

## **Appendix 39**

### **The Impact of FSA Guidance on Policyholders**

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

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## 1.00 Introduction and summary of conclusions

### 1.01 Introduction

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.

The CGNU Life and CULAC funds are both structured on the '90:10 principle' under which all distributions from the funds in excess of policyholders' minimum guaranteed benefits are normally shared between policyholders and shareholders in a ratio of 90:10. When a with-profits fund has an inherited estate, policyholders customarily have rights to 90 per cent of potential special distributions from that estate that may arise during their term as policyholders. Those rights have a value. Given that these rights exist, the question is how the rights are protected by regulation and common law.

However, there are a number of uses for the inherited estate permitted by the Financial Services Authority (FSA) under its regulations which reduce the value of the estate available for distribution to policyholders.<sup>1</sup> This appendix covers the impact of those regulations on the value of eligible policyholders' rights to potential future special distributions from the inherited estates of the CGNU Life and CULAC funds. This is critical to assessing the benefits being given up by policyholders who elect to accept Aviva's reattribution offer.

The policyholder advocate has sought guidance from the FSA as to how Aviva (and other companies managing with-profits funds) may use inherited estates. *Appendix 26: FSA Guidance Letters and Responses* sets out the policyholder advocate's requests for guidance from the FSA on the interpretation of its rules on uses of the inherited estates and the FSA's responses. The main source of regulation of with-profits comes from the FSA's conduct of business sourcebook (COBS).

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<sup>1</sup> Appendix 25: *Legal issues arising in respect of Rights & Interests in, and Uses of, the Inherited Estates* concludes that in the opinion of the policyholder advocate's legal advisers there should be no distinction between the way in which estate capital is used and fund capital is used.

The FSA guidance that is considered in this appendix can be divided into two groups:

- guidance that impacts the size of the estates; and
- guidance that impacts the division of possible future special distributions from the inherited estates between eligible and future policyholders.

Each of these impacts is introduced below in turn and a summary is provided of the financial impact of the FSA's guidance where applicable. The financial impacts are discussed in more detail in the remainder of the appendix. This analysis is based on the assumption that 100 per cent of eligible policyholders elect for the reattribution, and therefore that the entire inherited estates are allocated to the Reattributed Inherited Estate External Support Account (RIEESA).

## **1.02 Regulatory background**

The FSA advised that there are five “possible principal” uses of an inherited estate (as well as subsidiary permissions as contained in COBS 20.2: Treating with-profits policyholders fairly):

- “to provide investment flexibility by enabling a higher proportion of the fund to be invested in more risky assets (such as equities) which have a greater potential for yielding higher returns over the long term;
- to facilitate the 'smoothing' policy of the fund, particularly when there are sudden changes in investment markets;
- to provide a cushion against unexpected adverse events;
- to develop the firm's business, by investing to improve efficiency or the provision of additional services to customers; and
- to provide capital to support the writing of new business and development of new products”.<sup>2</sup>

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<sup>2</sup> Source: Letter from the FSA, 6 December 2007.

In principle, eligible policyholders may benefit directly from the first three of these, whether in the form of higher returns, lower volatility or greater security over the benefits that they might expect to receive.

In essence, the estate is an insurance fund which is used to back the guarantees attached to policies. The first two uses listed above are interrelated, as there is a choice between investing in higher risk assets with greater volatility but potentially higher returns, and mitigating this risk within the fund by smoothing returns between time periods.

The third use, as a cushion against unexpected adverse events, provides greater security for guarantees, but with a cost to eligible policyholders through the deferral of potential special distributions.

Under the fourth use permitted by current FSA rules, companies can choose either to use an inherited estate to fund business development costs (as Aviva does) or to charge those costs to asset shares; as these are costs that policyholders would pay anyway, this is not an FSA concession to shareholders in terms of permitted uses of inherited estates in the absence of a reattribution. Under the terms of the Aviva Scheme, however, after the reattribution these costs may not be charged to asset shares for eligible policyholders. As a result, under the reattribution, shareholders will need to bear them in future and require compensation today for doing so. The effect of Aviva's position on this point, endorsed by the FSA, is to reduce the size of the inherited estates against which a comparison of the value of the PIP to policyholders from the reattribution versus the value of possible future special distributions can be made. The value of these costs and allowances was discussed more fully in *Appendix 35: Size of the Inherited Estates*.

The FSA-permitted provision of inherited estate capital to support the writing of new with-profits business is more controversial in the policyholder advocate's view, as it is in practice a transfer of estate from the current generation to the next. It is therefore, in the policyholder advocate's view, a subsidy for new business which also takes significant estate away from the policyholders who will vote in a reattribution. This enables the firm in principle to offer less than it would otherwise need to do to buy the estate capital. The fact that the inherited estate

is in practice shared with future policyholders also means that if a higher risk strategy is undertaken, with consequent requirements for more capital to be held in the estate, any potential future special distributions to eligible policyholders will be deferred and therefore diluted through increased sharing with future policyholders.

