

## **Appendix 45**

### **Formulation of Guidance to Policyholders**

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

**June 2009**

**Report by: LECG Ltd.**

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## **1.00 Introduction and summary of conclusions**

### **1.01 Introduction**

The role of the policyholder advocate includes providing guidance for with-profits policyholders, or each group of with-profits policyholders, with reasons, on whether the firm's proposals are in their interests.

The policyholder advocate's assessment of Aviva's reattribution offer reflects current regulation of the with-profits industry by the FSA, which includes permitted uses of inherited estates that in the policyholder advocate's view, permits shareholders to use the inherited estates to fund activities that benefit shareholders outside the customary 90:10 principle of the funds and which shareholders would otherwise have to pay for themselves. In particular, the policyholder advocate believes the way in which the FSA permits the estates to provide capital support for new business, thereby allowing the free transfer of inherited estate capital between generations of policyholders, in the context of a reattribution, tilts the regulatory framework against policyholders' interests and favours shareholders. The policyholder advocate has challenged the current FSA rules as being biased towards shareholders.<sup>1</sup> The FSA has considered these challenges, but has confirmed that its current rules will not be changed in any significant way for the foreseeable future. However, the FSA said that the amount which would go to future policyholders without a reattribution should be shared with current policyholders as part of the firm's reattribution offer. In this context, the policyholder advocate has assessed Aviva's reattribution offer to policyholders against four basic criteria:

- an aggregate PIP (Policyholder Incentive Payment) offer that exceeds the aggregate value of the special distributions that policyholders would potentially receive from their

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<sup>1</sup> The value lost by eligible policyholders as a result of current regulations is detailed in *Appendix 39: The Impact of FSA Guidance on Policyholders*.

interest in the inherited estates across a range of scenarios, under current FSA regulations;

- a reasonable share of the estate for eligible policyholders (at least 50 per cent of the ‘residual value’ under Aviva’s new business assumptions<sup>2</sup>) that, without a reattribution, would have gone to future policyholders, but with a reattribution is shared, after meeting the costs and taxes associated with a reattribution, between eligible policyholders and shareholders;
- an allocation mechanism for the PIP that correlates as closely as possible to policyholder special distributions forgone, given the data and technical constraints faced by Aviva; and
- for non-electors, protection of their aggregate potential special distributions without a reattribution following the transfer of their policies to the Old With-Profits Sub-Fund (Old WPSF).

The third objective is particularly important in the context of this appendix, which aims to provide support to the decision-making process of individual policyholders and their financial advisers. Ideally, Aviva would have put in place a mechanism that allocated the aggregate PIP in a manner closely correlated with the value of individual policyholders’ potential special distributions forgone without a reattribution. Under those circumstances, an aggregate PIP in excess of policyholders’ aggregate potential special distributions forgone, under current FSA rules, would have translated into an individual PIP allocation in excess of each policyholder’s estimated potential value of future distributions from the inherited estates.

For the reasons set out in *Appendix 43: Allocation of the Aggregate PIP between Policyholders*, the allocation method to be used in the reattribution does not closely reflect the value of potential special distributions forgone for all policyholders. In turn, that means that

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<sup>2</sup> Aviva’s new business assumptions are based on specific amounts to the end of 2010 and 5% annual increases in new business thereafter. The policyholder advocate’s alternative new business assumptions are based on 5% and 15% annual declines in new business from 2011 onwards.

there are some policyholders for whom the value of potential special distributions forgone is likely to exceed the value of their individual PIP allocation. If such policyholders were to elect for the reattribution, they could be giving up potential future special distributions which over time could be of greater value than the Policyholder Incentive Payment offered to them by Aviva. Such policyholders may be better off not electing for Aviva's proposals and having their policy placed in the Old WPSF.

In this appendix, LECG and the policyholder advocate endeavour to assist policyholders to identify whether Aviva's PIP offer is likely to exceed the value of potential future special distributions which policyholders who elect for the reattribution offer will forgo.

The remainder of the appendix is therefore set out as follows:

- Section 2 summarises the policyholder advocate’s analysis of Aviva’s offer that is described in detail in Appendix 41 to Appendix 44;
- Section 3 identifies the key drivers of the value of potential future distributions of excess surplus to individual policyholders;
- Section 4 discusses the key considerations, aside from the comparison of potential future special distributions to their individual PIP offer, that policyholders should bear in mind in making their decision as to whether to elect for the reattribution or not;
- Section 5 quantifies the value of Aviva’s offer in relation to the potential special distributions forgone for a range of policy types; and
- Section 6 contains LECG’s conclusions.

The analysis contained within this paper is based, like Aviva’s offer, on a range of potential values of Reattribution Estate at 1 October 2009, the assumed effective date of the reattribution (the Effective Date). The policyholder advocate also considers a range of alternative new business assumptions. The data used for this analysis has been provided by Aviva, based on policies in force on the date for eligibility (21 November 2006). During the summer guidance to particular groups of policyholders will be checked against end 2008 data that Aviva will be providing. If this results in any significant change to the present guidance, Aviva will enable the relevant policyholders to decide whether or not to change their vote.

## **1.02 Summary of conclusions**

The policyholder advocate has assessed Aviva’s PIP offer in detail in Appendix 41 to Appendix 44. Broadly, the policyholder advocate is satisfied that the offer meets each of the four conditions set out in Section 1.01 over a wide range of potential future outcomes, taking into account costs, taxation and allowances, in light of current regulation.

When formulating guidance to particular groups of policyholders, the policyholder advocate considered:

- factors that drive distributions of excess surplus, especially the future level of investment returns and the volume of new business assumed to be written by Aviva. All else being equal, higher investment returns will tend to increase the probability and size of special distributions of excess surplus from the inherited estate, while higher levels of new business will tend to reduce the value of such distributions, and vice versa<sup>3</sup>;
- individual considerations such as their personal circumstances, risk appetite and long-term saving objectives. If policyholders are unable or unwilling to hold their policy for a sufficient long period, or are unable to easily bear the possibility that future distributions of excess surplus are either later or smaller than expected, they should in general choose to accept Aviva's offer. Policyholders should also bear in mind that future distributions of excess surplus may not be free of tax, as their PIP offer is;
- the experience of other policyholders. For example the more other policyholders lapse, the more special distributions are left for remaining policyholders, absent a reattribution; and
- the characteristics of the policy they hold, in particular whether it is regular premium or single premium and the maturity date or expected surrender date. All else being equal, policies that remain in the funds for longer periods are more likely to share in distributions of excess surplus. Equally, because regular premium policies grow faster than single premium policies, individual PIP offers to regular premium policies (which are based on a proxy for each policy's realistic liabilities in 2006) may not fully reflect their potential value of future special distributions.

On Aviva's best estimate fund returns of 6.60 per cent pre-tax (6.15 per cent after tax), a majority of policyholders are made better off by the reattribution offer under a wide range of

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<sup>3</sup> As new business levels are an extremely important factor determining potential future special distributions to eligible policyholders, the policyholder advocate has assessed Aviva's PIP offer using Aviva's assumptions of a 5 per cent annual increase in new business from 2011 onwards, as well as the policyholder advocate's own assumptions of annual decreases of 5 per cent and 15 per cent from 2011 onwards.

new business assumptions when the PIP is compared with an estimate of the possible future special distributions they would forgo in accepting the firm's offer. Of those policyholders whose PIP offer is lower than the estimated potential value of their future special distributions from the inherited estates, many face a shortfall that is low in either percentage terms or monetary value, or both. Under the most favourable circumstances to eligible policyholders assessed by the policyholder advocate (a Reattribution Estate value of £2,500 million and a 15 per cent decline in new business) regular premium policyholders may need to wait until at least 2015, and single premium policyholders until at least 2014 to receive a value of special distributions that exceeds the value of their PIP offer; the time a policyholder might be expected to wait before special distributions exceed the PIP offer is referred to as the "payback period".

LECG has considered the position of four distinct types of policy under twenty different scenarios. These scenarios consist of fifteen combinations of three different new business levels and five different sizes of the inherited estates at 1 October 2009, and five scenarios in which special distributions increase by 25 per cent above those under Aviva's new business assumptions.

