

**The policyholder advocate's report of the High Court proceedings
and subsequent developments**

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

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Comment by Clare Spottiswoode CBE, policyholder advocate

This will be our last report to policyholders at the end of a three year process. It covers the High Court hearing and developments since our supplementary report and its purpose is to inform policyholders. Since the High Court approved the reattribution Scheme put forward by Aviva, no further action is required of policyholders.

It is important to put the Court proceedings in context. As the Judge made clear, his decision is in a sense a “binary” one. His function was either to accept or to reject the Scheme as a whole and the only ground for rejection was if a particular provision or group of provisions was “manifestly unsatisfactory and is of such fundamental importance that sanction might be withheld on that account”. He also made clear that he was deciding “this case on the law as it is” and with regulation and the COBS rules as they are.

Law and Regulation

This means that the High Court hearing was not the appropriate place to test whether the current interpretation of the law is correct. Moreover, as outlined in my supplementary report, it was by no means clear how as policyholder advocate I could in practice have brought such a “test case” and any such challenge was very unlikely to have been in the interests of the policyholders I represent.

Aviva might have withdrawn the reattribution offer if a legal challenge had been made and there is no mechanism to ensure that the offer would have remained on the table. In addition, any court support for the legal position of my QCs would virtually certainly have been referred up to higher courts, and eventually to the House of Lords. The time any legal challenge would have taken would therefore have meant that many policyholders would have left the funds before the matter was settled.

In reality therefore I did not have the option of challenging the law in this court or any other court, and it seemed clear to me that no one else would mount such a challenge. As a result my view and the legal view of my QCs, that the inherited estate should not be permitted to be used differently from the rest of the with-profits fund, has not been tested by any court.

However, in practice a more important issue has been the stance of the FSA in relation to its own rules, particularly concerning its permitted uses of inherited estates.

Despite my vigorous representations, the FSA said that it was willing to allow with-profits firms to continue to write new with-profits business on terms that involve an “intergenerational transfer” of estate capital from current to future policyholders. It also permits inherited estates to be used to meet costs that would otherwise have to be paid by shareholders, such as tax on shareholder distributions.

The fact that the FSA permits “intergenerational transfer” seems to me to be contrary to its own rules which prohibit new with-profits business from having a materially detrimental effect on existing policyholders. The material detriment arises because existing policyholders would have been significantly better off if either the fund was closed, or if new business was charged properly for the use of estate capital held to back their prospective policies.

This would not occur if, in line with normal investment practice, the with-profits fund was required by the FSA to be run so that all investments including investment in new with-profits business, were written only if those investments were beneficial to the fund. As with any other investment the cost of the capital required for the new business would be part of the calculation in assessing whether the investment was justified.

More fundamentally I consider that neither the practice of funding new with-profits business in a way that brings about an intergenerational transfer of the inherited estate, nor the COBS rules which allow estate capital to be used to cover costs which are not permitted to be charged to asset shares, would survive if the with-profits market was regulated to ensure that it was competitive. Permitting new with-profits business to be written using estate capital without charge, and allowing the estate to be used by the company for its own benefit, as permitted by the FSA, have to fail the pro-competitive test. Therefore it follows that regulation of with-profits would be quite different if it were under an economic regulator who used competitive behaviour as a guide in ensuring customers are properly protected and who would ensure that those companies without inherited estates were not at a competitive disadvantage.

As noted above, the Court did not address these regulatory challenges.

Governance

My other serious challenge was to Governance. In my witness statement I pointed out that the directors of a with-profits firm have wide discretionary powers. At the same time there is a conflict of interest between policyholders and shareholders which is inherent in the fact that the directors of a with-profits firm are in general required to pursue the interests of the firm, and therefore in practice its shareholders. In my experience as a former regulator, this means that a vital protection against the misuse of discretionary powers is that those exercising those powers are subject to regular and vigilant external scrutiny. This in turn means that a combination of transparency and regulatory oversight and enforcement is required to protect policyholders.