The effect of this transfer of inherited estate capital to new policyholders, which passes the rights to participate in potential special distributions from the inherited estate from one generation of policyholders to the next, is referred to as the “intergenerational transfer”. It is discussed in detail in Section 3.00 below. However, whilst the FSA does permit this ‘intergenerational transfer’ of estate capital, the FSA has confirmed that it expects new business to be written on the basis that it does not erode the estate over time, with the exception of non-market risk, which the FSA permits the estate to cover.

Were the inherited estate not permitted to be used to provide capital support for new business, the costs and benefits of the trade-off between greater security and special distributions noted above would be made within the same generation; however, with the intergenerational transfer permitted under current regulations, each generation tends to bear the costs of higher security for the benefit of the next generation. Current policyholders benefited from this intergenerational transfer when their policies were created.

In addition to the five principal uses set out above, the FSA also allows an inherited estate to be used:

- to pay mis-selling compensation costs. The inherited estate has historically been used to pay for all compensation arising from mis-selling claims from policyholders. The FSA is currently consulting on whether this practice should be allowed to continue;
- to pay shareholder tax. The FSA permits all of shareholder taxes on both regular and special distributions to be paid by the inherited estate “if the firm can show that to do so is consistent with established practice [as] explained in

the firm's PPFM."<sup>3</sup> These taxes are not permitted to be charged to asset shares, and shareholders will therefore have to pay these taxes themselves after a reattribution. The Treasury Committee asked the FSA to consult on whether this practice should be permitted to continue, but the FSA has not responded directly on this point; and.

- to make "strategic investments". These are investments in businesses which the firm, or an affiliate of the firm, has an interest as long as the investments "*do not prejudice the interests of existing policyholders*", taking into account the potential returns and risks associated with the investment. The CGNU Life and CULAC funds' strategic investments have underperformed the market in recent years, but in its analysis LECG has not assumed any losses from these assets going forward.

The policyholder advocate considers that each of these additional uses of the inherited estate can be seen as a 'concession' to shareholders as they reduce the value of policyholders' potential future special distributions from the inherited estate, since they reduce the value of the estate and therefore reduce policyholders' 90 per cent share of future distributions. They are FSA concessions to shareholders as all of these items benefit shareholders beyond their 10 per cent share of the inherited estate, and all of these costs will have to be borne by shareholders after a reattribution (assuming that all eligible policyholders vote to accept the PIP). As a result, shareholders will require compensation for these benefits that they are expected to lose post-reattribution, on the presumption that these concessions will continue.

In addition, as noted above, the FSA allows the inherited estate to pay for non-market risk, which benefits policyholders, both current and future. Under Aviva's Scheme, the FSA non-market risk concession to eligible policyholders remains after a reattribution as it is a current benefit, and since these costs will be paid by shareholders after a reattribution, shareholders require compensation for this expected cost.

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<sup>3</sup> Ibid.

The same concession does not apply to new business, and although eligible policyholders will see their future benefits reduced through the estate being eroded from non-market risk charges for new business, shareholders will not write new business if it destroys value, and so can be expected to make this charge to new business going forward. However, the FSA has held to a position that deductions for non-market risk in respect of new business are acceptable because there is no requirement that new policyholders incur an explicit charge for it. Therefore, absent a reattribution, the inherited estate would bear the risk (and any implicit cost). The FSA's position means that a deduction has to be made for the cost of non-market risk for new business.

### **1.03 FSA guidance which erodes the value of the CGNU Life and CULAC inherited estates**

The impact of the permitted uses described above that affect the size of the CGNU Life and CULAC estates is discussed in Section 2 of this appendix. Since none of these uses may be charged to asset shares, after the reattribution shareholders will have to bear these costs themselves. The policyholder advocate believes that the uses are inappropriate, but has to recognise that under current FSA rules they reflect benefits that would continue to accrue to shareholders in the absence of a reattribution. Given the FSA's position, therefore, allowance needs to be made for them in the assessment of the Aviva offer, since shareholders will not agree to an offer that does not compensate them for benefits forgone, regardless of whether those benefits are, or are not appropriate.

Since these uses benefit shareholders beyond their normal 10 per cent, the FSA may change the rules in future, although the FSA has indicated that such changes are unlikely to occur in the near future, except in relation to the misselling consultation being undertaken at the present time. LECG has not therefore made any prediction about when or if such changes in the FSA's permitted uses of inherited estates might occur. The policyholder advocate has evaluated Aviva's offer to determine the extent to which the offer exceeds the value eligible policyholders might receive in potential special distributions from the inherited estates absent a reattribution, under current FSA rules. LECG has calculated that Aviva's aggregate PIP

offer provides a margin above what eligible policyholders might receive in possible future special distributions under current FSA rules. This suggests that Aviva's offer would still be seen to be beneficial, in aggregate, even if the FSA does change its rules in future so as not to permit the inherited estate to benefit shareholders beyond their normal 10 per cent (see Appendix 42: *Evaluation of the aggregate PIP offer*).