The results of that analysis for regular premium policies suggest that, on average:

- for policyholders making regular payments for policies which will mature or be surrendered before the end of 2016, the PIP offer is likely to be far higher than any special distributions that might be made before the policy matures or is surrendered, under all scenarios considered;
- for policyholders making regular payments for policies which will mature or be surrendered between 2017 and 2021, under some circumstances future special distributions could be more than the PIP offer. If the sale of new policies was to fall substantially, potential distributions could be higher. However, it could take until at least 2019 (with an estate of £1,200 million) for possible special distributions to equal the amount of the cash offer being made; and

- policyholders making regular payments for policies which will mature or be surrendered after 2021 might receive special distributions which exceed their PIP offer under all scenarios considered. Under the ‘base case’, with an estate value of £1,200 million, it could take until 2028 for possible special distributions to equal the amount of the cash offer being made.

In the portfolio of policies there are some paid-up and whole life policies. However, they make up a relatively small proportion of the funds. For the purposes of this guidance, policyholders who were paid-up as of November 2006 may consider themselves in the same category as single premium policyholders. For all other regular premium policies, this guidance is based on the assumption that premiums will continue to be paid. Whole life policies have been assumed to pay out according to Aviva's assumptions and have been grouped with the other endowments that mature at the same time. In neither case does this make a material difference to the analysis.

For single premium policies, which grow more slowly than regular premium policies, the appropriate decision hinges on how long the policyholder is prepared to leave their policy in the fund. These policies might receive special distributions which exceed their PIP offer under all scenarios considered, with relatively long payback periods.

The policyholder advocate encourages all policyholders who face an uncertain choice, or who feel that they lack sufficient information to make an informed decision, to seek professional financial advice. It should be emphasised that estimations of potential future special distributions are necessarily uncertain, as they require assumptions about future variables, such as investment returns and new business levels, which cannot be predicted with any certainty.

## **2.00 Summary of the policyholder advocate’s analysis of Aviva’s offer**

LECG has set out the policyholder advocate’s assessment of Aviva’s offer in detail in Appendix 41 to Appendix 44. This section summarises those appendices insofar as they relate to the guidance to individual policyholders and groups of policyholders.

### **2.01 Aviva’s offer**

Aviva’s offer is made to all eligible policyholders in the CGNU Life and CULAC with-profits funds and will take the form of a cash payment, save where Aviva considers that payment in cash would be disadvantageous to the policyholder. Policyholders choosing to accept Aviva’s offer (“electors” or “electing policyholders”) will receive a portion of the total cash amount offered by Aviva, the Policyholder Incentive Payment (PIP). In exchange, they will give up any interest they have in potential future special distributions from the inherited estates of the funds and will pass their interest to Aviva.

Aviva is offering eligible policyholders an aggregate PIP with a minimum value of £500 million for 100 per cent of the inherited estates of CGNU Life and CULAC, conditional upon the Reattribution Estate being valued at £1,200 million or more at the Effective Date; this condition can be waived by the Aviva plc Board, in which case the aggregate PIP offer would remain at £500 million.<sup>4</sup> The aggregate PIP will be supplemented by what Aviva calls an ‘Enhancement Factor’, an additional aggregate sum that increases pro rata with any value the Reattribution Estate has in excess of £1,200 million. The Enhancement Factor added to the £500 million minimum value of the aggregate PIP offered will be calculated as 55 per cent

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<sup>4</sup> The Reattribution Estate is the inherited estate calculated in accordance with Aviva’s annual audit and reporting procedures and does not include any of the adjustments considered appropriate by KPMG, nor any deductions for risks, costs and allowances, as discussed in Appendix 35: *Size of the Inherited Estates*, and Appendix 37: *Valuation of the Reattributed Estates*, respectively.

of the value of the Reattribution Estate in excess of £1,200 million. The aggregate PIP will therefore scale with the movement in the Reattribution Estate.

To protect policyholders and shareholders from sharp changes in financial market conditions, the value of the Reattribution Estate will not be calculated at a single date. Rather, the value used to calculate the Reattribution Estate will be calculated as the unweighted average of the unadjusted value of the combined CGNU Life and CULAC inherited estate at close of business on 30 June, 31 July and 28 August 2009. Each of the month-end valuations will involve an economic roll-forward of the prior “hard close” valuation, in this case at 31 May 2009. The June valuation will be audited as will the roll forward mechanism. The averaged estates will be increased by two months interest using LIBOR to cover the period to the Effective Date.

The value of the Aviva offer for a range of values of Reattribution Estate is shown in Table 1 below.

**Table 1 Value of aggregate PIP, £ million**

<b>Reattribution Estate</b>	<b>Aggregate PIP</b>
1,200	500
1,300	555
1,400	610
1,500	665
1,570	704
1,600	720
1,700	775
1,800	830
1,900	885
2,000	940
2,100	995
2,200	1,050
2,300	1,105
2,400	1,160
2,500	1,215

The PIP is in addition to the special distribution of £2.3 billion from the inherited estates announced by Aviva in February 2008, which will be added to policyholders' asset shares in instalments over three years, provided their policies remain in force at the time of each bonus declaration. The full amount of the aggregate PIP would only be paid if 100 per cent of eligible policyholders accept the reattribution offer.

Aviva's aggregate payment will be allocated between policyholders pro-rata to a proxy for the realistic liabilities of each policy at 21 November 2006 (the PIP Liability). Policies' PIP

Liabilities will be adjusted by a multiplier for policies that, in Aviva's view, are likely to have a larger interest in the inherited estates than is indicated by the value of their realistic liabilities alone.

Aviva's proposed mechanism is also subject to a minimum individual payment per policy. The minimum payment will be £200 if the Reattribution Estate is valued at £1,200 million. The minimum PIP Payment will be increased by £22 for each additional £100 million of value in the Reattributed Estate above the £1,200 million minimum. While no policyholder will receive less than the minimum payment, the lowest payment any individual policyholder can expect is contained in the offer letter mailed by Aviva. Aviva has confirmed that the minimum payment to policyholders will not be lowered beyond that included in the letters to policyholders, and that payments will be increased if the estate is greater than £1,200 million at the time of the payment. As agreed with HM Treasury, UK-resident policyholders will not be liable for taxation on their PIP allocation. The relationship between the unadjusted estate and minimum individual PIP is illustrated for a range of values of the unadjusted estate in Table 2 below.

**Table 2 Value of minimum PIP**

<b>Reattribution Estate (£m)</b>	<b>Minimum PIP (£)</b>
1,200	200
1,300	222
1,400	244
1,500	266
1,570	281
1,600	288
1,700	310
1,800	332
1,900	354
2,000	376
2,100	398
2,200	420
2,300	442
2,400	464
2,500	486

The policyholder advocate, Aviva, and the FSA have agreed that any non-electing policyholders should, on the whole, not be disadvantaged by the reattribution. The FSA has said that it would consider a reattribution to be fair, if amongst other conditions, ‘policyholders have been given the opportunity to retain the status quo, that is to retain their interest in the inherited estate without suffering detriment.’ Aviva and the policyholder advocate have agreed certain safeguards, described in Appendix 44: *The Position of Non-Electing Policyholders*, to ensure that the interests of non-electing policyholders are protected

across a broad range of potential outcomes for future special distributions and potential voting patterns by eligible policyholders.

Aviva's offer is described in greater detail in *Appendix 41: The Aviva Offer*.

## **2.02 The policyholder advocate's assessment of Aviva's aggregate offer**

The policyholder advocate has evaluated the aggregate position of all policyholders in the funds, on the assumption that 100 per cent of policyholders elect for the reattribution, in comparison to the aggregate position in which they would potentially be if there were no reattribution.

In order to assess Aviva's offer to eligible policyholders, the policyholder advocate has looked at two general criteria:

- in aggregate, do eligible policyholders receive a PIP that is at least equal to their estimated potential future special distributions across a range of new business assumptions and estate values?
- do eligible policyholders receive at least a 50 per cent share of the policyholder advocate's estimate of the residual value of the inherited estates (as detailed in *Appendix 37: Valuation of the Reattributed Estates*) under Aviva's new business assumptions?