There is a particular problem with non-electing policyholders, since my guidance as to whether Aviva's reattribution offer is in their interests was based on what policyholders are expected to be giving up in terms of possible future special distributions from the inherited estate. These calculations are of course uncertain. But they naturally assumed a level of governance that would ensure that the conflicts of interest inherent in running a with-profits fund would not affect the level of any future special distributions to non-electing policyholders. I do not believe that current governance is sufficient to provide this assurance.

I pressed Aviva to agree to increased transparency by requiring a detailed annual report to policyholders by the With-profits Actuary and also by the With-profits Committee. Aviva's annual reports produced to comply with the current FSA COBS rules are very short and provide very little information that is useful to policyholders. I am very disappointed that Aviva would not agree to provide what I consider to be a minimal level of transparency for its policyholders as I requested.

The FSA said that it had no objection to the inclusion of additional governance measures "assuming that they are agreed with Aviva". This statement takes no account of the fact that without FSA help I could not get such improvements.

I had hoped that since the requirement for better governance could be provided by Aviva without affecting the Scheme, that the Judge would ask Aviva to improve its governance. However the Judge decided that he could not force Aviva to alter the detailed terms of its offer.

My concern is that without the assurance of the increased transparency for which I pressed, non-electing policyholders will be relying on the FSA to provide strong pro-active regulation to ensure their rights are properly protected. Policyholders cannot rely on the protection provided by the With-profits Actuary and With-profits Committee without significant FSA oversight.

I have recommended acceptance of the PIP as being in the interests of the majority of eligible policyholders under current FSA rules. This recommendation was predicated on good governance. The FSA said it is satisfied that the present governance arrangements are “capable of providing adequate security” (paragraph 101 of the FSA’s second report). Policyholders are dependent on the FSA providing that security going forward.

I also consider that, apart from my reservations concerning governance which I raised with the Court, non-electing policyholders are adequately protected by the Scheme. However, I consider that under a more robust regulatory regime, including in respect of governance, policyholders’ interests would have been better protected.

I will be making representations to the FSA in the context of its current with-profits review and to the Board for Actuarial Standards on Governance with the hope that real improvements to with-profits regulation will eventually be forthcoming.

Presentation of information

The policyholder advocate has tried to ensure that this report is as accessible as possible but, given the considerable complexity of the reattribution, some parts of the report are likely to be more readily understandable to readers who have some familiarity with the concepts involved.

A glossary of certain abbreviations used in this report can be found at Annex 3 of the policyholder advocate's June 2009 report. In addition, where technical terms are used in the report, they are generally explained in the context in which they are used.

Introduction

Aviva's proposed reattribution of the inherited estates of the CGNU Life Assurance (CGNU Life) and Commercial Union Life Assurance Company Ltd (CULAC) with-profits funds culminated in a High Court hearing which commenced on 14 September 2009. At the hearing Aviva sought approval of its Scheme for the reattribution and the associated transfer of the with-profits funds to Aviva Life and Pensions UK Ltd (AVLAP). Mr Justice Norris gave his decision on 18 September, which was to approve the Scheme, and his reasoned judgment on 16 October 2009.

In June 2009 Aviva had written to CGNU Life and CULAC policyholders who were eligible to participate in its proposed reattribution and asked them to vote on whether or not they wished to accept a policyholder incentive payment (PIP) in exchange for giving up their rights to participate in any future special distributions from the inherited estates of the funds. Voting was completed at the end of September 2009.