#### **1.04 FSA guidance which impacts eligible policyholders' share of the CGNU Life and CULAC inherited estates**

With respect to the use of estate capital to support the writing of new business (the intergenerational transfer), the impact of the FSA's guidance is of particular importance to policyholders in the context of a reattribution. Current policyholders benefited from this intergenerational transfer and the FSA has reconfirmed it is happy with the continuation of the historical practice of the estate providing the reserve capital required to back new policies, without compensation. The effect of the free transfer of capital, in the case of funds with an inherited estate, is to pass the rights to participate in potential special distributions from one generation to the next without any recognition of the economic value of the transfer. On all the different new business assumptions used by LECG, this results in a transfer to future policyholders of more than 50 per cent of the potential future special distributions from the CGNU Life and CULAC estates that would otherwise have gone to eligible policyholders if the intergenerational transfer was not permitted. The financial effect of intergenerational transfer is considered in Section 3 below.

The value of the benefits that might have gone, absent a reattribution, to future policyholders is large, and a firm has little incentive to share that value with eligible policyholders in its reattribution offer. Rather, it could offer a payment to eligible policyholders that is just large enough to cover the potential value of the special distributions that might, absent a reattribution, have accrued to them, and thereby to seek to secure the value of the special distributions that might otherwise have gone to future policyholders for its shareholders, without payment.

The ability of eligible policyholders to secure some part of this value rests in large part on the stance taken by the FSA as to what it believes would constitute a fair outcome of the reattribution negotiations. Since the FSA confirmed that it will continue to permit the intergenerational transfer of estate capital, the policyholder advocate therefore sought guidance from the FSA on how the estate that would otherwise be passed to future policyholders should be treated in a reattribution. The FSA responded that the offer to policyholders needs to take into account the value of future policyholders' interest in the inherited estates.<sup>4</sup> The extent to which Aviva's offer shares this value between policyholders and shareholders is discussed further in *Appendix 42: Evaluation of the Aggregate PIP Offer*.

### **1.05 Summary of impact of FSA guidance**

Tables 1 and 2 below summarise the impact of FSA guidance on the size of the CGNU Life and CULAC inherited estates and the share of the estates attributable to eligible policyholders.

Table 1 summarises the FSA guidance that impacts the size of the estates. This is divided into three sections: first, it shows the deductions from the Realistic Balance Sheet made by Aviva in line with FSA guidance which reduced the value of the published estates; secondly, it shows the adjustments KPMG has made to those deductions for levels of prudence that are not appropriate for assessing the reattribution offer (as described in *Appendix 35: Size of the Inherited Estates*); and finally, it shows further deductions which are made when modelling potential future distributions from the estates.

All of the figures shown in Table 1 are considered by the policyholder advocate to be concessions to shareholders, as they reduce the value of the CGNU Life and CULAC estates that is available to policyholders for the benefit of shareholders. These values do not vary with the size of the inherited estate.

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<sup>4</sup> Letter from FSA, 1 February 2008.

**Table 1 Summary of FSA guidance that impacts the size of the combined estate, values as at 31 December 2008, Aviva new business assumptions, £ million**

<b>Aviva Realistic Balance Sheet deductions for FSA Guidance</b>	Amount
Pensions review reserve	(13)
Mortgage endowment mis-selling reserve	(32)
Product governance	(21)
Strategic investments, contingency and data provisions	(96)
Shareholder tax reserve	(101)
<b>Subtotal</b>	<b>(263)</b>
<b>KPMG adjustments to Aviva deductions for levels of prudence</b>	
Mortgage endowment mis-selling reserve	10
Contingency reserve	33
<b>Subtotal</b>	<b>43</b>
<b>Net policyholder advocate deductions from estates for impact of FSA Guidance</b>	<b>(220)</b>
Deduction in respect of shareholder tax on new business benefit	(14)
Deduction for non-market risk in respect of new business	(20)
<b>Total policyholder advocate deductions to the estates in respect of FSA guidance</b>	<b>(254)</b>

Table 2 summarises the overall impact of FSA guidance, including that which impacts the size of the estates and that which affects the division of benefits between current and future policyholders. This division is affected by the FSA guidance on capital subsidies in with-profits funds and results in an inter-generational transfer of the estate from the current generation of policyholders to the next. The final row shows the total impact of the FSA guidance on eligible policyholders. Each of these deductions is detailed in the remainder of this appendix. The value of the capital subsidy to new business (intergenerational transfer), varies with the size of the inherited estate and with the level of new business assumed.

