

Report Number 41 A

The Aviva Offer

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

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

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Appendix by: Aviva UK Life – June 2009

Aviva Life Services UK Limited. Registered in England No 2403746. 2 Rougier Street, York, YO90 1UU.

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1.00 Context

Aviva has always said that it will only go ahead with a reattribution of the inherited estates of the CGNU Life and Commercial Union Life Assurance Company (CULAC) with-profit funds if it believes it is fair to both policyholders and shareholders to do so. As such, we will only make an offer which we believe is fair to all parties.

There have been many aspects of the proposals to consider and negotiate in reaching a conclusion on the eligibility for the Policyholder Incentive Payment (PIP); the amount of the aggregate PIP and the individual PIP that will be offered to policyholders; the position of non-electing policyholders and in assessing the benefits of reattribution to policyholders and shareholders. This has involved many complex discussions with different external parties, for each of whom fairness to policyholders has been a key consideration. These have included:

- The Financial Services Authority
- The Policyholder Advocate
- The Independent Expert

In addition, internal over-sight looking at the implications of the proposals has been carried out by the CGNU Life & CULAC Boards.

The purpose of this appendix is to provide a summary of the outcome of the negotiations and the offer Aviva will make to eligible with-profits policyholders in the CGNU Life & CULAC with-profit funds. In doing so, this appendix addresses:

- The background and rationale for the offer
- The reattribution offer, protections and benefits
- Our assessment of the fairness of the offer

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2.00 Why is Aviva Proposing a Reattribution of the Inherited Estates of CGNU Life and CULAC?

2.01 Background to Inherited Estates and Reattribution

2.01.01 What is the inherited estate?

An inherited estate is money that has built up in a with-profits fund over many generations, which is over and above the amount that is expected to be needed to meet current and future policyholder commitments and other obligations of the with profits fund.

The Financial Services Authority (FSA) describes¹ inherited estates as: "The 'inherited estate' is part of the with-profits fund. Generally, it is that part of the with-profits fund over and above the part required to meet realistic liabilities that the firm nevertheless retains for commercial reasons. For example, to ensure it has a strong capital base or to fund future growth plans. The inherited estate provides working capital for the with-profits fund in the longer term and supports its operation. In most with-profits firms, the inherited estate has built up over many years. It is usually made up of previous and current policyholders' premiums and investment returns, or past injections of capital from shareholders."

From both a legal and regulatory perspective it is clear that the inherited estate is an asset of the company and represents its working capital. However, the amount of this asset is by no means fixed. It is perhaps best described as the difference between two very large amounts, being the realistic assets and realistic liabilities of the with-profits company, both of which are highly volatile and susceptible to external influences such as interest rates, equity movements and property markets. The simplest practical description of the inherited estate is that it represents the assets in a with-profits fund over and above the money expected to be required to meet policyholder liabilities.

The primary purpose of the inherited estate is to support the features of with-profits business and provide security to policyholders. This manifests itself in how the inherited estate is used to support the investment strategy of the fund and to deliver flexibility in the smoothing of maturity payments. It also meets the excess between the cost of guarantees and asset share, and provides capital to support the writing of new business.

During periods of global economic volatility (such as now), the value of the inherited estate becomes more apparent. Aviva has determined that the funds whose inherited estates it is planning to reattribute should operate between an AA and AAA strength to align with policyholder expectations. As a result of this approach these funds have continued to provide good returns to policyholders despite many historic economic depressions, including both World Wars, the 1929 Great Depression and the 1974 OPEC oil shock.

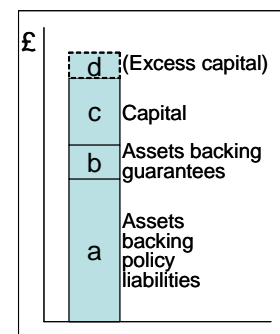
¹ <http://www.fsa.gov.uk/pages/Doing/Regulated/newcob/faqs/estates.shtml>

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2.01.02 What makes up the inherited estate?

Fund assets comprise money / investments:

- (a) To back (or “equal”) policy liabilities; plus
- (b) To back guarantees attaching to those policies; plus
- (c) To mitigate risks to assets in (a) and (b) such as the risk of a stock market fall making asset values insufficient to back liabilities / guarantees (“capital”) in respect of existing and future new business; plus, potentially
- (d) If it exists, this is the amount in excess of what is needed, because there is no realistic prospect of there being insufficient capital to support the fund (“excess capital”) ²



All the fund assets are “at risk”, e.g. of values falling with stock markets, but when assets in (a) and (b) fall, their value is topped up from capital (c), so the capital changes to reflect the increase in the costs of guarantees. Broadly the inherited estate comprises the aggregate value of (c) and (d) from time to time.

The FSA requires Aviva to hold a particular minimum amount of capital (known as ICA), but requires Aviva’s management to determine the appropriate level of capital to be held in respect of each with-profit fund. As the largest UK provider of life insurance Aviva wants to maintain a high level of confidence in our funds and ensure that they will remain strong for the long term. Aviva therefore holds more capital than the minimum FSA requirement. The amount we hold is determined by our risk appetite, which is a measure of the fund strength we want to maintain. Aviva’s CGNU Life and CULAC with-profit funds were sold to policyholders as very strong funds with high equity backing ratios.

In February 2008, Aviva announced that about £2.1 billion³ (as at 1st January 2008) would be distributed to qualifying policyholders from the inherited estates of CGNU Life and CULAC over the next 3 years. Additional surplus was created after we reduced the capital required to meet the guarantees within the fund through new de-risking techniques. This therefore represented a distribution of the available surplus.