The policyholder advocate produced a guidance booklet, which was sent to eligible policyholders by Aviva in its voting pack, and which gave guidance to policyholders about whether, in her opinion, Aviva's reattribution proposals were in their interests. Also in June 2009, the policyholder advocate produced a report and associated appendices which commented in detail on various aspects of the reattribution. On 3 September 2009, the policyholder advocate produced a Supplementary Report which provided updated information prior to the High Court hearing. As had been foreshadowed in her June 2009 report and guidance, the Supplementary Report included a reassessment using updated end 2008 data, supplied by Aviva, of the policyholder advocate's guidance to policyholders as to whether Aviva's PIP offer was in their interests. The September revised guidance remained essentially unchanged from that given in her June 2009 guidance booklet.

This report, which principally summarises and reviews the High Court hearing and Court judgment, is the policyholder advocate's final report to policyholders. Chapter 1 is a summary of additional documents issued by the policyholder advocate and her legal advisers, just prior to and during the High Court hearing. These documents include Clare Spottiswoode's own witness statement and the submission to the Court produced by the Queen's Counsel who represented the policyholder advocate in Court as well as further brief submissions made by the policyholder advocate during the High Court hearing.

Chapter 2 summarises the High Court proceedings and the main points made during the hearing by the legal representatives of Aviva, the policyholder advocate, the Financial Services Authority (FSA) and by a number of policyholders who chose to appear in Court in person to object to Aviva's Scheme for the reattribution and fund transfer. Chapter 3 outlines Mr Justice Norris's reasoned judgment for approving Aviva's Scheme which was issued on 16 October 2009.

Developments subsequent to the High Court hearing are described in Chapter 4. This includes the review by the policyholder advocate's actuarial advisers, KPMG, of Aviva's analysis which determined the valuation of the CGNU Life and CULAC combined inherited estate for the purposes of calculating the PIP amounts which will be paid to those eligible policyholders who voted to accept the firm's reattribution offer. It also includes Aviva's statement of 1 October 2009 about completion of the reattribution offer and an explanation of the policyholder advocate's continuing communication with policyholders in response to queries raised subsequent to Aviva's implementation of the reattribution on 1 October 2009. The chapter closes with an update on the FSA's with-profits review which was foreshadowed in its response to the Treasury Committee report on inherited estates.

Chapter 1: The policyholder advocate's court submissions

Introduction

This chapter is in three sections. The first is a summary of the policyholder advocate's witness statement to the High Court, the second is a summary of the submission to the Court by counsel for the policyholder advocate and the third is a summary of various submissions made and correspondence issued during the Court proceedings.

1. The policyholder advocate's witness statement

In her witness statement, Clare Spottiswoode confirmed that she had set out her views and guidance to policyholders regarding the reattribution in her Policyholders' Guide, her June 2009 Report and in her September 2009 Supplementary Report. She explained that her witness statement was made to assist the Court further in dealing with Aviva's application for an order approving its proposed Scheme for implementing the reattribution.

Her witness statement addressed four matters: first, Ms Spottiswoode's role as policyholder advocate; second the regulatory context within which the reattribution was taken forward; third the protection of non-electing policyholders; and finally concern about a general provision in the Scheme which would allow Aviva to continue with pre-existing practices. The full text of her witness statement is set out in Attachment 1 to this report.

Role as policyholder advocate

Ms Spottiswoode pointed out that she is the first person to be appointed as a policyholder advocate in connection with a reattribution since the FSA rules which introduced the role came into force in 2005. Those rules describe the policyholder advocate's role, including negotiating with the firm on behalf of the relevant policyholders, commenting on various aspects of the reattribution and telling them, with reasons, whether the firm's reattribution proposals are in their interests. The policyholder advocate's terms of reference, which were negotiated with Aviva and approved by the FSA, envisaged a continuing role for the

policyholder advocate after she had issued her report to policyholders, including attending Court to give evidence and continuing to communicate with policyholders. It is against this background that Ms Spottiswoode raised particular points in her witness statement for the Court to consider with a view to improving the position of the policyholders she represented.

The regulatory context of negotiations

Ms Spottiswoode said that her ability to negotiate effectively on behalf of policyholders was seriously constrained by current FSA rules, which she had therefore pressed the FSA to change.

