2007	2008
Savings & bonds	83	122	196
Pensions	12	25	24

Source: Aviva, CULAC and CGNU Life funds only.

Aviva's position is that there is a sustainable long-term future for with-profits products and that with-profits products will continue to form a core business line for the company, despite a recent history of declining supply and demand. Aviva's case is supported by the strong growth it has experienced in new with-profits business since 2005. Aviva's business plans acknowledge, however, that there are external challenges to the with-profits market. Aviva plans to overcome those challenges by continuing to offer with-profits products on attractive terms to consumers and by a programme of education and support for distributors, including IFAs.

Aviva's assumptions show sustained growth in new business APE value over the period from 2010 to 2031. Aviva says that the characteristics of with-profits products match investor requirements, particularly in respect of investment guarantees and smoothing, and that a sufficient proportion of advisers continues to recommend with-profits products as appropriate investments in the overall context of a diversified portfolio.²¹ Overall, Aviva assumes the market for long-term savings products to grow by around 5 per cent p.a. in future (in nominal

²¹ From the AIFA document *Stakes in the Ground* December 2006
 15 of 27

terms), for with-profits products to maintain their share of that market and for Aviva to maintain its share of new with-profits business. Aviva assumes the 5 per cent annual growth after 2010 to be divided approximately equally between real growth of 2 per cent or 3 per cent and inflation of 2 per cent or 3 per cent.

3.03 Aviva's new business assumptions

Aviva has provided new with-profits business assumptions up to the year 2031, consistent with the projection period of the fund-level data that Aviva has provided to LECG in the context of the reattribution. Aviva's new business projections have not been adjusted to include actual sales in 2007 and 2008. All policies sold over the period are assumed to be unitised, rather than conventional with-profits policies.²² New with-profits pensions values (APE) are assumed to grow throughout the projection period to 2031, by around 10 per cent p.a. to 2010 and by 5 per cent p.a. thereafter.

Aviva's new business assumptions for with-profits bonds show:

- a steep fall in sales in 2009, reflecting the reduction or withdrawal of subsidies to new business;
- a year of stabilisation in 2010; and
- continuous growth in the value of sales of 5 per cent p.a. thereafter.

All of the figures presented by Aviva are in nominal terms, that is, they have not been adjusted for inflation. Aviva's projections are summarised in Table 3 below.

²² Conventional with-profits policies have a basic sum assured to which bonuses are added. Unitised policies are similar, save that the policy value is represented by units. Over time, a policy would typically expect to have a claim on an increased number of units in the fund, the value of units remaining constant.

Table 3 New with-profits business values, CULAC and CGNU Life funds, APE £ million ²³

	2007 (actual sales)	2008 (actual sales)	2009 (assumption)	2010 (assumption)	2010+ (assumption)
Life	122	203	93	95	+5% p.a.
Pensions	25	18	23	25	+5% p.a.

Source: Aviva, CULAC and CGNU Life funds only.

4.00 The policyholder advocate's new with-profits business assumptions

In this section, we set out the policyholder advocate's assessment of Aviva's new business projections and describe the policyholder advocate's alternative new with-profits business assumptions. Differences arise from differing interpretations, first, of the state of the market for with-profits products (discussed in Section 2 above) and, second, of the impact of a reattribution on the shareholders' and future policyholders' economic incentives (4.01 below). In addition, the policyholder advocate notes that with-profits is only a small portion of the UK market for long-term savings products and therefore small changes in with-profits share of the savings market would have a large impact on volumes sold. The future performance of with-profits policies over the next 25 years, and Aviva's share of that market, may in future be influenced by a wide variety of factors that cannot be accurately foreseen today. Given the inherent uncertainty surrounding new business levels in the future, the policyholder advocate has looked at sensitivities for the amount of new with-profits business that Aviva may write in future (4.02 below).