**Table 2 Summary of impact of FSA guidance, 1 October 2009, assuming an adjusted Reattribution Estate of £1,200 million, Aviva new business assumptions, £ million**

<b>Item</b>	<b>Amount (£m)</b>	<b>Cost to eligible policyholders* (£m)</b>
<b><u>Guidance which impacts the size of the estate</u></b>		
Policyholder advocate deductions to the estate in respect of FSA guidance	(265)*	(93)
<b><u>Guidance which affects the division of the estate between eligible and future policyholders</u></b>		
Capital subsidy of new business / intergenerational transfer (100% cost to eligible policyholders)	(1,087)**	(1,087)
<b>Total impact of FSA guidance on eligible policyholders</b> Assuming an unadjusted Reattribution Estate of £1,200 million, plus adjustments as advised by KPMG of £177 million rolled forward to 1 October 2009		(1,180)

\* £265 million represents the £254 million of deductions summarised in Table 1, rolled forward from 31 December 2008 to 1 October 2009 at the fund rate.

\*\*The value of the intergenerational transfer to future policyholders varies with different values of the inherited estate. At a Reattribution Estate of £1,570 million (the published end-2008 figure of £1,529 million plus a £41 million post year-end adjustment), this transfer is worth £1,298 million.

## **2.00 Financial impact of FSA guidance that erodes the inherited estates**

As noted in Section 1, in addition to the five principal uses, the FSA permits certain *additional* uses of the inherited estates which impact the value of eligible policyholders' rights:

- the company is permitted under COBS rule 20.2.25 to charge the cost of compensation payments to the inherited estate;
- the company is permitted under COBS rule 20.2.27 to pay corporation tax on distributions to shareholders from the inherited estate; and
- the company is permitted under COBS rule 20.2.36 to make strategic investments in related companies using capital from the inherited estate.

All three of these uses either explicitly erode, or have the potential to erode, the inherited estate: they are costs to the estate that bring direct benefits to shareholders but which are additional to the 10 per cent of distributions received by shareholders, and they serve to reduce or potentially reduce the 90 per cent of distributions otherwise available to policyholders. Strategic investments could in theory appreciate in value and therefore represent a gain to policyholders, but the policyholder advocate does not consider this likely, a view supported by recent experience.

Under the current regulatory regime for with-profits funds, Aviva is required to make provisions against expenses that it expects the fund to incur in future. These provisions for future liabilities serve to reduce the size of the inherited estates and are discussed in more detail in *Appendix 35: Size of the Inherited Estates*.

## **2.01 Payment of mis-selling and other expenses**

The FSA has permitted Aviva to deduct amounts from the value of the inherited estates in respect of future expenses for:

- mis-selling compensation (on which subject the FSA is currently consulting);
- non-endowment compensation;
- data provisions; and
- the effect of the pensions review.

The policyholder advocate believes that these deductions unnecessarily favour shareholders: first, because there is no certainty that any of these costs will actually be incurred; second, to

the extent that they do arise, it is the policyholder advocate's view that they should be met by shareholders alone. As a matter of principle, the policyholder advocate believes that the cost of regulatory compliance is not a matter for policyholders. Accordingly, such costs should not be charged to the inherited estates. The amounts set out below are described in greater detail in *Appendix 35: Size of the Inherited Estates*.

The inherited estates of the funds have historically been used to pay all compensation arising from mis-selling claims from policyholders. Tighter regulation of the sale of financial products in recent years means that most such claims have already been met. Nevertheless, Aviva anticipates that there remains a residual group of policyholders who are expected to claim compensation in future, the expense of which will fall to shareholders rather than the inherited estates after the reattribution.

Aviva has made deductions in the Realistic Balance Sheet (RBS) in respect of mis-selling, expenses, and other costs, reducing the value of the inherited estates. However, KPMG has advised the policyholder advocate that two of these deductions (the future mis-selling provision and the contingency reserve) incorporate levels of prudence, and therefore KPMG has made adjustments to the estate value, as detailed in Table 1 above.

## **2.02 Payments of shareholder taxes**

As described in *Appendix 34: Tax Matters in relation to the Reattribution*, the FSA permits CGNU Life and CULAC funds to pay shareholders' corporation tax on all distributions from the funds from the estates. The inherited estates therefore pay corporation tax on shareholders' 10 per cent of all bonus declarations, whether reversionary or terminal bonuses or special distributions of excess surplus from the inherited estates. The FSA does not permit shareholders' tax to be paid out of asset shares. The value of corporation tax is therefore deducted from the value that policyholders might receive from the inherited estates absent a reattribution, to which Aviva's offer is compared.

The policyholder advocate has sought guidance from the FSA as to whether insurers should be allowed to have their corporation tax paid from the inherited estates. In its letter of 6 December 2007, the FSA confirmed that the existing practice of allowing shareholder tax to

be deducted from the estates of with-profits funds should be allowed to continue. The Treasury Select Committee (TSC) asked the FSA to consult on this practice before the end of 2008. The FSA responded to the TSC but without addressing the issue directly.