When she first took up her role, her understanding was that the with-profits fund was a 90:10 fund such that at least 90 per cent of the whole fund, including the inherited estate, was effectively “owned” by policyholders and up to 10 per cent by shareholders. Consistent with this understanding, the policyholder advocate thought the current generation of policyholders, who would be invited to give up 100 per cent of policyholders’ rights in the inherited estates, could also be expected, over the term of existing policies, to receive 100 per cent of the policyholders’ share of any future special distributions. The policyholder advocate presumed that, in line with normal investment practice, a with-profits fund was run so that all investments, including investments in new with-profits business, would be written only if those investments were beneficial to current policyholders. Therefore, as with any other investment, the cost of the capital required to support this new business would be part of the calculation in assessing whether the investment was justified.

However, during her time as policyholder advocate, Ms Spottiswoode learned that the operation and regulation of with-profits funds was quite different from her expectations in two key respects – the practice of “intergenerational transfer” and uses of the inherited estate which favoured shareholders.

Intergenerational transfer

The “intergenerational transfer” of the inherited estate from current policyholders to future policyholders derives from the fact that FSA regulation permits with-profits firms to use

inherited estate capital to support new with-profits business, provided that the capital is not eroded over time. A consequence is that “intergenerational transfer” skews the balance of power in reattribution negotiations as between the firm and the policyholder advocate in favour of the firm because it dilutes current policyholders’ rights to special distributions from the inherited estate in favour of future policyholders. This in turn makes the volume of new with-profits business critical to the evaluation of current policyholders’ interests in possible future special distributions: the higher the level of new with-profits business assumed, the lower will be current policyholders’ future special distributions from the estate. A second consequence of intergenerational transfer is therefore that new with-profits business is in general detrimental to the interests of current policyholders. They would be better off if the fund was closed to new with-profits business because they would then expect to receive, over the lifetimes of their policies, future special distributions equivalent to 90 per cent of the entire value of the inherited estate.

The policyholder advocate was able in part to address the uneven bargaining power which intergenerational transfer introduces in that, following her request for guidance, the FSA said that a firm’s reattribution offer should share, as between current policyholders and shareholders, that part of the inherited estate that without a reattribution would have been distributed to future policyholders. However, under FSA rules, in considering whether the reattribution offer was in the interests of eligible policyholders, the policyholder advocate was required to consider the offer against the value of the future special distributions from the inherited estate that current policyholders could reasonably expect in the absence of the proposed reattribution. Once the firm’s reattribution offer was greater for many eligible policyholders than they could reasonably expect to receive from future special distributions, and provided the interests of policyholders who did not choose to elect for the reattribution were protected, the policyholder advocate’s role was one of evaluating and explaining the firm’s offer to policyholders and advising them whether or not it was in their interests.

It is for this reason that the policyholder advocate formed the view that, since intergenerational transfer is permitted by the FSA, the ultimate protector of policyholders’ interests vis-a-vis those of shareholders has to be the FSA in its “fairness review” of Aviva’s

offer which it makes available to the Court. In this respect, the policyholder advocate's views are aligned with those of the House of Commons Treasury Committee which stated that "...the bargaining power of the policyholder advocate, however, is limited...because a firm undergoing a reattribution would know that most policyholders would accept any offer that provided adequate compensation for the foregone chance of benefiting from future distributions...Given this weak bargaining position...it is incumbent upon the FSA to ensure that a fair price is offered, not just an adequate price. They are two quite different things."¹

Uses of the inherited estate favouring shareholders

The second major difference between what the policyholder advocate expected and how with-profits funds are permitted by the FSA to be run is that the FSA allows a firm to use the inherited estate to pay for items, such as the payment of shareholder tax on distributions, which if there were no estate the FSA would insist the firm paid for itself. Allowing the firm to deplete the inherited estate capital for items which would not otherwise be charged to any other part of the with-profits fund is clearly detrimental to policyholders' interests in that, in the long term, this erosion of estate capital means that less money will be distributed to policyholders. Instead, such permitted uses benefit shareholders over and above their right to "up to 10 per cent" of the inherited estate. In the policyholder advocate's view, the whole of the with-profits fund, including the inherited estate, should be managed by reference to the 90:10 interests of policyholders and shareholders, and her views in this regard accord with the principles discussed by the policyholder advocate's legal advisers (set out in chapter 13 of the policyholder advocate's June 2009 report).