LECG has also been asked to calculate Aviva shareholders' estimated internal rate of return (IRR) from the reattribution transaction. It is the FSA's responsibility to decide if that return is fair in the circumstances. The FSA has been provided with the results of LECG's calculations.

The policyholder advocate uses three base line scenarios against which to measure Aviva's offer. All scenarios use the policyholder advocate's calculations in respect of the size of the

estates and the appropriate deductions to make from them. The differences between the scenarios are the new business assumptions, which include Aviva's assumptions of 5% annual growth from 2011 onwards and alternative assumptions of a 5 per cent annual decline and a 15 per cent annual decline from 2011 onwards.

The policyholder advocate notes that policyholders may, on Aviva's new business assumptions, receive more than half (between 54 and 61 per cent) of the residual value of the inherited estate, the amount of the inherited estate that would be allocated to future policyholders absent a reattribution; the policyholder advocate is therefore satisfied her second criteria for evaluation of the aggregate offer has been met. On lower new business assumptions, policyholders may receive considerably less than half of the residual value of the inherited estate: assuming a 5 per cent annual decline in new business from 2011, policyholders may receive between 35 and 43 per cent of the residual value, falling to between 15 and 22 per cent assuming an annual decline of 15 per cent. Nevertheless, under current FSA rules, the offer is on average superior to what policyholders might receive if there were no reattribution.

On any of the scenarios considered, therefore, under current FSA rules, the value of Aviva's offer exceeds the value of the potential special distributions forgone by policyholders under a reattribution. On Aviva's new business assumption, policyholders also receive a majority of the residual value of the inherited estates after all costs and allowances. The policyholder advocate is therefore satisfied that Aviva's offer meets the conditions set out in Section 1.01 above, and that policyholders, in aggregate, are likely to receive more than they would expect to receive under a wide range of scenarios if there were no reattribution, plus a reasonable share of the residual value of the estate, taking into account costs, tax and allowances over a wide range of future new with-profits business assumptions.

With regards to the sharing of the estate between eligible policyholders and shareholders, it should be noted that a special distribution of £2,363 million was announced in February 2008, of which £2,080 million was allocated to policyholders. This special distribution and the

aggregate Aviva PIP offer release of a portion of the inherited estate to eligible policyholders. The table below shows the percentage of the overall value of the estate available for reattribution that is being offered to policyholders. Assuming all policyholders accept, the Aviva PIP offer will release between 42 and 49 per cent of the inherited estates to policyholders, excluding the special distribution announced in February 2008. Including the special distribution announced in February 2008, in aggregate policyholders could receive up to 72 per cent of the available estate.

**Table 3 Percentage of estate offered to policyholders**

Reattribution Estate value (£m)	1,200	1,570	1,800	2,100	2,500
PIP (£m)	500	704	830	995	1,215
Policyholder share of estate excluding the special distribution announced in February 2008	42%	45%	46%	47%	49%
Policyholder share of special distribution announced in February 2008 (£m)	2,080	2,080	2,080	2,080	2,080
Total to policyholders, including the PIP and the special distribution announced in February 2008 (£m)	2,580	2,784	2,910	3,075	3,295
Policyholder share of estate including the special distribution announced in February 2008	72%	71%	70%	69%	68%

Regarding shareholder returns from the reattribution, on Aviva's original analysis, Aviva estimated that the PIP offer allows a rate of return to shareholders of between 8.2 and 10.6 per cent per year, depending on the value of the inherited estates as at the Effective Date. (More recently, Aviva has estimated the shareholder IRR as 13.5 per cent). On the policyholder advocate's analysis, the rate of return is about 10.3 to 11.5 per cent per year. This is significantly above Aviva's assumed long range fund rate. It is for the FSA to consider if the return is fair to shareholders in current circumstances.

The policyholder advocate's detailed assessment of Aviva's offer is contained in *Appendix 42: Evaluation of the Aggregate PIP Offer*. Further details about the structure and nature of

special distributions forgone by electing policyholders can be found in *Appendix 40: Analysis of Potential Future Special Distributions for Policyholders and Shareholders*.

### **2.03 The policyholder advocate’s assessment of Aviva’s allocation mechanism for the aggregate PIP**

The allocation mechanism for the aggregate PIP determines how the aggregate PIP is divided among policyholders, therefore determining if the value of each policyholder’s PIP allocation exceeds the potential value of the special distributions forgone by that policyholder without a reattribution. As noted above, Aviva proposes to allocate the PIP pro-rata to a proxy for each policy’s realistic liabilities, subject to a minimum individual payment of £200 (this will be increased if the unadjusted estate is valued in excess of £1,200 million at the Effective Date – see table below). However, for many policyholders, the lowest payment they could receive if they accept Aviva’s offer is higher than £200; the offer letter Aviva sent to policyholders contained the minimum payment that each individual may expect to receive for their specific policy.

Certain policies, particularly those making regular premium payments and/or with long outstanding terms have had their realistic liabilities adjusted by a multiplier. The multiplier has been applied in cases where the policy’s potential special distributions forgone are likely to be higher than would be suggested by the policy’s PIP Liabilities alone. On the basis of its calculations, Aviva estimates that around 95 per cent of policyholders would need to remain in the funds beyond the expected maturity date of their policies, or beyond 25 years, to receive the same value from potential future special distributions as the PIP that they are being offered; they estimate 99 per cent of policyholders would have to wait at least 10 years.

After estimating potential future special distributions from the inherited estates to groups of policyholders, LECG has modelled the allocation of these distributions to individual policies using a separate model. These individual policyholder estimates of potential future special distributions are then compared to the estimated PIP allocated to each individual to determine which value is greater. It is important to recognise that this does not mean LECG has

modelled individual policies, but rather has estimated the proportion of policies in each group for which potential future special distributions may exceed the PIP offer, based on estimated allocations of special distributions and the aggregate PIP. Estimated potential special distributions have been calculated on each of the policyholder advocate's scenarios, using either Aviva's new business assumptions or the alternative new business scenarios. All scenarios assume that the FSA's current rules and guidance persists.

Under Aviva's new business assumptions, LECG has calculated that between 84 and 97 per cent of policyholders are offered a PIP that is in excess of the value of their potential special distributions forgone. On the alternative assumption that new business amounts decline by 5 per cent per annum from 2011, between 80 and 90 per cent of policyholders are offered a PIP in excess of the value of their potential special distributions forgone. On the lowest new business assumption considered, that of a 15 per cent annual decline in new business amounts, between 78 and 87 per cent are offered a PIP allocation that is in excess of the value of their special distributions forgone.

The overall impact of Aviva's allocation mechanism is that small policies will benefit from the minimum payment offered, while policies whose PIP Liabilities have been adjusted by Aviva should also receive a PIP offer that is more closely aligned with the potential special distributions they would forgo if they elected to accept the offer.

The policyholder advocate is satisfied that Aviva's allocation mechanism, despite its weaknesses, ensures that a majority of policyholders receive a PIP offer in excess of their potential special distributions forgone on a wide range of assumptions about potential future outcomes.

A detailed analysis of Aviva's allocation mechanism is contained in *Appendix 43: Allocation of the Aggregate PIP between Policyholders*.

## **2.04 Safeguards for non-electing policyholders**

As noted above, Aviva and the policyholder advocate agree that, without special safeguards being put in place, it is possible that non-electors' potential future special distributions from the inherited estate of the Old WPSF, following the reattribution, will be lower than they could have been, absent a reattribution. That situation potentially arises because Aviva's proposed allocation mechanism is not perfectly correlated with the potential future special distributions to individual policyholders, absent a reattribution. Such a position would run counter to the fourth principle set out in Section 1.01 above, the protection of the aggregate potential special distributions of non-electors, which include both regular benefits from their policies and any expected future special distributions from the inherited estate.

In response, Aviva has proposed to "top up" the inherited estate of the Old WPSF with up to £100 million from the RIEESA in order to preserve non-electors' benefits at approximately the same level following a reattribution. The estimation of the required "top-up" will be based on an assumption that new business decreases by 10 per cent per annum from 2011 in order to cover a reasonable range of potential outcomes and to ensure that non-electing policyholders will be at least as well off, following a reattribution, as they would have been if a reattribution had not occurred.