The remaining amount within the inherited estate continues to be required to support the strength of the funds within the preferred AA to AAA range. At the end of 2007 fund strength was in the middle of AA and AAA, whereas at the end 2008 valuation it was outside the preferred range of surplus but comfortably within the acceptable range of surplus following significant market falls and increases in market volatility in 2008. ⁴

Our aim is for the funds’ strength to remain within the range of AA to AAA and the CGNU life and CULAC with-profit funds continue to be managed to achieve this.

² Amounts falling into this category would be considered for distribution by the Board in line with the risk appetite framework for the funds

³ Based on the funds’ financial position at end 2007

⁴ The negotiated reattribution offer announced on 30th July 2008 was based on the financial position of the CGNU Life and CULAC funds at 30th June 2008. Since then, as a result of continued market falls, the offer has been restructured using a scaled approach which allows the value of the inherited estate to be assessed nearer to the Effective Date.

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2.01.03 Uses of the inherited estate

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

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

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

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

2.01.04 What could happen to policyholders' benefits if the inherited estate no longer existed?

We've discussed in the sections above how the inherited estates are used to provide the necessary capital reserves to manage risk, meet the cost of guarantees and allow investment freedom and smoothing.

If we now consider a situation where the inherited estate no longer existed (say, if it was all distributed rather than reattributed), the implications for policyholders policy benefits could be enormous, and under certain circumstances could mean that Aviva would be unable to meet the promises it has made to policyholders. For instance:

- The way that the funds are invested would have to change so that more of the assets that back with-profits policies would be invested in lower risk investments. This would most likely ultimately result in lower returns, reduce bonuses and in turn reduce policy benefits.
- There would be no cushion against unexpected adverse events, meaning that in difficult economic times the company may not be able to meet its promises or guarantees under the policies.

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- Less smoothing of maturity and surrender payouts could take place leaving policy benefits unprotected from stock-market falls should they occur immediately before policy payouts are made, resulting in lower than expected policy payouts.
- Less new business could be written in the with-profits fund, so existing policyholders would have to share a higher proportion of the costs of managing the fund.

This helps illustrate why Aviva does not distribute all of the inherited estates of CGNU Life and CULAC.

2.01.05 Why is Aviva proposing a reattribution?

Aviva is proposing to make changes to two of its funds:

- CGNU Life with-profits fund, and
- CULAC with-profits fund.

We are proposing a reorganisation: consisting of a reattribution and a fund transfer.

Legally, the inherited estate belongs to the company and not the policyholder. Policyholders have a contingent interest in possible future special distributions from the inherited estate which would normally be paid in the proportions of 90% to policyholders and 10% to shareholders. From a legal perspective, a policyholder has no right to expect such distributions during the lifetime of their policy.

In this reattribution, eligible policyholders can choose to receive a payment in return for giving up their interests in possible future special distributions from the inherited estate. The benefit to the individual policyholder is a certain payment now versus uncertain distributions in the future. Each eligible policyholder is able to decide whether or not to wait for any potential future distribution or accept the offer – there is no majority vote.

Only policies invested in the with-profits funds of CGNU Life and CULAC are eligible.

The potential reattribution is beneficial to eligible policyholders because:

- It offers a payment to eligible policyholders that would not be available under normal circumstances;
- The payment is made by Aviva plc, not taken from the with-profits funds (including the inherited estate);
- Security for investments is maintained.

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

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

2.01.06 What happens to the inherited estate after reattribution?

The inherited estate will be split proportionally between the Non-Profit Sub-Fund (NPSF) of Aviva Life and Pensions UK Limited (AVLAP) and the Old With-Profit Sub-Fund (OWPSF). Generally speaking,

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the split will be done pro-rata to the PIP proportions of eligible policyholders who elect / do not elect to accept the reattribution offer.⁵

The reattributed inherited estate transferred to the NPSF will not be immediately available for release to shareholders. Rather, it will be 'locked-in' to provide support so that the security of policyholder benefits and the freedom to manage the funds continue in the same way as before the reattribution. This lock-in is for at least six years, although capital must continue to be held in the fund until it is no longer needed to provide the security and freedom, which will generally be for much longer.

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

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3.00 Basis for the Aviva Offer

As part of the reattribution, eligible policyholders will be offered an individual Policyholder Incentive Payment (PIP) in return for giving up any interest they have to any future potential distributions from the inherited estates. The PIP is paid by shareholders and in return shareholders become entitled to 100% of any distribution of the reattributed inherited estate (RIE) in the future.

The PIP offer is based on the principle that value unlocked by the reattribution should be shared fairly between policyholders and shareholders.

Although the early origins of the inherited estate are difficult to ascertain, Aviva recognises that significant emphasis is placed on the extent to which recent and current generations of policyholders may have contributed to, or benefited from, the inherited estate.

Aviva has concluded that in aggregate the current generation of policyholders has not contributed to the inherited estates of CGNU Life or CULAC. Since Aviva's view is that the majority of the inherited estate has arisen through the running of the funds, it has not asked the Policyholder Advocate to take the known shareholder contributions to the funds into account in assessing the reattribution proposal.

The reattribution is beneficial because:

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

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

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

Since the current generation of policyholders has not made a net contribution to the inherited estate or "earned" the PIP, Aviva might be expected to be indifferent over the timing of a reattribution in so far as it affects which policyholders will or will not benefit from the transaction. Having said this, many policies are expected to surrender or mature in the next 2-5 years and so Aviva has a choice between sharing the benefit among a greater number of policyholders now, or a smaller number later. Aviva has preserved the rights of policyholders whose policies have matured, or if they died between 21st November 2006 and the Effective Date by maintaining their eligibility for the reattribution. The preference is to reattribute now and share the benefit with as many customers as possible.