The policyholder advocate challenged the FSA on the COBS rules which permit the inherited estate capital to be used in ways that favour shareholders. The FSA considered this challenge but confirmed that (except for a change it announced in July 2009 about no longer permitting future mis-selling compensation costs to be paid from an inherited estate) the relevant rules will not be changed in any significant way for the foreseeable future. As a result, the

¹ House of Commons Treasury Committee, *Inherited Estates*, Twelfth Report of Session 2007-08, HC 496, 10 June 2008, page 50

policyholder advocate's negotiations with Aviva had to be conducted under the assumption that these current rules would persist for the time being. In the end, the policyholder advocate succeeded in obtaining a reattribution offer which she considers is very substantially greater than current policyholders could reasonably expect to receive by way of possible future special distributions from the CGNU Life and CULAC inherited estates under current FSA rules, and which she therefore considered to be in the interests of the majority of eligible policyholders.

Protection of non-electing policyholders

The second point the policyholder advocate raised in her witness statement relates to the position of policyholders who did not elect to accept Aviva's reattribution offer and who therefore retain their rights in the inherited estate of the Old With-Profits Sub Fund (Old WPSF) into which the policies of non-electing policyholders will be transferred. The main area of concern to the policyholder advocate was the governance of the Old WPSF. She also had concerns as to whether the Scheme sufficiently protects the interests of non-electing policyholders if in the future the FSA should change its rules and prohibit the payment of shareholders' tax from inherited estates.

Governance

The policyholder advocate considered that the wide discretion conferred on the firm by FSA rules which permit the inherited estate to pay for items which, if there were no estate, would have to be paid from shareholder funds and to provide capital support for new with-profits business meant that the firm must inevitably prefer to have estate capital to draw on. This discretion strengthens the conflict of interest between policyholders and shareholders which, in any case, is inherent in the fact that the directors of a with-profits firm are in general required to pursue the interests of that firm (and thus in practice its shareholders) rather than its policyholders. In particular, given her experience as a former regulator, this led the policyholder advocate to believe that a crucial protection against the misuse of discretionary powers is that the person exercising such powers is subject to regular external scrutiny.

In relation to non-electing policyholders, in the policyholder advocate's view a particular need for transparency arises because her guidance to policyholders as to whether Aviva's reattribution offer is in their interests is based on what policyholders are expected to be giving up in possible future special distributions from the inherited estates and Aviva made similar calculations. Whilst these calculations are inevitably subject to uncertainty, they naturally assumed a level of governance that would ensure that the acknowledged conflict of interest inherent in the running of a with-profits fund would not impact on expected special distributions.

The policyholder advocate said, therefore it appears to her, that the only protection non-electing policyholders have against the risk that the firm will not exercise its discretion as assumed in the material the policyholder had when he or she made the decision to reject the offer is "...that the manner in which the firm exercises its discretion should be subjected to a very high standard of transparency and good governance coupled with very strong levels of supervision and control by the FSA." The policyholder advocate therefore pressed Aviva, as foreshadowed in her June 2009 Report, to agree to an annual report to policyholders by the With-Profits Actuary (WPA), accompanied by one from the With-Profits Committee (WPC).