Based on the FSA's response, in formulating her guidance the policyholder advocate has had to take account of the tax on shareholder transfers paid by the inherited estates in calculating the value of the benefits that policyholders would forgo in the event of accepting the reattribution offer. Given the FSA's position on the issue, it is clear that shareholders would have received this benefit from the estates in the ordinary course of business if no reattribution were to occur. This practice may change in the future, but there is no certainty about when or if this might occur.

Aviva has reserved £101 million for future corporation tax payments on their 10 per cent of potential special distributions from the inherited estates. Were insurers obliged by the FSA to pay their own taxation, instead of paying it from the inherited estates, no deduction would have been necessary from the value to be received from the estates by policyholders.

Finally, shareholders will be required to pay their own taxation on new business profits following a reattribution (as opposed to having the taxation paid by the inherited estates). A further deduction of 15% of the marginal value of new business to shareholders has therefore been made from the inherited estates, amounting to £15 million at 1 October 2009 under Aviva new business assumptions.

### **2.03 Strategic investments**

The FSA allows insurers such as Aviva to use the assets of with-profits funds under their management, including their inherited estates, to make "strategic investments" in firms related to the insurer. Aviva has used the inherited estates to purchase shareholdings in, for instance, European life insurers with which Aviva has a strategic connection or interest. Such investments are limited to 1 per cent of the funds' investments in any single strategic holding and 2.5 per cent of funds invested in total.

Aviva says that such investments may be made for strategic reasons considered not to be to the detriment of policyholders. The policyholder advocate considers such investments to have been made, arguably, primarily for the benefit of shareholders, in that the risk-adjusted returns on these investments are only part of the reason for their being made.

In 2008, the amount of the loss to the funds from Aviva's strategic investments was [REDACTED],<sup>5</sup> compared to the return achieved by the FTSE All-Share index. We note that the funds' strategic investments have underperformed the market in recent years, perhaps as a result of the instability that has particularly affected the financial sector as a whole, in which all of the strategic investments have been made. However, we have not projected any losses from strategic assets going forward and have assumed that they will grow at the average fund rate.

The policyholder advocate has objected to the inclusion of strategic assets in the inherited estates as they are not considered likely to benefit policyholders, a view borne out by recent experience. The policyholder advocate has requested that all strategic assets be removed from the non-electors' portion of the inherited estates following the reattribution. Aviva has stated it is inclined to do so, but will not make a guarantee until it receives the results of policyholder voting on the reattribution offer.

#### **2.04 The treatment of non-market risk**

The policyholder advocate accepts that it is appropriate to make some allowance for shareholders bearing non-market risks (following a reattribution) that would otherwise have been borne by the inherited estates. The transfer of non-market risk on existing business from the inherited estates to shareholders is therefore an implied cost for which shareholders should be compensated and which is discussed in *Appendix 37: Valuation of the Reattributed Estates*.

In assessing the level of surplus potentially available for distribution, however, Aviva also makes an additional deduction for non-market risk on *future* with-profits business. The policyholder advocate considers that new with-profits business, to the extent that shareholders

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<sup>5</sup> 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.

choose to write it, should properly be assumed to be written on a profitable basis, including an allowance for any non-market risk taken on as a result of the writing of that new business. On that basis, no such deduction should be required. The policyholder advocate therefore sought guidance from the FSA particularly in respect of permitted non-market risk on new with-profits business to be charged to the inherited estates.

The FSA held to a position that deductions from an inherited estate for non-market risk that is incurred but that was not anticipated by the firm in respect of new business are acceptable, absent a reattribution. The cost of non-market risk on new policies written into the funds, therefore, does not represent value that could be received by eligible policyholders. As such, non-market risk on new business is properly viewed as being part of the capital transfer between generations of policyholders. However, the FSA's position means that an estimate has to be made of the cost of non-market risk for new business, and a deduction made to reflect the implication that the inherited estates would bear the associated costs in the absence of a reattribution.

KPMG has advised that deductions of £30 million for non-market risk on existing business, and £20 million for non-market risk on new business, valued at 31 December 2008, are appropriate (i.e., £31 million and £21 million, respectively, at 1 October 2009). These costs were originally calculated based on annual percentages of the fund which resulted in much higher figures. This approach, although not particularly detailed, is used by many companies in the industry. However, subsequent analysis of the total allowance for non-market risk in Aviva's calculations led KPMG to revise the figures downwards. The figures assumed became immaterial in the context of the negotiations and simple fixed figures, remaining constant across estate levels and new business assumptions, were assumed to be adequate by KPMG. These allowances are spread over future years in line with existing business liabilities and new business liabilities, respectively.