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3.01 Financial Conditions on which the Offer is based

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

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

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

At the end of 2007 fund strength was in the middle of AA and AAA preferred range of the risk appetite framework, whereas it was outside the preferred range of surplus but comfortably within the acceptable range of surplus at 31st December 2008 following significant market falls and increases in market volatility in the year.⁶

3.01.02 Size of the estate at 31st December 2008

The effect of this market downturn has been to reduce the size of the inherited estate by £1110m (or 42%) in 2008.

The combined CGNU Life and CULAC inherited estates were valued at £1,529 million at 31st December 2008.

In line with normal business practices, the realistic balance sheet, giving the financial position at 31st December 2008, was reviewed by Ernst & Young.

3.01.03 Adjustments to the size of the estate for the purposes of the reattribution

In preparing their realistic balance sheets insurance companies have to make careful assumptions on what might happen in the future (many of the policies could be in existence for more than 25 years). Inevitably there will always be differences of opinion on whether the assumptions made are prudent or optimistic, the key 'check and balance' for Aviva is to take a collective look at all of the assumptions and ensure that they are reasonable as a whole.

Individual assessment of selective assumptions to test whether they are considered optimistic or pessimistic could produce differences of opinion, however if changes are made on such a piecemeal basis they are likely to unbalance the overall reasonableness of the assumptions as a whole, which could in turn have a negative impact on the long-term security of policyholder benefits.

For the purposes of the reattribution negotiations, Aviva has agreed to make allowance for a notional adjustment to the value of the inherited estate which recognises the inherent uncertainty involved in assessing possible future events.

⁶ The negotiated reattribution offer announced on 30th July 2008 was based on the financial position of the CGNU Life and CULAC funds at 30th June 2008. Since then, as a result of continued market falls, the offer has been restructured using a scaled approach which allows the value of the inherited estate to be assessed nearer to the Effective Date.

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For the purpose of assessment the merits of the offer, Aviva agreed to a notional adjustment of £100 million; while the Policyholder Advocate has allowed for an adjustment of £177 million. The adjustment principally relates to differences in approach on the reserves in the realistic balance sheet.

3.02 Special Bonus

In February 2008 Aviva announced that it had changed the way that it manages the with-profit funds of CGNU Life and CULAC by reducing some of the investment risk.

As a result, less money (capital) was needed to cover the cost of the guarantees offered under with-profit policies invested in the CGNU Life and CULAC funds.

This allowed the Board to announce that about £2.1 billion would be distributed to qualifying policyholder from the inherited estates of CGNU Life and CULAC over the next 3 years.

3.02.01 Changing the investment approach for the cost of guarantees

The investment strategy for the CGNU Life and CULAC inherited estates was, on the whole, the same as that for the rest of the fund. This meant that the inherited estate was exposed to equity and property risk from three sources:

- Exposure from the equities and property held in the inherited estate
- Exposure from investing asset shares in equities and property
- Exposure from backing the liabilities for the cost of guarantees in equities / property

These (and other risks) are reflected in the calculation of the funds' capital requirements.

During 2006 the FSA advised Aviva that, for the purposes of assessing the fairness of the reattribution proposals, they would assume that the investment strategy for the assets backing the cost of guarantees had been de-risked. Their approach was intended to largely immunise the value of the inherited estate being assessed for reattribution from the impact of falls in equities backing the guarantees.

Having assessed the implications of this approach, during 2007 the CGNU Life and CULAC Boards took the decision to change the investment approach for the assets backing the cost of guarantees. In doing so they implemented a dynamic hedging strategy which reduced the funds exposure to losses that might arise from an increase in the cost of guarantees as a result of falls in the value of equities and property held as part of the asset shares.

This change in approach did not affect or remove investment in equity and property for the inherited estate or the assets backing policy liabilities.

As a result of the change in investment strategy, less money needed to be held to back the guarantees attaching to policies in the CGNU Life and CULAC with-profits fund. This enabled a distribution of surplus from the inherited estate to be made on a 90/10 basis (90% to policyholders, 10% to shareholders) as a special bonus for qualifying policyholders.

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3.02.02 The terms of the special bonus

The special bonus will be added to qualifying with-profit policies in addition to any other standard bonuses over 2 years.

Qualification dates for the special bonus are:

- 1st special bonus – 1st January 2008
- 2nd special bonus – 1st January 2009
- 3rd special bonus – 1st January 2010

Further detail can be found in the leaflet “Special bonus – your questions answered” which was sent to qualifying policyholders in March / April 2008.

3.02.03 Qualification for the special bonus

Qualification for the recent special bonus could be summarised as:

- Any with-profits policy within the CGNU Life and CULAC funds which was in force on 1st January 2008 qualifies for the first special distribution payment.
- With-profit policies in the CGNU Life and CULAC funds which were in force on 1st January 2008, and remain invested in the same fund until 1st January 2009 qualify for the second special distribution payment.
- With-profit policies in the CGNU Life and CULAC funds which were in force on 1st January 2008, and remain invested in the same fund until 1st January 2010⁷ qualify for the third special distribution payment.
- If the policy ends for any reason, or is switched to another fund before any of these qualification dates, qualification ceases.
- The special distribution qualification criteria take no account of policyholders’ eligibility for the reattribution.
- As any decision to distribute a part or all of the inherited estate is taken based on the risk appetite for the funds with the full involvement of the With-Profits Committee, it is not contingent on the reattribution going ahead.

Further detail is given in the leaflet “Special bonus – your questions answered” dated February 2008.

⁷ For the avoidance of doubt, this is unaffected by the proposed Part VII fund transfer to AVLAP

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3.03 Modelling the Future

In formulating its reattribution proposals and offer Aviva has undertaken extensive stochastic modelling in order to assess the impact of a wide range of possible economic scenarios over the next 25 years. Stochastic modelling builds volatility and variability (randomness) into the simulation and therefore provides a more accurate representation of real life.