4.01 The effect of a reattribution on new with-profits business incentives

Aviva says that its new business assumptions are unaffected by the reattribution: it would write the same value of new business, absent a reattribution, as it would following a reattribution. It is possible that Aviva's sales will not be affected by the reattribution. There

²³ As previously noted, Aviva's new business projections from 2009 forward have not been adjusted to include actual sales in 2007 and 2008.

are reasons to believe, however, that the reattribution may affect Aviva's position and incentives in the market for new with-profits business.

In our 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.

With respect to the terms on which with-profits products are offered to consumers, we note that Aviva has provided both capital and expense subsidies to new business in recent years.²⁴ In effect, Aviva's new business projections are based on recent sales of policies whose terms divide regular benefits between policyholders and shareholders in a range from 95:5 to 98:2. Those subsidies may have been a significant factor in Aviva's recent growth of new with-profits business APE. It is not known, however, whether such terms are sustainable. Aviva itself notes that it may not actually write new business on those terms in future. If shareholders do not write new business on terms similar to those recently on offer, it seems likely that the products will be less attractive to consumers, which could be expected to result in lower sales of new with-profits policies than in the recent past.

Alternatively, if shareholders do write new business on terms similar to those currently on offer, it is likely that shareholders will earn lower returns on new with-profits business. For those returns to be both sustainable and attractive to shareholders they must:

- exceed Aviva's cost of capital. It is possible that writing new business on 98:2 terms does offer an overall return in excess of Aviva's cost of capital once the returns from management fees, charges and the benefits of the reattribution to shareholders are taken into account, although these should be provided on an

²⁴ We understand that direct capital subsidies have been withdrawn from Aviva's recent product offers. Aviva continues to subsidise new policies' expenses. We understand that the subsidy is drawn from shareholder funds and does not erode the inherited estate. The capital subsidy inherent in transferring the estate from one generation to the next is assumed to continue.

arms-length basis and hence would not provide any ‘supernormal profits’ (i.e. profits above a risk-adjusted rate of return) and would add no economic value; and

- be superior to the next-best use that Aviva could find for the capital used to write new business. Aviva has noted that writing new business on 98:2 terms offers an acceptable rate of return to shareholders, while they receive 10% of all special distributions.

We do not know what returns are available to shareholders on other business lines or projects in the Aviva group and neither do we know Aviva’s returns on management fees and charges. It is therefore unknown whether the writing of new business on 98:2 terms in what may be a declining market segment will be the best use that Aviva can find for the capital in the reattributed inherited estate.

With respect to supply, as noted above, the writing of new business increases a with-profits fund’s capital requirement and, therefore, reduces the probability of distributions of excess surplus from the estates. Under the funds’ current Principles and Practices of Financial Management (PFFM), and absent a reattribution, 90 per cent of the potential special distributions forgone as a result of that higher capital requirement are borne by policyholders (mostly current eligible policyholders) who would otherwise benefit from greater distributions from the inherited estate if less new business were written. In addition, if the inherited estates fall in size as a result of low or negative investment returns, 90 per cent of the reduction in their value is implicitly borne by policyholders. Following a reattribution, shareholders bear all of the risk associated with the value of the reattributed inherited estate and, by extension, the potential value of capital releases from it. If investment performance is poor, the value of the reattributed inherited estate (RIE) is reduced. In addition, under those circumstances, the RIE may be called upon to support policyholders’ guarantees, again at shareholders’ cost.

In addition, shareholders have in recent years been getting higher returns than the fund from new business through continuing to receive 10 per cent of special distributions to new policyholders, which is higher than shareholders’ proportional investment in new business of

between 2 and 5 per cent. This excess return means that the prices of new policies would have to rise, following a reattribution, to enable shareholders to maintain the current return on new business.

The writing of new business on terms that effectively provide shareholders with only 2 per cent of the regular benefits would also appear inferior to the historic 90:10 basis on which with-profits business has been written by Aviva. Even absent a reattribution, therefore, it is possible that shareholders' best interests may be served by writing less new business than has been projected by Aviva. The lower profitability of new business post-reattribution can only reinforce that tendency.