The deduction for non-market risk on existing business is not considered an FSA concession to shareholders, as it benefits eligible policyholders. However, the deduction for non-market risk on new business is considered a concession to shareholders. Absent a reattribution, FSA rules dictate that any new business written must not be loss making. However, the FSA has

said that any associated non-market risk need not be charged to new policyholders. Consequently, absent a reattribution, the costs of any non-market risk would be borne by the inherited estates and therefore by policyholders. Post reattribution, if similar practices were followed, the costs for non-market risk on new business become the responsibility of shareholders; hence, a deduction has been made in LECG's analysis for this FSA concession.

### **3.00 Financial impact of intergenerational transfer**

#### **3.01 Introduction**

As previously noted, the CGNU Life and CULAC funds are both structured on the '90:10 principle' under which all distributions from the funds in excess of policyholders' minimum guaranteed benefits are shared between policyholders and shareholders in a ratio of 90:10. Absent any reattribution, the intergenerational transfer of capital preserves the 90:10 principle of a with-profits fund – the right to receive 90 per cent of any special distribution is passed from one generation of policyholders to the next. However, the practices adopted by the funds may influence the total value received by policyholders from the inherited estates and the division of those benefits between generations of policyholders.

As noted in Section 1, the transfer between generations of policyholders of benefits from the inherited estates of with-profits funds currently occurs without any recognition of the value being transferred. There is an implicit subsidy inherent in this transfer, since new policyholders acquire that right without charge and eligible policyholders pass it on without receiving compensation; eligible policyholders benefited from this same transfer from the previous generation. In the absence of an inherited estate, this subsidy would not be available. The free intergenerational transfer of capital could provide, in our view, in effect, an unfair competitive advantage to those funds with inherited estates as their new policyholders freely acquire something of value that is not available to policyholders in funds without an inherited estate. Nevertheless, following her request for guidance, the policyholder advocate acknowledges that intergenerational transfer of the capital in an estate is permitted by the FSA in the ordinary course of business.

In the context of a reattribution, in which the rights of eligible policyholders to potential future special distributions are required to be valued, the effects of the intergenerational transfer of potential future special distributions from the estates are particularly important. Particular attention needs to be paid to the impact of practices, such as having a low risk appetite or writing large amounts of new business, that have the effect of transferring potential special distributions from current (or eligible) policyholders to future (or ineligible) policyholders. The impact of such practices is to reduce the value that eligible policyholders are assessed as giving up (their potential special distributions forgone) and thereby to reduce the level of the offer required in principle to compensate them for forgoing this value by accepting the offer.

In the extreme, it would be possible to imagine practices that would have the effect of ensuring that no special distributions were likely to be made to eligible policyholders. In such circumstances, it might be argued that policyholders were giving up no value whatsoever in electing for a reattribution, and therefore that the level of PIP required to compensate them properly for the value of the rights that they were giving up could be close to zero.

The question therefore arises as to whether the firms' practices assumed in the calculation of potential policyholder benefits are reasonable ones. In the case of a reattribution, it falls to the FSA, as part of its overall oversight of the process, to offer guidance as to the reasonableness of practices assumed in the assessment of policyholders' benefits forgone. These special distributions are discussed in detail in *Appendix 40: Analysis of Potential Future Special Distributions for Policyholders and Shareholders*.

### **3.02 FSA guidance in respect of new business**

As noted above, under current FSA rules, Aviva and other life insurers are permitted to use the inherited estates of their with-profits funds to support the writing of new business. Indeed, the FSA has confirmed that the use of estate capital to support new business is a “principal possible” use of the inherited estate.<sup>6</sup>

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<sup>6</sup> Source: Letter from FSA, 6 December 2007

The FSA was asked by the policyholder advocate for guidance in respect of the terms on which insurers may write new business. In the past, there was no barrier to insurers using the inherited estate of a with-profits fund to subsidise new business, even if the subsidy eroded the inherited estate. Importantly, the FSA has now ruled that new business must be managed so as not to erode the inherited estate over time. The implication of the FSA's ruling is that (with the exception of costs incurred due to non-market risk) the amount of new business written must not affect the value of potential benefits to policyholders as a whole (existing and future policyholders) from the inherited estate.

Following the reattribution, electing policyholders' interest in the CGNU Life and CULAC inherited estates will be transferred to shareholders and their portion of the inherited estates will be transferred to the RIEESA. In effect, therefore, any new business written after the reattribution will be supported with shareholder capital.

Aviva's new business assumptions represent only one of a broad range of potential outcomes. In *Appendix 38: Aviva's New With-Profits Business Assumptions*, LECG sets out the reasons why it believes Aviva's assumptions may lie at the upper end of those outcomes. The FSA has said that it will critically assess the reasonableness of Aviva's new business assumptions. However, the FSA takes no firm view as to the possible level of new business that Aviva might write in future, either absent or following a reattribution. The policyholder advocate has therefore assessed Aviva's offer against a range of potential new business outcomes.