This numerical analysis has been one of the factors taken into account in assessing the benefits of reattribution to both policyholders and shareholders, and in reaching our conclusions on the fairness of the PIP and the treatment of non-electing policyholders.

A large number of assumptions are made in order to assess the possible scenarios over the next 25 years. Inevitably unforeseen circumstance (both beneficial and detrimental) in the future can be different from the assumptions made. It is not possible to accurately predict what might happen over the next 25 years, the basis used by Aviva is felt to provide a balanced representation of possible 'real life' events that could take place in the future.

The various analysis results have been shared with the policyholder advocate during the course of the negotiations.

3.03.01 New business

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

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

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

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

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

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

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

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

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

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

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

The Policyholder Advocate and Aviva are satisfied that the offer is in the interests of the vast majority of policyholders when compared against a wide range of potential new business scenarios.

3.03.02 Run-off profile for the funds

The run-off profile for the existing business in the CGNU Life and CULAC with-profit funds shows us that many policies are expected to surrender or mature in the next 2-5 years.

This information, combined with other analysis undertaken (explained further below) and the limited prospects for any further distributions of the inherited estate in the short to medium term, leads Aviva to conclude that our preference is to reattribute now and share the benefit with as many existing customers as possible.

3.04 Aviva's Approach to Making a Fair Offer

3.04.01 Value of potential distributions to policyholder (VPDP)

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

As future distributions depend on a range of factors⁸ that interrelate and are hard to predict, the methodology has significant inherent limitations and therefore can't be viewed as the definitive answer – there is no such thing.

⁸ These factors include, for example, new business volumes, market performance, management actions, and the pattern of individual policyholders' own decisions

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

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

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

3.04.02 PIP breakeven periods

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

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

- The offer is considered “good value” if a policyholder would have to wait at least 10 years before the estimated value of any future distributions (VPDP) could exceed the offer.
- The offer is considered “excellent value” if a policyholder would have to wait at least 25 years before the estimated value of any future distributions (VPDP) could exceed the offer, or if the offer will always exceed the estimated future distributions.

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

3.04.03 Intergenerational transfer

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

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

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

3.05 Measuring Acceptable Return to Shareholders

As mentioned in Section 3.00 above, the PIP offer is based on the principle that value unlocked by the reattribution should be shared fairly between policyholders and shareholders.

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

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

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

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

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

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

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

3.05.02 Why should shareholders get a return from the transaction?

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

As part of the reattribution process, the shareholder provides new money, up front to pay for the PIP and pays all of the costs associated with the transaction in return for the policyholders giving up their

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rights to any future distributions from the inherited estate. They also take on the entire risk that some or all of the reattributed inherited estate may be needed now and in the future to make payments guaranteed to policyholders as well as to maintain the investment flexibility and security of the with-profits funds.

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

3.05.03 How quickly could shareholders get releases from the RIE?

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

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

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

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

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

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

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

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

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

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3.06 Reattribution Eligibility

3.06.01 Eligible policies

The basic criteria for eligibility are:

- 1a, the customer's product must be in force on the day on which we announced the Policyholder Advocate's formal appointment (21 November 2006 - announcement day), or, in the case of a new product, a customer's application must have been received by Aviva on or before announcement day; and
- 1b, the customer's product must still be in force on the date on which the reattribution is implemented (Effective day - E day).
the customer's product must be invested in the with-profits funds of CGNU Life or CULAC on announcement day and remain so between announcement day and E day;

The leaflet "Norwich Union with-profits reattribution: your guide to eligibility" provides specific details of those products which are included and excluded. All potentially eligible customers were sent a letter in December 2007 to advise them of the eligibility criteria for the proposed reattribution.

3.06.02 Eligibility time boundaries

When deciding the time boundaries we considered that:

- The date should be consistent with previous precedents, including demutualisations. Normal practice has been to set the cut off date for eligibility at the announcement day;
- Past Aviva communications informed both customers and shareholders only that we are actively investigating the feasibility of a reattribution;
- From the announcement day there was a higher chance that the reattribution would be going ahead and therefore more direct communication would be made available to aid decision making;
- In order to be fair to customers, the date should be clear, unambiguous and non-negotiable;
- Legally, a customer whose policy has come to an end before the announcement day has finished their contractual relationship with Aviva.

3.06.03 Effect of policy changes on eligibility

Our guiding principle is that all Aviva customers are treated fairly and openly. With this in mind, as of June 2006, we have been writing to with-profits policyholders (within the CGNU Life and CULAC funds) who are contemplating changes to inform them of the possible implications for eligibility.

Certain changes made to a customer's policy after the announcement day can affect whether or not it is eligible.

These changes are explained in the leaflet "Norwich Union with-profits reattribution: your guide to eligibility".

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3.06.04 Criteria for election

Eligibility to elect is dependent upon who legally owns the policy. The criteria conform to pre-existing processes that Aviva uses for its policy claims.

The leaflet “Norwich Union with-profits reattribution: your guide to eligibility” provides further information on who can elect.

3.06.05 Criteria for receiving a policyholder incentive payment

Eligibility to receive the incentive payment can depend on a number of factors, including:

- who legally owns the policy;
- who are the beneficiaries of the policy;
- any Court orders or legal rules affecting the policy.

Although in the case of many policies, the Policyholder Incentive Payment (PIP) will be made in the form of cash, for some policies it will be in the form of additional benefit added to the policy. The way in which the PIP will be made for a specific type of policy, and why, will be explained to customers.

3.06.06 Why hasn't eligibility for the reattribution and special bonus been aligned?

On 21st November 2006 Aviva announced that it was planning to make changes to the CGNU Life and CULAC with-profits funds, including a reattribution of their inherited estates.