Post-reattribution, shareholders may also receive lower returns from higher amounts of new business than they would from lower amounts, all else being equal. After a reattribution, shareholders will bear 100 per cent of the opportunity cost of leaving additional capital in the RIE, rather than releasing it for deployment in other areas of Aviva's business. In those circumstances, the writing of a higher value of new with-profits business will defer, but not dilute, the release of capital to shareholders (compared to a scenario in which less new business is written) and hence lower the present value of capital releases from the RIE to shareholders. The financial impact of the deferral is partially offset by the fact that shareholders can deploy some of the RIE capital (above thresholds approximating to the minimum prudential capital requirements) on investments that would otherwise have required alternative funding. This is referred to by Aviva as "capital synergy". The impact may also be mitigated by any profits earned by shareholders from the new business itself.

Nevertheless, such mitigating factors may not offset the opportunity cost of deferring future releases of capital and of losing the disproportionate return on special distributions to new business.

Although costs charged to the inherited estate pre-reattribution may continue to be charged to the RIE post-reattribution, shareholder ownership of electing policyholders' current interest in the inherited estate, via the RIE, means that shareholders will effectively bear such costs themselves in respect of the new with-profits sub fund (NWPSF). Potentially, therefore, shareholders may face higher costs following a reattribution than absent a reattribution,

particularly if Aviva chooses to pursue its present policy of subsidising expenses on new business and charging non-market risk to the inherited estate, via the RIE rather than to future policyholders.²⁵ To the extent that the RIE is used to write new business, shareholders must bear all costs and risks, but will earn 100 per cent of the profits on any new business written into the NWPSF.

In our view, if Aviva writes the same value of new business following a reattribution as absent a reattribution, all else being equal, it is accepting potentially higher costs and risks than would arise on the same value of new business absent a reattribution. It may also lower the value of releases of capital compared to a scenario in which it wrote less new business and need to accept lower returns than would be available on new business absent a reattribution. It therefore seems likely that Aviva's shareholders would need to accept lower profits and higher risks on new business than would be borne by the shareholders of competing firms whose funds have inherited estates where policyholders bear at least 90 per cent of the cost of subsidy.

Finally, with respect to demand for with-profits products, it is possible that Aviva's with-profits products will be less attractive to new policyholders, post-reattribution, than those of competing firms. First, new business policies will be written on terms that deny new policyholders any interest in the RIE. The FSA has recognised that policyholders' reasonable expectations of future distributions from the estates are not zero, suggesting that future policyholders will forgo something of value that is granted to current policyholders. All else being equal, therefore, a policy with an interest in the inherited estates will be more valuable than one without any interest in the inherited estates.²⁶²⁷ We note that other companies, including the largest with-profits provider Prudential, will continue to have the option of writing new business on terms that offer policyholders an interest in the inherited estate of their funds. In comparison to competing products, therefore, Aviva's with-profits policies

²⁵ Existing policyholders cannot be charged for the costs of non-market risks as they were not charged for these costs before the reattribution.

²⁶ New policyholders will continue to have a proportionate interest in the inherited estate of the OWPSF. Both Aviva and the policyholder advocate expect that the value of this interest will be very small in comparison to the value of the interest in the whole of the inherited estate that new policyholders would have in the absence of a reattribution.

may well be less attractive to consumers in future. Aviva notes that it already writes such policies, and has done so since November 2006 without suffering a fall in new business APE. In our view, however, Aviva's subsidisation of new business is likely to mask the potential reduction in demand associated with the loss of any interest in the inherited estates.

Aviva could redress such a disadvantage by enhancing its products' features, for instance their minimum guaranteed value. Given that the cost and risk of any such enhancements will be borne by shareholders following a reattribution, however, Aviva's shareholders would again need to accept lower returns and higher risk on its policies than its competitors' shareholders would on any similar policies that they offered. Alternatively, Aviva could offset the costs of such product features with higher charges to policyholders. Such a policy is also unlikely to render Aviva's with-profits policies more attractive to consumers than those of its competitors.