In the context of a reattribution, the policyholder advocate believes it would have been more appropriate to use a scenario where new business is fully self-supporting as the counterfactual against which to compare the benefits of a reattribution. A scenario of this kind would be compatible either with external capital or shareholder capital being used to write new business (as will happen post reattribution), or with the situation that would arise if new policyholders were charged for the capital needed to be retained to support their guaranteed benefits.

Within such a scenario, the base assumption would be that 90 per cent of the (adjusted) value of the inherited estates would go to eligible policyholders. In other words, assuming that new business is fully self-supporting serves to negate the effects of the free intergenerational

transfer of estate capital. Given the FSA's guidance, however, that is not a scenario that the policyholder advocate has been able to adopt in assessing the offer made by Aviva.

### **3.03 The value of the intergenerational transfer to future policyholders**

As noted earlier, the FSA has confirmed that it permits the intergenerational transfer of inherited estate to future policyholders. When considering whether the reattribution is in the interests of eligible policyholders, the reduction in eligible policyholders' potential future special distributions from the CGNU Life and CULAC inherited estates as a result of the transfer of value to future policyholders, needs to be taken into account when considering the benefits that they would have received absent a reattribution. Similarly, shareholders' benefits from a reattribution need to be compared against the position in which shareholders would find themselves absent a reattribution.

To reflect the FSA's guidance, for the purposes of assessing Aviva's reattribution offer, LECG has deducted from the value of the inherited estates attributable to policyholders generally (under the current FSA rules) only that portion that is estimated to be paid to eligible policyholders in the form of potential future special distributions. The remainder, the portion of the inherited estates that is unallocated (which would have been potentially distributed to future policyholders) is then viewed as a residual amount available for division between eligible policyholders and shareholders in the firm's reattribution offer, after making due allowance for the benefits shareholders are forgoing, and additional costs and risks they incur as a result of the reattribution. For estimates of the 'residual value' of the estates after deducting all policyholder and shareholder benefits forgone and appropriate allowances for costs and risks, see Appendix 37: *Valuation of the Reattributed Estates*.

The table below shows the projected value of future policyholders' interest in the combined CGNU Life and CULAC estate (in the form of special distributions) across a range of combined inherited estate values and new business assumptions.

**Table 3 Value of future policyholders' interest in potential special distributions at 1 October 2009, £ million**

New business growth at:	£1.2 billion	£1.57 billion	£1.8 billion	£2.1 billion
+5% per annum*	1,087	1,298	1,405	1,521
-5% per annum**	866	1,055	1,148	1,253
-15% per annum**	753	904	990	1,090

Source: LECG analysis

\*Aviva's assumption

\*\*policyholder advocate's assumptions

## 4.00 Conclusions

The FSA is responsible for setting the regulatory framework for the life insurance and pensions industry, including the regulation of with-profits funds. The policyholder advocate has sought the FSA's guidance in respect of a number of issues that have arisen in the course of the reattribution negotiations.

Broadly speaking, there are two ways in which the FSA's guidance has lowered the value of possible future special distributions to current policyholders in the absence of a reattribution.

The first is by permitting the CGNU Life and CULAC inherited estates to be used to fund activities that are primarily of benefit to shareholders which shareholders receive in addition to the customary 10 per cent of distributions from the funds. These additional uses have the effect of eroding the estates and, therefore, reduce the amount potentially available to eligible policyholders.

The erosion of the estates is caused by its use for three separate purposes: to make compensation payments for mis-selling or meet regulatory requirements; to pay corporation tax on distributions to shareholders; and to invest in 'strategic assets' in which Aviva has an interest. The FSA has ruled that each of these uses of the estates is permitted because they are 'customary', although each falls outside the 90:10 principle of the funds, primarily for the benefit of shareholders. In recognition of the FSA's guidance that shareholders could continue to receive these benefits from the inherited estates absent a reattribution, the policyholder advocate has made deductions of £119 million (for mis-selling, compensation

and regulatory expenses, and strategic investments) and of £115 million (for corporation tax), at 31 December 2008. No deduction has been made for the potential loss of value associated with the possible future underperformance of strategic assets in the funds. LECG notes, however, that during 2008, Aviva's strategic investments cost the estate [REDACTED],<sup>7</sup> compared to the return achieved by the FTSE All-Share index.

In addition, the FSA allows the inherited estates to pay for non-market risk on existing business, which benefits policyholders. Since these costs will be paid by shareholders after the reattribution, shareholders require compensation for this expected cost which KPMG has estimated as £30 million at 31 December 2008 (£31 million at the proposed Effective Date of the reattribution of 1 October 2009).

The second way in which the FSA's guidance has served to lower the value of current policyholders' possible future special distributions in the absence of a reattribution against which the reattribution offer can be compared, is in respect of the intergenerational transfer of capital in the inherited estates.