At the time of the reattribution announcement and de-risking (and likewise in the immediately preceding years) economic conditions were not as favourable as they had once been, as a consequence in the period prior to de-risking there was no excess surplus in the funds.

The timing of the implementation of the de-risking decision was therefore a key driver of when excess surplus emerged in the funds. Since the implementation involved selling both equities and property held as assets to cover the cost of guarantees, this was not something that could be rushed or backdated.

As a result of the de-risking of guarantees carried out in 2007, additional surplus was generated in that year and this enabled a distribution of surplus to be made over the subsequent three year period. Special bonuses are added to policies, and any tax payable determined as part of policy proceeds in line with the tax treatment of the particular policy.

Unlike the reattribution (where the PIP is made from shareholders' funds) the special bonus payments are being made from the CGNU Life and CULAC with-profits funds.

For both legal and tax reasons it is not possible to make special bonus payments to policies which are not in force (as a result of maturity, lapse, transfer or surrender) in the funds on the qualifying dates announced for the special bonus. Accordingly special bonus payments cannot be backdated to a point before the additional surplus for distribution arose.

This differs from the eligibility criteria for the reattribution where greater flexibility can be applied because the PIP comes from shareholders' funds and not from the with-profits funds.

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4.00 The Aviva Offer

4.01 Aggregate PIP

4.01.01 Aggregate PIP offer made for election decisions

For the purposes of the offer on which eligible policyholders will make their election decisions, the aggregate PIP is £500 million. This has been calculated using an assumed Reattribution Estate value of £1,200 million at 1st October 2009 (“the Effective Date”). This restructured PIP is directly proportional to the originally proposed PIP of £1 billion for an inherited estate valued at £2.115 billion at 30th June 2008.

Individual PIP offers will be determined based on this aggregate PIP amount and will represent the lowest payment that electing policyholders could receive in exchange for giving up their rights to any future distributions of the inherited estates if the reattribution proceeds.

As described below, the actual amount payable may be higher than this figure.

4.01.02 Aggregate PIP offer for calculation of payments to electing policyholders

At the Effective Date, calculations will take place to ‘set’ the size of the inherited estates for the purposes of the reattribution payment (“Reattribution Estate”). The Reattribution Estate will be used to calculate the Enhancement Factor (if any) to be applied to the aggregate PIP. The resulting “Enhanced PIP” will be the value on which individual PIP payments will be made to electing policyholders.

We recognise that the Reattribution Estate could be calculated in a number of ways. The desires to protect both policyholders and shareholders from sharp market movements on any particular day; make the PIP payments as quickly as possible after the Effective Date and make the calculation basis easy to understand all need to be balanced in evaluating how best to approach the calculation.

The valuation of the inherited estate on which payment of the PIP is made to policyholders who elect to accept the offer will be calculated using an unweighted average valuation of the CGNU Life and CULAC inherited estates at 30th June 2009, 31st July 2009 and 28th August 2009 the “Reattribution Estate”).

In practice these valuations will be performed using the methodology Aviva employs for its interim valuation reports each year – which means that a realistic balance sheet calculation for CGNU Life and CULAC will be performed as at 31st May 2009 and then an agreed balance sheet economic impact projection applied.

For PIP payments this methodology will be used to derive the Reattribution Estate. The Reattribution Estate figure will be increased by two months interest using the London Interbank Offered Rate (LIBOR) to allow for the period to the Effective Date.

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Ernst and Young have reviewed the balance sheet economic impact projection and concluded that the proposed methodology is consistent with the introduction and purpose as described and that they had found nothing to suggest that it was inherently biased when approximations to economic movements were applied.

Details of the methodology and the Ernst and Young review have been shared with the Office of the Policyholder Advocate, the Independent Expert and FSA.

In addition, when calculated the values will be reviewed by Ernst and Young.

We also agreed with the Policyholder Advocate that, in order to speed up payments to policyholders after the Effective Date, it was appropriate to refresh the individual data on eligible policies (to remove policies that are no longer eligible as a result of voluntary discontinuance) at the end of the month preceding 'E-day minus 1 month' (for 1st October 2009 effective Date this would mean end August 2009) rather than the Effective Date.

The Enhancement Factor will be calculated as $55\% \times (\text{Reattribution Estate} - \text{£1,200m}) \div \text{£500m}$, with a minimum Reattribution Estate of £1,200 million.

The Enhancement Factor will be applied to the £500 million aggregate PIP to give the Enhanced PIP that will be payable as at the Effective Date.

In summary, the following table gives details of variations in the aggregate Enhanced PIP with movements in the value of the Reattribution Estate:

Reattribution Estate (£m)	PIP (£m)	Minimum PIP per eligible policy
2,500	1,215	486
2,400	1,160	464
2,300	1,105	442
2,200	1,050	420
2,100	995	398
2,000	940	376
1,900	885	354
1,800	830	332
1,700	775	310
1,600	720	288
1,500	665	266
1,400	610	244
1,300	555	222
1,200	500	200

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4.02 Allocation of the PIP and the Minimum Payment

There will be a minimum payment of £200 per eligible policy which will be met from the aggregate PIP.

Allocation of the PIP will be made pro-rata to a proxy for realistic liability (PIP liability) of the eligible policies at the announcement date⁹ adjusted by a multiplier for policies in selected product groups, as follows:

	Outstanding Term (years)					
	<=5	>5 and <=10	>10 and <=15	>15 and <=20	>20 and <=25	>25
Conventional WP Regular Premium	1	1.7	1.85	2	2	2
Defined Benefit	1.7	1.7	1.7	1.7	1.7	1.7
Deposit Admin	1.7	1.7	1.7	1.7	1.7	1.7
WP Annuity	2	2	2	2	2	2
Unitised Pensions	1	1.3	1.9	2.05	2.05	2.05

4.03 Payment of the PIP

Payment of the PIP will be made in cash unless Aviva considers that payment in cash will be disadvantageous given the nature of a particular policy. Such cases will have an additional benefit added to their policies.