LECG has reviewed Aviva's analysis of the position of non-electors under a wide range of potential voting patterns and levels of new business. According to LECG's analysis, a shortfall in the estate of the Old WPSF is most likely if a significant number of regular premium policyholders with long outstanding terms and/or policyholders with single premium policies that have no fixed maturity date do not accept Aviva's offer. Likely non-electors generally fall into these categories.

The scenario needing the highest take up rate requires 95 per cent of policyholders to accept the offer in order for the proposed transfer to cover any potential shortfall in benefits. This is however an isolated scenario and LECG's assessment of take-up rates is based on a steeper new business volume decline of 15 per cent per annum from 2011. Under these circumstances

LECG could envisage take-up rates of up to 95 per cent, after taking into account the uncertainties and timing associated with future distributions from the inherited estate. If the actual outcome of the vote approximates the results suggested by the analysis, Aviva's proposed transfer would preserve non-electors potential benefits following the reattribution, provided the amount of new business written by Aviva declines by less than 10 per cent p.a. from 2011.

If there are more non-electors than LECG would expect from its analysis, or if Aviva's new business declines more steeply than expected, the safety net may prove inadequate. On the basis of the expected proportion of non-electors across a reasonable range of new business projections, however, LECG believes that Aviva's proposals are likely to preserve non-electors' benefits at a level similar to that which would have pertained absent a reattribution.

This is an important principle, and it has been maintained across a broad range of scenarios, with a notable exception. Currently, the FSA rules permit tax on distributions to shareholders from the WPSFs to be borne by the inherited estates. It is conceivable that the FSA rules could change so that shareholders would have to bear this cost. The policyholder advocate is concerned that under the Scheme the Old WPSF policyholders could not be sure that they would benefit from such a change (whereas absent the reattribution they would have done so). Although the possibility that FSA would not insist on this is remote, the policyholder advocate considers that the Scheme should be changed to put this beyond doubt.

More details of the analysis of the position of non-electing policyholders are in *Appendix 44: The Position of Non-Electing Policyholders*.

### **3.00 Factors affecting all policyholders**

The policyholder advocate's guidance to individual policyholders is divided into three parts. In this section, LECG considers the drivers of potential special distributions forgone that apply to all electing policyholders. In principle, there are many drivers of the potential value of special distributions from the inherited estates. Many of those, such as the risk appetite of the funds which dictates the amount of prudential capital to be held, are, in practice, within the control of shareholders or subject to regulation. As part of the reattribution exercise, these practices have been codified in the Scheme and Actuarial Function Holder's (AFH) report and are therefore taken as "given".

There are two key drivers of the value of special distributions from the inherited estates, however, whose value cannot be known in advance and on which a view must be taken: the volume of new with-profits business written by Aviva, and the investment performance of the funds.

In addition to these two factors, which are discussed in more detail below, the behaviour of individual policyholders, which cannot be predicted with accuracy, influences the level of special distributions available for each policyholder. Aviva estimates the rates at which each type of policy will be surrendered (i.e. leave the fund voluntarily before maturity), impacting the policyholder advocate's projections of future special distributions. In particular, policies without a known maturity date can be surrendered at any time, making predictions of distributions to these policies more difficult. Policyholders should bear in mind that these assumptions, while necessary, introduce a further element of uncertainty into projections of future distributions, which will likely be higher or lower than the best estimates put forth by the policyholder advocate.

LECG emphasises that the charts and tables presented in this section are not a perfect predictor of the actual magnitude or pattern of special distributions from the estates. The charts and tables are intended as a guide to the potential timing and magnitude of such distributions on the presumption that the fund continues to grow at a steady pre-tax rate of around 6.60 per cent per annum, or 6.15 per cent after tax (from its value at the Effective Date) consistent with Aviva's best estimate forecast of future fund performance, with varying levels of new business. In practice, however, the actual volumes of new with-profits business and the actual investment returns of the funds are likely to be different, whether higher or lower, from those assumed by LECG in its analysis. Policyholders and their advisers should therefore bear in mind that the projected distributions of excess surplus may be higher or lower than those shown here.

### **3.01 Future new with-profits business assumptions**

The trend and amount of new with-profits business written by Aviva into the funds is a critical determinant of the value of potential future distributions of excess surplus to eligible policyholders without a reattribution. If new business was not permitted by the FSA to be supported from inherited estate capital, the level of new business would not affect eligible policyholders' expected distributions. Given current FSA rules, however, all else being equal, a higher volume of new business serves to:

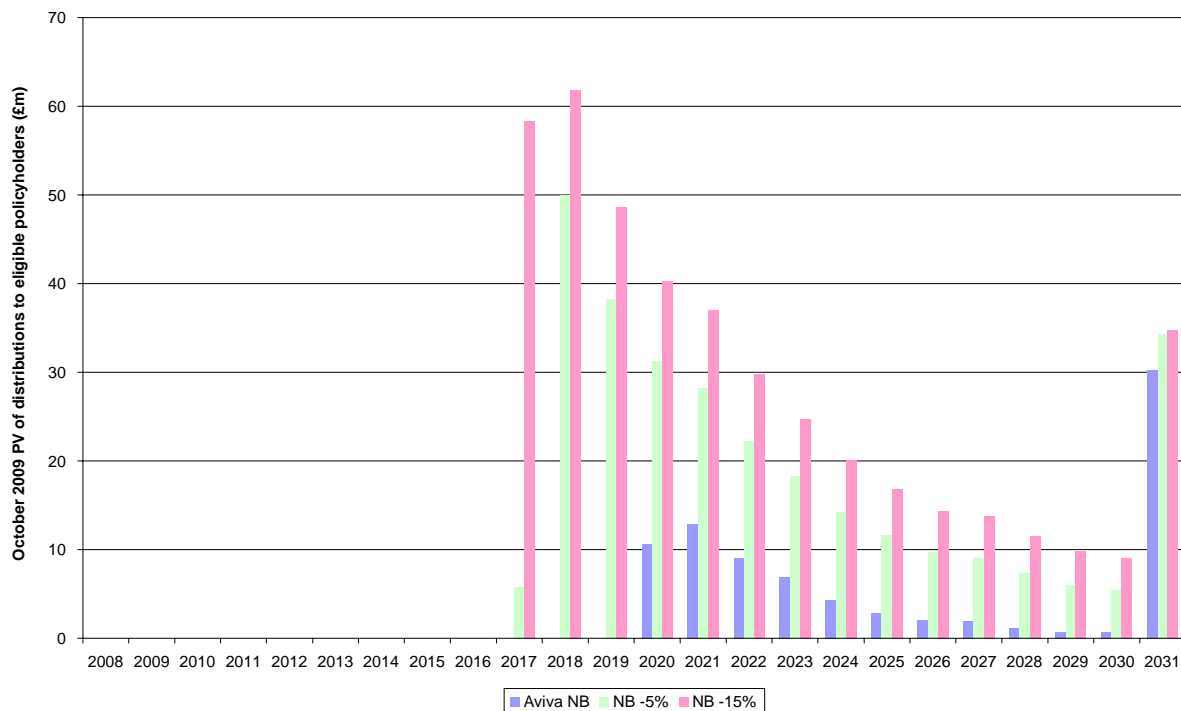
- defer any such distributions of excess surplus, as higher volumes of subsidised new business will increase the capital requirement of the funds and so it will take longer for investment returns to build up the value of the inherited estate to a level in excess of the raised threshold for distributions; and
- dilute the value of any future distributions to eligible policyholders, as such distributions will be shared with a larger number of future policyholders.

To the extent that more new business is written, the higher will be the threshold for releases of capital from the inherited estate and when there are distributions, the more new policyholders there will be to share the distributions with. Higher new business volumes therefore diminish

the value of future distributions of excess surplus, particularly once those future distributions have been discounted back to present value terms

The effect is illustrated graphically in 00 below, which shows the value of potential distributions of excess surplus to policyholders using Aviva’s new with-profits business assumption (5 per cent per annum growth from 2011) and also alternative policyholder advocate assumptions of new business declines from 2011 of 5 per cent per annum and 15 per cent per annum.