In conclusion, therefore, we believe that Aviva's with-profit products will be less attractive to consumers after a reattribution. We also believe that Aviva must accept lower profits and higher risks, all else being equal, if it wishes to write the same value of new business following a reattribution as it would write absent a reattribution. A reattribution exposes shareholders to potentially higher costs and increased risk on any new business written, compared to those they would bear absent a reattribution. A higher amount of new business, all else being equal, also reduces the present value of releases of capital from the inherited estates. Given lower potential values of capital releases from the RIE, potentially higher costs and increased risks, it seems probable that writing large amounts of new business after a reattribution will lower overall returns to shareholders compared to the position prior to the reattribution. We therefore consider Aviva's claim that it will write the same amount of new business post-reattribution as it would have written absent a reattribution to be inconsistent with its economic incentives.

We also believe that there is significant uncertainty surrounding future levels of with-profits business generally. As noted in Section 2.01, the market for with-profits products faces a number of significant challenges that, together, have reduced the profitability of, supply of and demand for with-profits products. The fact that providers bear a share of the insolvency

risk of funds means that with-profits are relatively risky to offer in comparison to other products, where savers alone bear all investment risks. For those reasons, we believe that the with-profits market may continue its long-term decline rather than grow in line with the remainder of the UK long-term market.

4.02 Sensitivity analysis of Aviva's new business assumptions

Aviva's position is that the sales value of with-profits products is assumed to grow in future at the same rate of 5 per cent that it predicts for the long-term savings market as a whole and that its own share of the with-profits market will remain constant. Our analysis, set out in Section 4.01 above, suggests that Aviva's projections for the with-profits market could lie at the upper end of the range of potential outcomes. However, especially given that with-profits is now only a small segment of the savings market, future new business levels are very uncertain and any forecast is likely to be wrong. To gauge the effect of lower levels of new business, particularly the effect on possible future special distributions from the inherited estates to current policyholders, we have looked at alternative sensitivities.

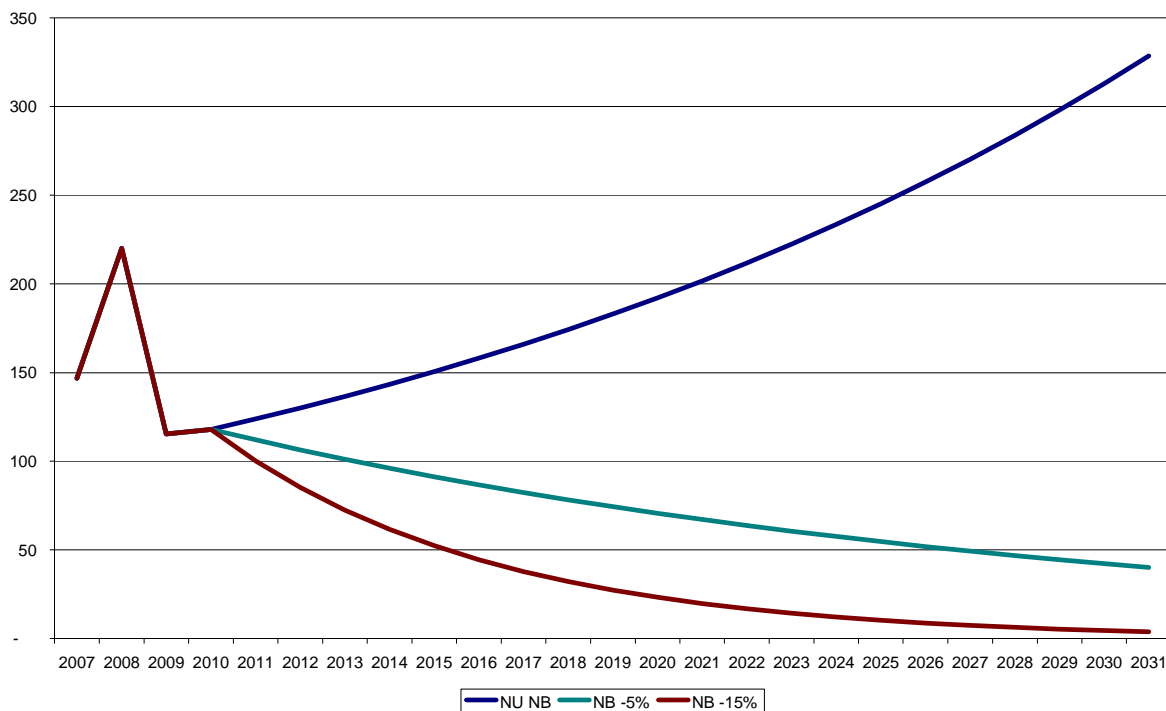
From Aviva's starting point of a 5 per cent p.a. growth in new business from 2011 onwards, LECG has analysed potential outcomes consistent with Aviva's new business levels declining by 5 per cent p.a. from 2011, or declining by 15 per cent p.a. from 2011, rather than increasing as Aviva projects. Any decline could be caused by a decline in either or both of the overall demand for with-profits products and/or Aviva's market share. Given the uncertainty associated with the future of the with-profits segment as a whole, however, the policyholder advocate has not sought to project the performance of the with-profits segment as a whole separately from Aviva's performance.