4.04 Additional Benefit Payments

For a small number of policies it is not possible to provide a cash PIP without affecting the tax status of the underlying policy, as a result a cash equivalent PIP will be applied to the policy to provide additional benefits. The following products fall into this category:

- CGNU Life and CULAC individual life policies with Swedish correspondence addresses
- CGNU Life and CULAC individual pension policies with Swedish correspondence addresses

⁹ Updated to reflect any subsequent reductions in with-profit investments as set out in the leaflet "Norwich Union with-profits reattribution: your guide to eligibility"

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- Group occupational pension schemes with UK, Isle of Man and Channel Islands correspondence addresses
- CGNU Life French Branch Policies Individual life policies
- CGNU Life German Branch Policies DIVA policies
- Aviva Life International Limited Individual life policies with correspondence addresses outside UK, Isle of Man and Channel Islands

A detailed description of the treatment of the additional benefits payment can be found in the Scheme. In brief our intention is to ensure that an amount equivalent value to the cash PIP is applied to the policy to secure additional benefits. The exception to this is where there has been a contractual termination or maturity, when a cash PIP will be paid as the policy will no longer be in force.

4.05 Inherited Estate Allocation and Protection of Non Electors

From a policyholder perspective, the inherited estate allocation basis should aim to:

- Broadly maintain equivalent security of policyholder benefits between the OWPSF and New With-Profits Sub-Fund (NWPSF) (considered together with the RIEESA) on a standalone basis
- Broadly maintain the aggregate VPDP for non electors as a whole at the point of transfer
- Ensure that the OWPSF and the NWPSF can be run in a manner consistent with the operation of the with-profits funds of CGNU Life and CULAC prior to the reattribution, for example in terms of Equity Backing Ratio (EBR) and bonus setting, and in a consistent way with how the CGNU Life and CULAC funds were operated prior to the reattribution

It is imperative that the basis for allocating the inherited estates between the OWPSF and NWPSF reflects the primary purposes of the inherited estate (from the perspective of existing policyholders) namely providing security for policy benefits and investment freedom. Any other basis that did not achieve this outcome would be considered unfair.

Having said this, it is reasonable to expect that the VPDP for non-electors as a whole should be broadly preserved by the reattribution when tested under a wide range of take-up scenarios. The inherited estate allocation will accommodate both factors.

4.05.02 Calculation of inherited estate allocation between OWPSF and RIEESA

The basis for the allocation of the inherited estate between the OWPSF and Reattributed Inherited Estate External Support Account (RIEESA) use a realistic balance sheet calculation as at 30th September 2009.

The value calculated will be reviewed by Ernst & Young before being apportioned between RIEESA and OWPSF based on the proportion of eligible policyholder who elect / do not elect to accept the offer.

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4.05.03 Scenarios tested

If the take-up of the PIP is close to being uniform (i.e. limited difference between the mix of electors and non-electors) then there would be little, if any, effect from employing an alternative to a liability based allocation. As a consequence, analysis has focused on the effects of the “pro rata to PIP” basis in several scenarios where take-up is non uniform.

A range of assumptions were tested against each of the scenarios in order to assess the fairness of the inherited estate allocation mechanism to non-electing policyholder, this gave 110 possible outcomes. A proportion of these scenarios were selected to be deliberately extreme in order to stress test the approach.

The analysis results (post safety net) showed that in the vast majority of scenarios the aggregate VPDP for non-electors as a group has either been protected or enhanced. In addition the analysis showed that benefit security of non electors is protected across all our tested scenarios. Aviva therefore concludes this offer to be fair to non-electors.

The full analysis results have been shared with the Office of the Policyholder Advocate and the FSA.

4.05.04 Inherited estate allocation basis

Broadly speaking, the allocation of the CGNU Life and CULAC inherited estates between the RIEESA and the Old WPSF will be pro rata to PIP paid to electors and PIP declined by non-electors. The Enhanced PIP value (discussed earlier in this document) will be used in the calculation outlined below:

- If the total cost of the PIP paid to electing policyholders is X; and
- The total amount of the PIP which would have been paid to non electors whose policies are allocated to the OWPSF is Y; then
- $100 \times X / (X + Y)$ % of the inherited estate will be allocated to the RIE; and
- $100 \times Y / (X + Y)$ % of the inherited estate will be allocated to the OWPSF.

This calculation will be based on the size of the inherited estate at the Effective Date and valued in accordance with the basis used to determine Aviva UK Life’s published realistic balance sheet.

Initial scenario testing and analysis of this basis showed us that it was not possible to confidently confirm that VPDP for non-electors as a group had been preserved in a sufficiently wide range of voting patterns. The safety net mechanism was therefore developed to mitigate this risk.

Secondly the “safety net” mechanism described below is applied.

4.05.05 Safety net mechanism for non-electors

The safety net mechanism is designed to ensure that VPDP for non-electors and the ‘Old WPSF Proportion’ of the VPDP determined for transferring ineligible with-profits policies, determined as a whole is maintained at the point of transfer (the Effective Date).

The safety net mechanism is designed to broadly work as follows:

- The VPDP is determined for with-profits policies of the Old WPSF as a class immediately before and immediately after the Effective Date of the scheme.