**Figure 1 Present value of estimated special distributions to eligible policyholders from the inherited estate, without a reattribution, Aviva new with-profits business assumptions and policyholder advocate alternative new with-profits business assumptions, unadjusted estate of £1,200 million at 1 October 2009, £ million**



As may be seen from 0, the greater the volume of new business written into the funds, the lower the value of potential distributions of excess surplus to eligible policyholders. This reflects the larger amounts going to future policyholders when there are more of them.

The actual trend and volume of new with-profits that would be written by Aviva, absent a reattribution, cannot be known. Despite the company's assurances of its intent to write such business, it is not possible to forecast Aviva's share of a small part of the long-term savings market with any accuracy. Small changes in attractiveness will have large impacts on new business volumes. For this reason, the policyholder advocate has also assessed Aviva's offer against lower new business assumptions of a 5 per cent and a 15 per cent annual decline from 2011.

### **3.02 Future investment returns**

Aviva uses a stochastic model to project the future status of its with-profits investment funds. The model uses assumptions about the level and volatility of investment returns, new business and other relevant factors to project 1,000 different potential outcomes for the fund over 25 years. Clearly, some of those outcomes at the upper and lower ends of the range represent extremes that are very unlikely to occur. Towards the middle of the range, however, there is a set of outcomes that reflects the central tendency of the long-term investment performance of the assets in which the funds are invested. Future investment outcomes will almost certainly vary from the central tendency, either positively or negatively, but the central projections of the model represent the average of the range of potential outcomes that might occur.

The fund-level data provided to LECG by Aviva is based on the outturn from Aviva's stochastic model at the 54<sup>th</sup> percentile. In other words, of the 1,000 projections made by the model, around 54 per cent produce lower returns than this projection and around 46 per cent produce higher returns. It therefore tends towards the centre of the range of potential outcomes. On average, the 54<sup>th</sup> percentile outcome shows pre-tax investment returns of 6.60 per cent, or 6.15 per cent post-tax. The fund-level dataset supplied to LECG by Aviva is deterministic, in that it assumes a 6.60 per cent pre-tax return in each and every year of the 25

year projection. However, the actual level of future investment returns is uncertain, depending on the performance of financial markets. Healthy markets mean that the inherited estates are likely to grow which makes it more likely that there will be money for special distributions in future. If markets do not perform well, it is also less likely that there will be money available for special distributions in future

LECG's analysis is therefore based on a range of potential values of the Reattribution Estate of between £1,200 million and £2,500 million at 1 October 2009. Additionally, LECG has considered a scenario where the possible amounts of special distributions are 25 per cent higher than those under Aviva's new business assumptions, in each year in which they are projected to occur as a proxy for stronger future investment performance, compared to the investment returns in the data supplied by Aviva.

## **4.00 Individual policyholder considerations**

The purpose of this section is to provide policyholders with a set of additional considerations that they may wish to bear in mind when deciding whether to elect to accept Aviva's PIP offer. The financial impact of many of these considerations cannot be exactly quantified, even for an individual policyholder, although in general terms it is possible to offer guidance as to the likely direction and potential magnitude of their effect.

The considerations discussed below concern the uncertainty of potential future special distributions from the inherited estates, in comparison to Aviva's certain, near-term PIP offer that most policyholders will receive in cash. Uncertainty is a necessary feature of all long-term investing and actual outcomes may be higher or lower than the expected outcome viewed from any given point in time. It is likely that many of these factors will influence policyholders in their decision to accept Aviva's offer.

### **4.01 The value of certainty**

In the reattribution election, policyholders are being offered a known value of benefits (cash or policy enhancement) in exchange for giving up an unknown value and timing of future benefits from special distributions of excess surplus from the inherited estates. The minimum value of potential special distributions is zero: under certain, relatively extreme assumptions, no such distributions may arise at all. It is likely however, that the value of special distributions to policyholders will not be zero if they were to remain in the funds for a sufficient period of time absent a reattribution.

There are four separate uncertainties associated with the value of future special distributions:

- their timing. It is almost certain there will be no special distributions before 2012. Beyond that date, however, it is not known exactly when any special distributions will

be made as any distributions depend largely on the future path of investment returns from equities, property and bonds; on the amount of new with-profits business assumed to be written; and on the actuarial assumptions underpinning calculations of the liabilities of policies (principally, the level of long-term interest rates). ;

- their amount. Like the timing of special distributions, the amount of special distributions depends primarily on future investment returns, future new with-profits business, and actuarial assumptions. A sustained period of highly positive investment returns could lead to a series of significant special distributions. Lower, or more volatile investment returns will tend to reduce the amount distributed, as well as to defer it. Conversely, higher new with-profits business levels will tend to reduce the value of potential future special distributions to eligible policyholders. The behaviour of other policyholders also affects potential special distributions: if more policyholders than Aviva is assuming decide to surrender their policies, there will be fewer people to share possible special distributions in future, while if fewer policyholders than assumed surrender their policies, any special distributions will be less valuable to them as there are more people with whom it will be shared. None of these variables can be known with any certainty;
- the form they will take. Future special distributions may be used to enhance policy benefits. In addition, special distributions may not be paid out as a single lump sum, but might be spread over several years, in a manner similar to that of the special distribution announced by Aviva in February 2008. Ultimately, the form of distributions is a matter for shareholders' discretion; and
- their tax treatment. Under an agreement with HM Treasury, UK-resident policyholders electing to accept Aviva's PIP offer will not incur tax on it. Future special distributions from the inherited estates may be subject to tax, depending on the individual policyholder's tax position. Policyholders will need to take into account the tax status of any future special distributions, and may wish to seek professional advice.

Policyholders should also bear in mind that the tax status of their policy may be affected by unforeseen changes to tax legislation.

How a policyholder should respond to these uncertainties depends on their personal circumstances and investment considerations. Some relevant aspects of these factors are set out below.

#### **4.02 The interaction of uncertainty and policyholders' individual circumstances**

An individual policyholder's response to the presence of uncertainty will depend on various factors, including the following:

- willingness to accept risk. All else being equal, a policyholder more willing to take risk will be more willing to remain in the funds in the hope that future special distributions will exceed their current expected values, assuming the value of their future special distributions has a reasonable probability of exceeding the value of Aviva's PIP offer. In contrast, a policyholder with a lower willingness to take risk would place a higher value on the certainty of Aviva's PIP offer, all else being equal.
- ability to accept risk. Even if a policyholder is keen to accept risk, practical or financial limitations may limit the amount of risk that a policyholder wishes to assume. Again, policyholders with a higher ability to take risk, all else being equal, should be more willing to consider declining Aviva's offer if there is a reasonable probability that the value of future special distributions from the inherited estates may exceed the value of their PIP offer from Aviva; and
- investment horizon. In many cases, the investment horizon of a policyholder in respect of their investment in the CGNU Life or CULAC funds will be constrained by the expected maturity date of their policy. It is not normally possible to extend this date, placing an upper limit on the period in which the policy can remain in the funds and the policyholder's investment horizon. Some policyholders with a known maturity date

may also intend to allow their policies to lapse in the interim period, resulting in a shorter time horizon. Single premium policyholders, however, can often surrender their policy without penalty at a date of their choice once a minimum investment period has been fulfilled. Such policyholders have greater flexibility in the time horizon of their investment. In general terms, the longer the investment horizon of the policyholder, the greater is the probability that they will be able to benefit from special distributions from the Old WPSF inherited estate and the greater their flexibility in exercising a choice between accepting Aviva's PIP offer, or choosing not to elect and accepting the associated unknown future value of benefits from special distributions.

