

**IN THE HIGH COURT OF JUSTICE  
CHANCERY DIVISION  
COMPANIES COURT**

**No. 13755 OF 2009**

**IN THE MATTER OF  
CGNU LIFE ASSURANCE LIMITED**

-and-

**IN THE MATTER OF  
COMMERCIAL UNION LIFE ASSURANCE COMPANY LIMITED**

-and-

**IN THE MATTER OF  
AVIVA LIFE AND PENSIONS LIMITED  
(FORMERLY NORWICH UNION LIFE & PENSIONS LIMITED)**

-and-

**IN THE MATTER OF  
NORWICH UNION LIFE (RBS) LIMITED**

-and-

**IN THE MATTER OF THE  
FINANCIAL SERVICES AND MARKETS ACT 2000**

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**SUPPLEMENTARY NOTE ON BEHALF OF THE  
POLICYHOLDER ADVOCATE  
REGARDING FSA METHODOLOGY**

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1. This note supplements the note dated 16 September 2009 prepared on behalf of the Policyholder Advocate (*PA*) regarding shareholder value and IRR (the *IRR note*).
2. As the PA observed in the IRR note, in its fairness review, the FSA does not reveal the method it used to calculate the shareholders' IRR from the

retribution, or the IRR itself, or even the FSA's acceptable range of IRRs. This lack of transparency is regrettable given that the FSA itself has placed reliance on transparency by insurance companies to help ensure policyholders are treated fairly.

3. The PA considers that it would be helpful to policyholders if the FSA reconsidered its position in this regard, not least because of a number of apparent errors in the methodology used by the FSA to calculate the IRR of the retribution and the clawback payments, and to formulate comparators for the FSA's fairness review. The reasons why the PA believes there are errors in the FSA's methodology are set out below and in the IRR note.

#### **Methodology used in calculating the IRR of the retribution**

4. As noted in the IRR note, the PA is concerned by the FSA's reference in paragraph 79 of its second report to the "projected level of new business sales" in the context of the calculation of IRR. The PA has sought to explain her concerns in this regard in the IRR note.
5. An alternative way of understanding this concern is to bear in mind that investing profits from one project in a second project does not affect the return generated by the first project.
6. Aviva is paying a PIP in return for obtaining the reattributed estate capital. To include future new business or any other investment choices in projecting the IRR of the deal is to use an incorrect IRR calculation for an assessment of fairness. Using this incorrect IRR could make any conclusions about fairness assessment unsafe.

#### **Methodology used in calculating the clawback payments**

7. The apparent flaws in the FSA's analysis on shareholder returns appear to the PA to have been repeated at paragraph 80.4 of the FSA's second report, which addresses the calculation of clawback payments and states: "The FSA is content that such payments [i.e. the clawback] reflect the additional profit expected to be made by Aviva as a result of the closure or near closure of the funds to new business."

8. Aviva will, if anything, expect to make less money if it closes the fund to new business, since it would forgo the profits and hence added value on new business. Therefore, it is not clear why the FSA asserts the reverse.
9. New business can only be expected to be written if it adds to shareholder value having taken account of any costs of capital locked in. To do otherwise would be to destroy shareholder value, which would be contrary to the duties of directors of the company.

#### **Methodology used in formulating comparators for the fairness review**

10. The PA has a further concern about the FSA's IRR calculation in the context of a fairness review arising from paragraph 77 of the FSA's second report, which states: "The FSA would expect to object to a reattribution that provided an IRR to the shareholder that falls outside the reasonable range of returns that the firm could expect to receive from alternative uses of its capital."
11. This implies that the FSA is comparing the return on this deal with the average cost of capital to Aviva across the firm. As Professor Richard Brealey has noted, this is an incorrect comparison. The correct comparison is with the return the company gets from investing its capital in the fund itself. Returns on other investments with different risk profiles are not relevant when looking at the shareholder returns from the reattribution.
12. As Professor Brealey points out, any return above the fund rate of return is a profit to shareholders over and above what they would have expected otherwise.
13. Clearly, Aviva will invest in many projects, and many will have a higher hurdle rate than the fund rate from these funds. But that is not where this capital is currently invested. For this capital, Aviva has chosen to place the money in a portfolio of mixed investment choices, mainly in the public markets.
14. A fairness review should look at the return the company is making for its investment of the PIP in return for the capital in the reattributed estate and compare this with what the company would have earned if the capital had

been kept in the fund. In investment parlance, the calculation is a net present value calculation. The IRR calculation should be translated into the net value added to shareholders over and above what they would have expected to get from keeping the capital in the fund.

15. On the face of paragraph 77, this does not appear to be what the FSA has in practice done. This calls into question whether the FSA has in fact done its fairness review on a correct basis.

### **Conclusion**

16. On the face of it, therefore, the PA disagrees with the method used by the FSA to calculate the shareholders' IRR and clawback payments, and to formulate comparators for its fairness review.
17. However, the PA cannot assess properly the FSA's methodology in approaching these issues, given the paucity of information published by the FSA on what the PA considers to be important subjects.

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Matrix  
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JAMES AYLIFFE QC  
Wilberforce Chambers  
Lincoln's Inn

16 September 2009

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