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- Calculations of VPDP will be based on Aviva's view of:
 - The size of the inherited estate on the Effective Date valued in accordance with the basis used to determine Aviva UK Life's published realistic balance sheet
 - Assumed future new business based on the average of the 3 years new business immediately prior to the Effective Date, with projected growth at -10% p.a.¹⁰ after the first year

If, as a result of performing these calculations, the VPDP for with-profits policies of the Old WPSF is reduced by the reattribution, then the OWPSF inherited estate will be increased (via a transfer of assets from the RIEESA) by the amount required to bring the with-profits policies of the Old WPSF VPDP up to 100% of the pre-effective date VPDP (subject to a maximum transfer of £100m)

In some circumstances it is possible that the safety net mechanism would drive an immediate distribution of such amounts, this would unfairly treat those longer term policyholders that the safety net is designed to protect and therefore a mechanism to defer such distributions is required in order to address this issue.

4.05.06 Effective Date Benefit Security Factor (BSF)

Since the primary purpose of the inherited estate (from the perspective of existing policyholders) is to provide security for policy benefits and investment freedom to policyholders, the allocation of the inherited estate is subject to a "true-up" adjustment which is designed to ensure that the financial strength of the OWPSF and NWPSF (considered together with the RIEESA) are sufficiently similar. The measure of financial strength used for this purpose is the Effective Date Benefit Security Factor ("BSF") which is the probability of the fund being able to meet its obligations to current policyholders when they fall due.

To ensure that electing policyholders benefit security is not unduly affected it is necessary for the BSF test to be applied after the safety net is calculated (the safety net is explained below).

The BSF test specified in the Scheme requires the Old WPSF to provide a contingent loan (the "BSF Loan") to the RIEESA if the benefit security factor (BSF) determined for the OWPSF on the Effective Date exceeds that of the NWPSF (considered together with the RIEESA) by more than 0.5%. The market value of the assets loaned will be that which will result in the BSF of the OWPSF being exactly 0.5% higher than that of the NWPSF. However, the amount loaned will be further restricted to the extent that the VPDP calculated for OWPSF with-profits policies immediately after the Effective Date excluding the amount to be loaned would otherwise be lower than the VPDP determined for such policies immediately prior to the Effective Date. In particular, if the VPDP safety net results in a transfer of assets from the RIEESA to the Old WPSF then no such contingent loan will be provided.

In addition, if the OWPSF Bonus Amount (see below) determined as at the Effective Date is non-zero then the amount of any such loan will be recalculated after excluding assets of the inherited estate of the OWPSF with market value equal to the OWPSF Bonus Amount (which will reduce the BSF of the OWPSF on the Effective Date, and hence the amount of any such loan).

¹⁰ N.B. this is not Aviva's best estimate forecast of new business, it is the rate selected to ensure that we could confidently predict that the mechanism was robust enough to preserve VPDP across a wide range of voting patterns

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Any such loan will be contingent in the sense that repayments must be made if the financial strength of the NWPSF (considered together with the RIEESA) (determined as specified in the Scheme) exceeds 'AAA'.

Releases from the RIEESA to the AVLAP shareholder are not permitted if the loan (if made) has not been repaid in full.

4.05.07 OWPSF Bonus Amount

The mechanism to avoid the possibility of potential immediate distributions from the OWPSF as a result of the application of the safety net (and after the BSF test) will broadly operate as follows:

Following any safety net addition (and after the BSF test), should the OWPSF inherited estate exceed 100% of the funds' AAA Capital Requirement then the excess (the "OWPSF Bonus Amount" or "OBA") will be set aside in a separate account in the OWPSF to distribute to policyholders at a future date. The effect of this will be to reduce surplus to 100% of the AAA Capital Requirement

- Eligibility to participate in distribution(s) of the OBA will be restricted to those with-profit policyholders transferring to the OWPSF at the Effective Date and that are still in force at the date(s) of distribution (i.e. the post-effective date new business allocated to the OWPSF will not benefit from the OBA)
- The OBA cannot be distributed for at least 3 years after the Effective Date. After this period, the OBA will be paid-out through one or more distributions, the timing and allocation of which, in accordance with the normal operation of the funds, will be decided by the Boards of AVLAP after taking into account the views of the With-Profits Committee
- The With-Profits Committee will be obliged to consider on an annual basis (after the 3 year initial period) whether a distribution of all or some of the OBA should be made and advise the AVLAP Board accordingly. The Board will decide whether or not a distribution will be made

4.06 Other Policyholder Benefits Included in the Scheme

In addition to the financial benefits of the special bonus and the reattribution, existing policyholders will benefit from a number of other improvements in the terms and conditions offered on their policies, these include:

4.06.01 Improvements in the mortgage endowment promise

CGNU Life and CULAC made a promise in 2000 to certain with-profits endowment policyholders to top up their policy maturity proceeds by a projected shortfall amount to assist in repaying their mortgages. The promise was subject (among other things) to a condition that there was sufficient investment earnings on the free reserves of the with-profits sub-funds of CGNU Life and CULAC to meet these top up payments (the Affordability Conditions). If the reattribution proceeds, the promise as it applies to relevant with-profits endowment policyholders of CGNU Life and CULAC will no longer be subject to those Affordability Conditions from the Effective Date.

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The Affordability Conditions attaching to the corresponding promise made to certain with-profits endowment policyholders of the PM Sub-Fund in 2000 and of the NULAP WPSF in 2001 are unaffected by the Scheme and will continue to apply.

4.06.02 Restrictions on the introduction of new asset share guarantee charges for existing business

The Scheme requires that, with the exception of certain development costs, only expenses or charges of a type which are being deducted prior to the Effective Date, can be deducted from the asset shares of transferring policies after the Effective Date. This is unless the AVLAP Board, having regard to the advice of the With-Profits Actuary and subject to the approval of the With-Profits Committee, considers that it is consistent with the interests of policyholders for other expenses to be taken into account in determining the benefits under policies allocated to the NWPSF or the OWPSF.