LECG has not analysed any outcomes that would involve Aviva writing higher levels of new business, other than Aviva's own assumptions. If higher levels of new business than Aviva is assuming were written, all else being equal, any special distributions to policyholders would occur later and existing policyholders' interest in them would be diluted. Accordingly, any policyholder made better off by accepting the reattribution offer (on the assumption that

Aviva’s new business projections come to pass) would also be better off if Aviva were to write larger amounts of new business than it projects.

The policyholder advocate’s new business sensitivities, alongside Aviva’s own assumptions, form the basis of the analysis that is used to assess Aviva’s offer in Appendices 42 to 45. A graphical illustration of the total new business sales values assumed by Aviva and alternative assumptions of 5 per cent and 15 per cent declines in annual new business values from 2011 onwards are shown in Figure 1 below.

Figure 1 Aviva and policyholder advocate value of new with-profits business assumptions, APE, £ million*



*The APE (annual premium equivalent) in any year is equal to the amount of new annual premiums written in the year plus ten per cent of the new single premium business written in the year.

5.00 Conclusions

The amount of new with-profits business assumed to be written by Aviva in future, absent a reattribution, is a key determinant of the potential value to eligible policyholders of future special distributions from the inherited estates. All else being equal, a higher value of new business entails a higher capital requirement for the funds. This dilutes the interests of existing policyholders in any special distributions made, because they are shared with new policyholders, and any special distributions that are made are deferred into the future, lowering their value to current policyholders since it is more likely that their policies will no longer be in force when any special distributions are made.

Aviva projects that it will write an increasing amount of new business in future. Beyond the explicit projection period that ends in 2010, Aviva says that it assumes the value of new with-profits written into the CULAC and CGNU Life funds will increase by 5 per cent p.a. until 2031. We understand that Aviva's projections assume, first, that the UK market for long-term savings products grows at 5 per cent p.a., second, that the with-profits segment maintains its share of the overall savings market and, third, that Aviva maintains its share of the with-profits segment. Aviva also says that the amount of new with-profits business that it writes will be unaffected by the reattribution.

There are reasons to believe that Aviva's new business projections could lie at the upper end of potential outcomes, in respect of their assumptions about both the with-profits market as a whole and about Aviva's share of it.