- liquidity needs. Policyholders who have been investing in the with-profits funds to save for a particular purpose (e.g. school fees, mortgage repayment) are likely to be constrained by a need to receive their full policy benefits by a particular date in the future. All else being equal, policyholders with greater liquidity needs in the short-term, can bear less exposure to fluctuations in the value of their policy and should place a higher premium on the certainty of Aviva's PIP offer. Policyholders with lower liquidity constraints in the short-term, should be able to accept more risk and, consequently, the uncertainties associated with future special distributions; an

In assessing Aviva's PIP offer, the policyholder advocate has considered and given guidance on the comparison of the PIP offer to the potential value of special distributions forgone under different assumptions. However, personal circumstances and the considerations listed above can be expected to be taken into account when policyholders are deciding whether or not to accept Aviva's reattribution offer. The general effects on policyholders' individual election decisions of the factors discussed in this section, all else being equal, are shown in Table 4 below.

**Table 4 Impact of personal circumstances on the election decision**

<b>Factor</b>	<b>More likely to accept PIP offer</b>	<b>More likely to accept uncertain special distributions</b>
Willingness to accept risk	Lower willingness to accept risk	Higher willingness to accept risk
Ability to accept risk/liquidity needs	Lower ability to accept risk	Higher ability to accept risk
Investment horizon	Shorter investment horizon / outstanding term < 10 years	Longer investment horizon / outstanding term > 10 years
Liquidity needs	Higher liquidity needs	Lower liquidity needs
Life stage	Older, savings goals (such as retirement) within 10 years	Younger, savings goals (such as retirement) in more than 10 years

## **5.00 Individual policy characteristics and potential special distributions forgone**

It is not possible to place any single reliable value on an individual policyholder's interest in potential distributions from the inherited estates. That uncertainty arises from uncertainty about:

- the future level of investment returns and of new business supported by estate capital, both of which have a significant impact on the level of potential future special distributions to eligible policyholders from the inherited estates; and
- the circumstances of individual policyholders and their intentions towards their long-term investments in Aviva's with-profits funds.

Nevertheless, it is possible to say that higher future special distributions, absent a reattribution and all else being equal, will be correlated with:

- the type of policy held. Regular premium policies could expect to gain a larger share of future distributions (as these policies asset shares increase with future premium payments) from the inherited estates than single premium policies, relative to the respective proxy for realistic liabilities used to calculate their PIP allocations. To some degree, Aviva's allocation mechanism takes account of this effect in the multipliers applied to the realistic liabilities of certain types of policy;
- the outstanding term of the policy (for regular premium policies) or the length of time for which the policyholder intends to remain invested in the funds (for single premium policies). Policies that remain in the funds for longer periods will have a greater chance of sharing in any future special distributions. Again, Aviva's allocation mechanism

takes account of this effect to some degree in the multipliers applied to certain policies' realistic liabilities; and

- the size of the policy. It has been assumed that special distributions are likely to be allocated to policies in proportion to asset shares. Larger policies will, pro-rata, receive larger future distributions from the inherited estates i.e. that a policy worth £5,000 will receive future special distributions five times greater than an equivalent policy worth £1,000.<sup>5</sup> Therefore larger policies will most likely receive a larger share of future special distributions than smaller ones. For that reason, policy size is not considered in detail in the analysis below.

The purpose of this section is to offer guidance to policyholders based on the type of policy held and its outstanding term (or for single premium policyholders, the length of time for which they intend to hold the policy). The analysis is intended to indicate whether, for a range of policy types, the value of the average PIP offer is likely to be greater than the present value of potential special distributions forgone and, if it is not, how long a policyholder might need to wait to receive potential future special distributions of excess surplus of a value greater than or equal to their PIP offer.<sup>6</sup>

LECG emphasises that these figures are indicative only and are intended to illustrate the sensitivity of policyholders' future special distributions to the type of policy held and its outstanding term, all else being equal. Factors influencing the level of future special distributions, such as investment returns and the level of new business, are highly uncertain. Actual outcomes for individual policyholders may differ from those shown here. For reasons of consistency with other appendices, all analysis shown here has been conducted on the basis of a range of potential values for the Reattribution Estate at the assumed Effective Date of the reattribution, 1 October 2009. The data used for this analysis has been provided by Aviva, based on policies in force on the date for eligibility (21 November 2006). The data used for

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<sup>5</sup> An equivalent policy is one of the same type and outstanding term.

<sup>6</sup> All amounts of future special distributions are expressed in 1 October 2009 values, discounted back from the assumed date of declaration at the expected long-term post-tax rate of return of the funds, 6.15 per cent.

this analysis has been provided by of policyholders will be checked against end 2008 data that Aviva will be providing. If this results in any significant change to the present guidance, Aviva will enable the relevant policyholders to decide whether or not to change their vote. Updates may be found at the policyholder advocate's website in due course, <http://www.policyholderadvocate.org>.

## 5.01 Basis for analysis

The analysis concentrates on four separate types of policy, summarised in Table 5 below.

**Table 5 Summary of policy types**

	Premium type	Outstanding term
1	Regular	Up to and including 2016
2	Single	No fixed maturity date
3	Regular	Between 2017 and 2021
4	Regular	Beyond 2021

Around 80 per cent of policy groupings in the LECG model match these four types of policy. The exceptions to this rule are CULAC conventional with-profits pension policies, and CGNU or CULAC unitised with-profits pension policies. Those three groups of policies contain a mixture of single and regular premium policies. LECG has therefore been unable accurately to illustrate the special distributions forgone by policyholders in these groups. Nonetheless, as this guidance has been developed for an "average policyholder" matching the characteristics of each policyholder type, individual policies within those groups are likely to match one of the four profiles shown above.

For each of the four policy types, LECG has analysed the potential outcomes using twenty different scenarios compatible with different post-retribution outcomes. The twenty scenarios use three different assumptions in respect of the level of new business to be written by Aviva from 2011 (+5 per cent per annum., -5 per cent per annum. and -15 per cent per

annum) and five different assumptions in respect of the size of the Reattribution Estate at the Effective Date (£1,200 million, £1,570 million, £1,800 million, £2,100 million and £2,500 million), with the additional consideration of a case in which special distributions increase by 25 per cent from those under Aviva new business assumptions, across all estate levels. Guidance is offered for each policy type for all twenty scenarios.

## **5.02 Interpretation of analysis**

The policyholder advocate's guidance has been formulated to enable policyholders to first select the policy type that most closely matches their own policy, then to consider when their policy matures (if it has a known maturity date) or when they wish to surrender it. Having identified the correct policy type and the year in which they expect to leave the funds, policyholders may then consult the appropriate tables, shown below.

In Section 5.03, for an average policy of four types set out above, tables indicate whether Aviva's PIP offer exceed the cumulative present value of potential future special distributions to each policy type, absent a reattribution.<sup>7</sup> If the present value of potential special distributions is lower than the value of Aviva's PIP offer, that is, if the policyholder is never expected to break even, the policyholder would be better off accepting Aviva's offer. These guidance tables correspond to those in the "*Making your choice*" brochure distributed by the policyholder advocate. The only difference is the additional consideration of a Reattribution Estate value of £2,500 million, which as it is considered a very unlikely situation given current market performance, was not included in the brochure; it is included in this appendix for completeness.

If Aviva's PIP offer might exceed the cumulative present value of potential special distributions, the table shows the approximate date (for that scenario) at which it is likely to occur.

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<sup>7</sup> It has been assumed that distributions are allocated to policies on the basis of their asset share. Distributions are shown in the year in which they are declared, rather than the year in which they might be distributed to policyholders as claims.

### **5.03 Results of analysis for each policy type**

#### **Regular premium policy maturing or surrendered before 2016**

Based on the analysis, all policyholders with regular premium policies maturing before 2016 should accept Aviva's offer. According to Aviva, it is almost certain there will be no special distributions before the end of 2011; LECG broadly concurs with this view. The value of special distributions forgone by policies leaving the funds before 2012 is therefore likely to be equal to zero. If any special distribution is made between 2012 and 2016, it is likely to be small in comparison to the value of the PIP offered by Aviva.

Policyholders in this category will benefit from the special distribution of £2.3 billion announced by Aviva in February<sup>8</sup> and from the PIP. The PIP increases in value as the value of the inherited estate exceeds £1,200 million around the Effective Date of the reattribution. As the table below shows, policyholders in this category are unlikely to receive a value of future special distributions which exceeds the value of their PIP offer, under all scenarios considered.