The expenses to be charged to the asset shares of policies written after the Effective Date will be determined by the relevant policy conditions, the terms of service agreements with relevant service providers to the with-profits funds and the requirement to treat customers fairly.

4.07 Overall Sharing of Value (PIP & special distribution combined)

An offer of £500 million¹¹ at 1st October 2009 equates to around 41% of the face value of the inherited estate. Combined with the £2.1 billion¹² special distribution to qualifying policyholders (announced in February 2008), which released around 42% of the inherited estate value at that time. The offer represents a significant combined payment to existing with-profit policyholders.

4.08 Why is Our Offer Fair to Policyholders?

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

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

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

¹¹ For a Reattribution Estate value of £1,200 million

¹² As at the valuation date of 1st January 2008

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

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

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

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

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

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

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

Aviva has undertaken extensive stochastic modelling in order to assess the impact of a wide range of possible economic scenarios over the next 25 years.

The outcome of this analysis leads Aviva to believe that the reattribution offer is good value for almost all eligible customers (99%), and represents excellent value for at least 95%.

- The offer is considered "good value" if a policyholder would have to wait at least 10 years before the estimated value of future distributions could exceed the offer.

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

The VPDP has continued to fall as a result of the falling markets, highlighting the uncertainty of the value of current policyholders’ potential interest in the inherited estate. The inherited estate value as at the date of this paper lies closer to the bottom of the risk appetite preferred range than at the end of 2007, which is expected to delay any distributions that we might make from the inherited estate in future.

4.09 Why is Our Offer Fair to Non-Electing Policyholders?

Non-electors will continue to benefit from the primary purposes of the inherited estate, which are to provide security; to ensure that a high equity backing ratio is maintained and to keep the fund open for new business.

Aviva has adjusted the allocation mechanisms to broadly preserve the VPDP of with-profits policies of the Old WPSF at an aggregate level across a range of scenarios and assumptions. VPDP at an individual level is something that cannot be reliably calculated

4.10 Why is Our Offer Not Excessive to Shareholders?

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

The fall in markets and increase in volatility significantly depresses the IRR. At the same time the cost of credit has increased, and its availability is restricted. All these factors serve to reduce shareholder value.

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5.00 A Summary of Aviva's Assessment of the Offer and Recommendations to Policyholders

Aviva has undertaken extensive stochastic modelling in order to assess the impact of a wide range of possible economic scenarios over the next 25 years.

The outcome of this analysis leads Aviva to believe that the reattribution offer is good value for almost all eligible customers (99%), and represents excellent value for at least 95%.

- The offer is considered "good value" if a policyholder would have to wait at least 10 years before the estimated value of future distributions could exceed the offer
- The offer is considered "excellent value" if a policyholder would have to wait at least 25 years before the estimated value of future distributions could exceed the offer, or if the offer will always exceed the estimated future distribution.

5.01 Overall Sharing of Value

An offer of £500 million¹³ at 1st October 2009 equates to around 41% of the face value of the inherited estate. Combined with the £2.1 billion¹⁴ special distribution to qualifying policyholders (announced in February 2008), which released around 42% of the inherited estate value at that time. The offer represents a significant combined payment to existing with-profit policyholders.

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

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

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

¹³ For a Reattribution Estate value of £1,200 million

¹⁴ As at the valuation date of 1st January 2008

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5.02 Non-Electors and the Potential for Future Special Distributions from the Inherited Estate

An important feature of the reattribution is for policyholders to be offered a real choice. In achieving this, mechanisms have been put in place that will, in the vast majority of scenarios, preserve the VPDP for non-electors as a whole by the reattribution.

5.02.01 Prospects of future special distributions from OWPSF

As part of the operation of the risk appetite framework (RAF) for the CGNU Life and CULAC funds, the Board periodically considers whether there is excess capital in the funds, by reference to the RAF. If there is, it then considers what actions it should take with the excess capital in the circumstances. One of those actions could be a special distribution to policyholders and shareholders.

A combination of the announced special bonus, the recent significant market falls and increases in market volatility in 2008 has taken the fund strength outside the preferred range of surplus but comfortably within the acceptable range of surplus. Our aim is to remain within the range of AA to AAA because this is not only prudent in fluctuating economic conditions but is also the basis upon which the funds were sold to our customers.

At this point, the Board (in consultation with the With-Profits Committee) considers that further special distributions from the estate are unlikely in the short to medium term.

5.03 Conditions of the Offer

The offer is conditional on various approvals of the boards of the relevant Aviva UK Life companies and Aviva plc throughout the reattribution process both before and after it is made to policyholders. There will be a series of interim approvals before then. The offer is also subject to the FSA having no objection to the Reattribution Proposals, the election threshold being achieved¹⁵ and the approval of the High Court.

The offer is also conditional on the value of the combined inherited estates of CGNU Life and CULAC being at least £1.2 billion at the Effective Date. This condition can be waived by the Aviva plc Board if it considers, in the circumstances, that the offer is still fair to policyholders and shareholders. In these circumstances the aggregate PIP offer will remain at £500 million.

The offer should to be considered in conjunction with the Scheme, and reports by Actuarial Function Holder, With Profit Actuary and Independent Expert – as these provide detailed descriptions of the mechanisms, controls and safeguards outlined in this document.

¹⁵ The election threshold is set to ensure that at least £500 million of with-profits liabilities are allocated to the NWPSF

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6.00 The Policyholder Advocate's Response

The Policyholder Advocate's letter to John Lister dated 8th April 2009 (also copied to FSA) concludes that that "Overall therefore, under the current FSA rules, I am of the view that Aviva's PIP offer is in the interests of eligible policyholders. It is for the FSA to decide if the offer is fair and appropriately balances the interests of policyholders and shareholders."