First, a continuous growth of the with-profits segment of the market in the years to 2031 assumes that the long-term, historical decline of the with-profits segment will be reversed. This decline has been caused by a number of factors, including changes in taxation; a fall in the number of providers of with-profits products; and the introduction of a range of alternative savings products offering lower charges and higher transparency. Today, the market for with-profits products constitutes only a small part of the UK long-term savings market. Although new with-profits business APE has risen since 2005, most of the increase has arisen as a result of increased sales effort by Prudential and Aviva. The long-term decline in sales by other

providers has continued. Aviva acknowledges that there are external challenges to the with-profits market.

Second, it is not clear that Aviva's present market share of around 20 per cent is sustainable over the medium term, irrespective of whether there is a reattribution or not. Aviva's market share has grown from around 3 per cent in 2001 to over 20 per cent in 2007, partly as a result of increases in its own sales, partly as a result of the decline in other firms' sales. Aviva's competitive position in the with-profits market may be eroded by the reattribution, as with-profits products offering the benefits of an inherited estate must be more attractive to consumers, all else being equal. If Aviva sought to compensate for the lack of access to an inherited estate by enhancing its with-profits products' features in other ways, the increased cost of such features must either serve to reduce shareholders' returns or be passed on to consumers in the form of higher charges. All else being equal, the reattribution seems likely to reduce the attractiveness of Aviva's with-profits offering relative to those of its competitors.

Even absent a reattribution, it is not clear that Aviva would wish to continue to write such a large volume of new business on terms similar to those offered today. In recent years, Aviva has subsidised new with-profits products. Taking the subsidies into account, Aviva is today writing new business on terms that are effectively 98:2, which are inferior to shareholders to the 90:10 split customarily offered. In 2006 and 2007, the writing of new business served to reduce the size of the inherited estate of funds managed by both Aviva and Prudential. It may be surmised that these subsidies have helped support Aviva's sales and market share of with-profits products and, all else being equal, that sales would fall if they were withdrawn.

Following a reattribution, those conclusions are reinforced because shareholders must bear the full costs of any subsidies offered to attract new with-profits business (instead of sharing them with existing policyholders) and share a portion of the investment risk associated with that business (as opposed to writing investment products where consumers bear all of the investment risks). All else being equal, therefore, if shareholders write an unchanged value of new business following a reattribution, they are potentially accepting higher costs and risks than they would face absent a reattribution.

Post-retribution, new business may also reduce shareholders' returns, as shareholders must retain capital in the reattributed inherited estate to support new business (where it may be assumed to earn the same rate as the funds), instead of distributing that capital for deployment in other areas of Aviva's business. All else being equal, a higher amount of new business defers the release of capital to shareholders from the RIE, lowering the present value of such releases. The benefits of writing new business may be insufficient to offset the lower returns associated with the higher capital requirements and delayed releases of capital associated with higher values of new business. Taken together, the potentially higher costs and risks and lower returns associated with new business post-retribution can serve only to reduce shareholders' incentives to write new business compared to the incentives that would exist absent a retribution.

In LECG's view, Aviva's assumptions may be at the upper end of the range of potential outcomes and it remains to be seen how the firm will behave following a retribution. Further, if Aviva were to reduce its sales effort following a retribution, and so experience a decline in market share, its experience would be consistent with that of AXA following its own retribution.

Nevertheless, given the uncertainty associated with the UK long-term savings market as a whole, of which with-profits in particular is only a small part of the whole market, the policyholder advocate has taken no firm view of the likely future trend of Aviva's with-profits sales. For the purposes of analysing the retribution, therefore, as well as using Aviva's new business assumptions the policyholder advocate has made two alternative assumptions in respect of new business. The first assumes that Aviva meets its new business projections until 2010, after which values decline by 5 per cent p.a. The second assumes a 15 per cent annual decline after 2010. We have not considered higher sensitivities as, if policyholders are better off in comparison to Aviva's assumption of a 5 per cent annual growth in new business from 2011, they will also be better off in comparison to one that assumes higher rates of growth.