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<sup>8</sup> Specifically, policyholders will benefit from all three tranches of the distribution if their policy remains in force until after 1 January 2010, two of the three tranches if their policy matures between 1 January 2009 and 31 December 2009 and by the first tranche of the distribution if their policy matures between 1 January 2008 and 31 December 2008.

**Table 6 Years in which potential special distributions may exceed PIP offers, on average, regular premium policies maturing before 31 December 2016**

Reattribution Estate / Aggregate PIP	Aviva's new business assumptions (A)	5% decline per annum (from 2011) in new business (B)	15% decline per annum (from 2011) in new business (B)	Aviva's new business assumptions, special distributions 25% higher in each year than in case A (D)
£1,200 million / £500 million	Never	Never	Never	Never
£1,570 million / £704 million	Never	Never	Never	Never
£1,800 million / £830 million	Never	Never	Never	Never
£2,100 million / £995 million	Never	Never	Never	Never
£2,500 million / £1,215 million	Never	Never	Never	Never

### Single premium policies with no maturity date

Policies in this category face a more finely balanced decision. The position of single premium policyholders differs from that of regular premium policyholders in two key respects:

- the value of their policies grows more slowly than the value of a comparable regular premium policy because no additional premiums are paid by policyholders; and
- most single premium policyholders can surrender their policy at a date of their choosing, subject to a minimum period of investment.

Together, these factors mean that for single premium policyholders whether Aviva's PIP offer is likely to exceed potential future special distributions depends primarily on the length of

time that they wish to remain invested in the funds rather than on the maturity date of their policy. Table 7 below summarises the years in which potential special distributions might be expected to exceed the PIP offer, on average.

**Table 7 Years in which potential special distributions may exceed PIP offers, on average, single premium policies**

<b>Reattribution Estate / Aggregate PIP</b>	<b>Aviva's new business assumptions (A)</b>	<b>5% decline per annum (from 2011) in new business (B)</b>	<b>15% decline per annum (from 2011) in new business (C)</b>	<b>Aviva's new business assumptions, special distributions 25% higher in each year than in case A (D)</b>
£1,200 million / £500 million	2024	2019	2018	2023
£1,570 million / £704 million	2020	2017	2017	2019
£1,800 million / £830 million	2018	2016	2016	2017
£2,100 million / £995 million	2017	2016	2015	2016
£2,500 million / £1,215 million	2016	2015	2014	2014

On average, policies in this group may receive future special distributions which exceed their PIP offer under all scenarios considered. The earliest year in which the potential distributions might exceed the PIP, assuming an estate of £1,200 million, is 2018.

However, the value of special distributions from the inherited estate is very uncertain and depends on returns from financial markets over the period that a policy is held. The value of future special distributions is also highly dependent on the decisions made by other policyholders: if more policyholders choose to remain in the fund, special distributions will be lower, and vice versa.

Therefore, policyholders in this category should note they will likely need to hold their policy at least to around the projected date shown in the table to receive the estimated value of future special distributions from the inherited estate of the Old WPSF. If there is a possibility that the policyholder wishes to surrender their policy before the break even year displayed under a given scenario in the table below, they should accept the PIP offer if they consider that scenario likely. When making their decision, policyholders should also allow for the possibility that they may incur taxation on future special distributions from the inherited estates, depending on their tax status, either at the date when the distribution is made (if the distribution is made in cash) or at the date of maturity of their policy (if the distribution is added to the value of their policy).

The policyholder advocate encourages all policyholders who face an uncertain choice, or who feel that they lack sufficient information to make an informed decision, to seek professional financial advice.

### **Regular premium policies that will mature or be surrendered between 2017 and 2021**

Policies in this category are more likely to receive a cumulative present value of special distributions that exceeds their PIP offer than regular premium policies leaving the funds before 2017. Table 8 below summarises the years in which potential special distributions might be expected to exceed the PIP offer, on average.

**Table 8 Years in which potential special distributions may exceed PIP offers, on average, regular premium policies maturing between 1 January 2017 and 31 December 2021**

Reattribution Estate / Aggregate PIP	Aviva's new business assumptions (A)	5% decline per annum (from 2011) in new business (B)	15% decline per annum (from 2011) in new business (C)	Aviva's new business assumptions, special distributions 25% higher in each year than in case A (D)
£1,200 million / £500 million	Never	Never	2019	Never
£1,570 million / £704 million	Never	2018	2017	Never
£1,800 million / £830 million	Never	2017	2016	2019
£2,100 million / £995 million	2019	2016	2016	2017
£2,500 million / £1,215 million	2017	2015	2015	2015

On average, for policyholders in this group, under some circumstances, as set out in the table above, future special distributions could be more than the offer. At an estate value of £1,200 million, it is likely that special distributions will not exceed the amount of the cash offer being made; if the sale of new policies was to fall substantially, potential distributions could be higher, but it could take until at least 2019 (with an estate of £1,200 million) for possible special distributions to equal the amount of the cash offer being made. These policies will be adding to their asset shares continuously, and therefore in the future will be receiving proportionally greater shares of any special distributions compared to single premium policyholders.

Policyholders should note that the policyholder advocate cannot predict the amount of new business that Aviva may write. If the amount of new business written by Aviva declines from

2011 onwards, then a policyholder would expect to receive more money in special distributions. Similarly, if financial markets perform better than Aviva's projected best estimate rate of 6.60 per cent per annum (pre-tax), policyholders could expect to receive more money in special distributions. There are however, many other considerations, such as tax and time to wait, in taking such a decision as to whether or not to elect for Aviva's PIP offer.

Before deciding whether to elect to accept Aviva's offer or not, policyholders in this category should bear in mind the same considerations as other policyholders who face an uncertain choice, such as single premium policyholders. In particular, they should consider the likelihood that they will hold their policy to maturity. They should also bear in mind the uncertainty surrounding the form, value and timing of any future special distributions from the inherited estate and that they may be liable for taxation on any such distributions.

The policyholder advocate encourages all policyholders who face an uncertain choice, or who feel that they lack sufficient information to make an informed decision, to seek professional financial advice.

### **Regular premium policies expected to remain in the funds beyond 2021**

Policies in this category are in a similar position to policies expected to leave the funds between 2017 and 2021, with the additional outstanding term serving to increase the scope of scenarios under which policyholders may receive potential future special distributions in excess of their PIP value. In these cases, the potential break-even periods are correspondingly long.

**Table 9 Years in which potential special distributions may exceed PIP offers, on average, regular premium policies maturing after 2021**

<b>Reattribution Estate / Aggregate PIP</b>	<b>Aviva's new business assumptions (A)</b>	<b>5% decline per annum (from 2011) in new business (B)</b>	<b>15% decline per annum (from 2011) in new business (C)</b>	<b>Aviva's new business assumptions, special distributions 25% higher in each year than in case A (D)</b>
£1,200 million / £500 million	2028	2019	2018	2025
£1,570 million / £704 million	2021	2018	2017	2020
£1,800 million / £830 million	2019	2017	2016	2018
£2,100 million / £995 million	2018	2016	2016	2017
£2,500 million / £1,215 million	2017	2016	2015	2016

On average, policies in this group are likely to receive potential future special distributions which may exceed their PIP offer under all scenarios considered. At an estate value of £1,200 million, under Aviva new business assumptions, it could take until 2028 for possible special distributions to equal the amount of the cash offer being made. Under a scenario in which possible special distributions in each year increased by 25 per cent above those estimated under Aviva new business assumptions, possible special distributions could be more than the current cash offer by around 2025 at an estate of £1,200 million. These policies will be adding to their asset shares continuously, and therefore in the future will be receiving proportionally greater shares of any special distributions compared to single premium policyholders.

Policyholders should note that the policyholder advocate cannot predict the amount of new business that Aviva may write. If the amount of new business written by Aviva declines from

2011 onwards, then a policyholder would expect to receive more money in special distributions. Similarly, if financial markets perform better than Aviva's projected best estimate rate of 6.60 per cent per annum (pre-tax), policyholders would expect to receive more money in potential future special distributions. . There are however, many other considerations, such as tax and time to wait, in taking such a decision as to whether or not to accept Aviva's PIP offer.