As previously noted, the FSA has advised that the reattribution should be evaluated against an assumption that eligible policyholders' interest in the estates would be reduced by the transfer of value to future policyholders absent a reattribution. Further, the FSA has advised that new policyholders should be assumed to acquire their interest in the inherited estate without charge: the subsidy from the present generation of policyholders to future generations of policyholders should be assumed to continue and future generations of policyholders should be assumed to acquire such interest freely.

These assumptions have important effects on the potential value of eligible policyholders' interests in the inherited estates, for three reasons:

- first, the intergenerational transfer of capital means that the insurer's selection of risk appetite is highly significant. All else being equal, a lower risk appetite

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<sup>7</sup> 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.

entails the retention of larger amounts of capital in the inherited estates, so reducing the potential value of future special distributions of excess surplus and increasing the transfer from the current generation of policyholders to future generations. In essence, the costs of a lower risk appetite are paid by one generation and the benefits in the form of special distributions may largely be received by another;

- second, the level of new with-profits business assumed to be written, absent a reattribution, also affects the potential value of distributions to the current generation of eligible policyholders. The presence of new generations of policyholders dilutes the interest of the present generation of eligible policyholders in potential distributions from the inherited estates. For the purposes of a reattribution, the policyholder advocate considers that a more appropriate assumption would have been that new business was fully self-supporting so that the intergenerational transfer no longer occurred. However, the FSA was not persuaded of this view; and
- third, the FSA has ruled that, because there is no requirement for future generations of policyholders to be charged for the costs of non-market risks associated with their policies, then the cost of such risks may be assumed to be borne by the inherited estates. Although the policyholder advocate believes that a more appropriate assumption would be that new business is written on terms that allow for policyholders to fund their own non-market risks, a deduction of £20 million at 31 December 2009 (£31 million at the Effective Date, based on advice from KPMG, has been made in recognition of this potential cost to shareholders after the reattribution. In the policyholder advocate's view, the FSA's guidance on this point is properly viewed as a concession to shareholders as, post-reattribution, shareholders choose whether (and on what terms) to write new business.

If, instead, the FSA had advised that future generations of policyholders should be assumed to be charged in full for the acquisition of their interest in the inherited estates, none of these

three issues would have arisen and eligible policyholders as a whole could be assumed to receive 90% of the (adjusted) value of the inherited estates over the lifetime of their policies.

In conclusion, FSA guidance significantly impacts eligible policyholders' share in the inherited estates. Firstly, amounts the FSA permits to be charged to the estates erode the value available for distribution to policyholders as a whole by £265 million; these concessions are estimated to reduce eligible policyholders' future special distributions by approximately £90 million. Secondly, as the FSA permits the estates to be used to provide capital to support the writing of new business, the amount that is available for distribution to policyholders is split between current and future generations: assuming an unadjusted Reattribution Estate of £1,200 million as at 1 October 2009, future policyholders would be projected to receive approximately £1,087 million through this intergenerational transfer, in the absence of a reattribution. In total therefore, through a combination of allowances that erode the size of the inherited estates, and regulation which permits the use of the estates to support new business, the reduction in the value of eligible policyholders' 90 per cent rights to future distributions as a result of the FSA rules is nearly £1,200 million.<sup>8</sup>

As under current FSA rules eligible policyholders are projected to receive less than £100 million (£83 million) in future special distributions from an assumed Reattribution Estate of £1,200 million,<sup>8</sup> it is clear that FSA regulation of with-profits funds is the primary factor influencing the assessment of the reattribution offer. Shareholders benefit from these allowable uses of the estate by approximately £297 million at 31 December 2008: £263 million in deductions Aviva makes to the Realistic Balance Sheet, plus £20 million to cover new business non-market risk, and £14 million in respect of shareholder tax on new business, as detailed in Table 1.

Whilst the FSA has said that it is not expecting to change its rules on uses of inherited estates in the near term (with the possible exception of mis-selling compensation, which is currently the subject of FSA consultation), it is possible that the FSA may amend its regulation of with-

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<sup>8</sup> Potential special distributions have been calculated after adding adjustments of £177 million at 31 December 2008 as advised by KPMG (£185 million at 1 October 2009). The Reattribution Estate upon which the aggregate PIP will be calculated is Aviva's valuation of the combined estate during the period leading up to 1 October 2009, and does not include the KPMG adjustments.

profits funds some time in the future. The policyholder advocate has evaluated Aviva's aggregate reattribution offer to determine the extent to which it builds in a sufficient margin above the possible future special distributions that electing policyholders could expect to forgo, in part to ensure that the interests of eligible policyholders are protected against the possibility that future regulatory change might have increased the value of the potential special distributions they could have received from their interests in the CGNU Life and CULAC inherited estates (see appendix 42 *Evaluation of the aggregate PIP offer*).