Before deciding whether to elect to accept Aviva's offer or not, policyholders in this category should bear in mind the same considerations as other policyholders who face an uncertain choice, such as single premium policyholders. In particular, they should consider the likelihood that they will hold their policy to maturity. They should also bear in mind the uncertainty surrounding the form, value and timing of any future special distributions from the inherited estate and that they may be liable for taxation on any such distributions.

The policyholder advocate encourages all policyholders who face an uncertain choice, or who feel that they lack sufficient information to make an informed decision, to seek professional financial advice.

The data LECG has used to make its estimates has been provided by Aviva, based on policies in force on 21 November 2006. Aviva is in the process of providing LECG with updated data as at end 2008. During the summer, the policyholder advocate will be checking her guidance to particular groups of policyholders against Aviva's updated data. If this results in any significant change to the policyholder advocate's present guidance, Aviva intends to give the relevant policyholders an opportunity to decide whether or not to change their votes.

## 6.00 Conclusions

The policyholder advocate has sought to ensure that Aviva's reattribution offer to policyholders meets four basic conditions:

- an aggregate PIP that is greater than the aggregate value of potential special distributions forgone by eligible policyholders;
- an aggregate PIP that implies a reasonable sharing of future policyholders' portion of the inherited estates between current policyholders and shareholders, and an allocation mechanism for the aggregate PIP that correlates as closely as possible to the potential special distributions forgone by individual policyholders; and
- the protection of the position of potential non-electing policyholders, such that all policyholders are offered a real choice between accepting the reattribution offer, or of having the scale and nature of their potential special distributions broadly preserved.

The policyholder advocate's assessment reflects the current regulation of the with-profits industry by the FSA, which, in her opinion, permits shareholders to use the inherited estate to fund activities that benefit shareholders outside the customary 90:10 principle of the funds. In particular, the policyholder advocate believes the FSA-permitted use of inherited estates capital to support new business (providing a free transfer of inherited estate capital between generations of policyholders), in the context of a reattribution, tilts the regulatory framework against eligible policyholders' interests. Given current regulation, however, the policyholder advocate is satisfied the offer meets each of the four conditions set out above over a wide range of potential future outcomes.(see Appendices 42, 43 and 44 for further discussion of these issues).

When formulating her guidance to groups of policyholders as to whether Aviva's offer is in their interests, the policyholder advocate has compared the PIP offer with the value of

potential special distributions which electing policyholders would forgo. In making that comparison, the policyholder advocate has considered:

- macro factors that drive potential future distributions from the inherited estates, especially the future level of investment returns and the volume of new business assumed to be written by Aviva; and
- the characteristics of the policy they hold, in particular whether it is regular premium or single premium and the maturity date or expected surrender date.

With respect to macro factors, the future level of investment returns is a key determinant of the potential value of special distributions from the inherited estates. All else being equal, higher investment returns will drive higher special distributions. Although LECG has not been able to analyse the numerical effect of varying the level of investment returns from Aviva's best estimate of 6.60 per cent pre-tax<sup>9</sup>, for the purposes of providing guidance to policyholders, LECG has considered a case in which special distributions increase by 25 per cent above those under Aviva new business assumptions.

The second key driver of the potential value of special distributions to eligible policyholders is the amount of new business assumed to be written by Aviva in future. All else being equal, a higher amount of new business reduces the value of any future special distributions to current policyholders. A higher amount of new business increases the capital requirement of the funds, so raising the threshold above which special distributions might be made and deferring any distributions further into the future, as it will take longer for investment returns to build the estates up to a level in excess of that threshold. The presence of a higher number of new policies in the funds dilutes the interest of eligible policyholders in any special distributions declared, the dilution increasing over time.

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<sup>9</sup> Obtaining the data necessary to vary the investment returns was considered prohibitively expensive and time-consuming. LECG and the policyholder advocate consider that using the best estimate average returns presents the most realistic future scenario and provides a sufficient basis for analysis.

With respect to individual considerations, policyholders may prefer the certainty provided by Aviva's offer to the uncertainty associated with potential future special distributions of excess surplus from the inherited estates. Future special distributions from the estates are uncertain in their timing, amount, form and tax treatment. Each of these uncertainties increases the risk associated with a decision to reject Aviva's offer and to wait for potential future special distributions. The policyholder advocate has evaluated Aviva's PIP offer over a wide range of potential outcomes, in determining whether the offer is likely to exceed possible future special distributions. In making their own decisions, individual policyholders can be expected to take into account their own personal circumstances.

Policyholders also need to consider the form of their policy and the length of time for which it is likely to remain in the funds. All else being equal, regular premium policies may be expected to receive a larger, and growing share of any future special distributions from the inherited estates. In addition, policies that remain in the funds for longer periods will also have a higher probability of sharing in one, or possibly more, such distributions. Aviva's allocation mechanism for the PIP takes account of these factors to some degree through the weightings applied to certain categories of policy.

On Aviva's best estimate fund returns of 6.60 per cent pre-tax (6.15 per cent after tax), a majority of policyholders are made better off by the reattribution offer under a wide range of new business assumptions. On the lowest new business assumption considered by the policyholder advocate, a 15 per cent annual decline from 2011, between 78 and 87 per cent of policyholders are offered a PIP which is in excess of their projected future special distributions. Those policies not made better off by the offer are also likely to need to wait some time before receiving a higher value of special distributions from the inherited estate. On the assumption of a 15 per cent annual decline in new business, it is likely to take at least nine years for regular or single premium policies to "break even" against the PIP offer, assuming an Reattribution Estate of £1,200 million and at least eight years for regular or single premium policies to "break even" against the PIP offer, assuming a Reattribution Estate of £1,570 million.

LECG has considered the position of four distinct types of policy under twenty different scenarios. Each scenario corresponds to a combination of one of three different new business levels and one of five different sizes of the inherited estate at 1 October 2009, with the additional consideration of a case in which special distributions increase by 25 per cent over those under Aviva's new business assumptions.

The results of that analysis for regular premium policies suggest that, on average:

- regular premium policies leaving the fund before the end of 2016 are unlikely to receive a value of future special distributions which exceeds the value of their PIP offer, under all scenarios considered;
- regular premium policies leaving the fund between 2017 and 2021 special distributions could be more than the offer under some circumstances. At an estate value of £1,200 million, it is likely that special distributions will not exceed the amount of the cash offer being made; if the sale of new policies was to fall substantially, potential distributions could be higher, but it could take until at least 2019 (with an estate of £1,200 million) for possible special distributions to equal the amount of the cash offer being made; and
- regular premium policies leaving the fund after 2021 are in a similar position, and might receive special distributions which exceed their PIP offer under all scenarios considered. At an estate value of £1,200 million, under Aviva new business assumptions, it could take until 2028 for possible special distributions to equal the amount of the cash offer being made. Under a scenario in which possible special distributions in each year increased by 25 per cent above those estimated under Aviva new business assumptions, possible special distributions could be more than the current cash offer by around 2025 at an estate of £1,200 million.

For single premium policies, which grow more slowly than regular premium policies, whether or not Aviva's PIP is likely to exceed potential future special distributions hinges on how long the policyholder is prepared to leave their policy in the fund. On average, policies in this group may receive future special distributions which exceed their PIP offer under all

scenarios considered. The earliest year in which the potential distributions might exceed the PIP, assuming an estate of £1,200 million, is 2018.

The policyholder advocate encourages all policyholders whose decision is not straight forwards, or who feel that they lack sufficient information to make an informed decision, to seek professional financial advice. It should be emphasised that estimations of potential future special distributions are necessarily uncertain, as they require assumptions about future variables, such as investment returns and new business levels, which cannot be predicted with any certainty.

The data LECG has used to make its estimates has been provided by Aviva, based on policies in force on 21 November 2006. Aviva is in the process of providing LECG with updated data as at end 2008. During the summer, the policyholder advocate will be checking her guidance to particular groups of policyholders against Aviva's updated data. If this results in any significant change to the policyholder advocate's present guidance, Aviva intends to give the relevant policyholders an opportunity to decide whether or not to change their votes.