The current FSA COBS rules require the firm to produce an annual report to policyholders which addresses compliance with its Principles and Practices of Financial Management (PPFM), all significant relevant issues, including ways in which it has exercised discretion, and any competing or conflicting rights, interests or expectations of policyholders and shareholders. However, in the policyholder advocate's view, Aviva's annual reports inadequately address these issues and provide very little information that is of use to policyholders (a copy of last year's report is included in Attachment 1 of this report).

Also, since the COBS rules do not specifically cover what additional reports might be required in the event of a reattribution, it would be for the Scheme or associated documents to ensure that policyholders are adequately informed. Since there was no such provision in the Scheme which Aviva submitted to the Court for approval, the policyholder advocate considered it important that the Court consider this omission. A copy of the suggested form

of such a report is set out at Annexe 5 of the policyholder advocate's September 2009 Supplementary Report (and also forms part of Attachment 1 to this report).

The policyholder advocate noted that the WPA is already required by the FSA's COBS rules to report annually to policyholders, although at present these reports are extremely short and lacking in substance (a copy of the WPA's 2008 report is shown in Attachment 1 to this report). The policyholder advocate believes that the WPA's report, as well as detailing how the WPA has carried out his work, should evaluate policyholders' interests, balance the respective interests of policyholders and shareholders over the year, assess how the differing interests of different policyholder groups have been handled, include an analysis of the uses of the inherited estate over the year, set out the justification for those uses and analyse the size of the estate and its movement over the year. In addition, the report should provide information separately regarding the management of the Old WPSF, new with-profits business and the justification for investment decisions made. It should include a commentary on the strength of the fund, the likelihood of future special distributions and any special distribution made during the year.

The policyholder advocate considers that the WPC should then comment (among other things) on certain specific aspects of the WPA's report, namely the justification for the amount of new with-profits business sold during the year, forward-looking plans, the strength of the Old WPSF, and the likelihood of special distributions.

In addition, there are certain specific respects, significant for electing as well as non-electing policyholders, in which the policyholder advocate considers that in Aviva's Scheme before the Court the WPC's role is too limited, and where its approval should be required, as set out in paragraph 63 of the policyholder advocate's witness statement.

The policyholder advocate explained in her witness statement that Aviva did not agree to her suggestions for more extensive WPA and WPC reports. Aviva's position is that policyholders are currently entitled to the reports required by FSA rules, will continue to be entitled to these reports after the reattribution and that no additional reports are necessary for their protection, although Aviva agreed to keep the situation under review. The policyholder advocate

expressed her frustration that Aviva is so reluctant to provide what should, in her view, be an uncontroversial, indeed a minimal level of transparency for its policyholders. Her concern therefore was that, if the FSA does not provide strong and proactive regulation of decisions that may favour the shareholder interest at the expense of the Old WPSF inherited estate, those who have not accepted Aviva's reattribution offer may wish that they had decided differently.

Tax on shareholder distributions

Currently the FSA rules permit the tax payable on shareholder distributions from with-profits funds to be borne by the inherited estate. The policyholder advocate was concerned that under the Scheme as currently drafted non-electing policyholders cannot be sure that they will benefit from any future change in the FSA rules. If they do not so benefit, this could violate one of the key principles of the reattribution which is that non-electors should not expect to be worse off as a result of the Scheme being put in place. The policyholder advocate therefore considered that the Scheme should be amended to make clear that non-electors would benefit from a change in FSA rules on shareholder tax.

Open-ended provision allowing continuation of pre-existing practices

A final issue raised by the policyholder advocate, affecting both electing and non-electing policyholders, is that, as currently drafted, the Scheme includes a general provision which allows the continuation of pre-existing practices which Aviva has not yet been able to identify that could otherwise be a breach of the Scheme. In the policyholder advocate's view, the Scheme should be amended so that the scope of this provision is expressly limited to those examples of pre-existing practices which Aviva has already identified.

Annexe on recent developments

In an annexe to her witness statement, the policyholder advocate provided a brief update on three developments which were also referred to in her September 2009 Supplementary Report.

New business assumptions

For inclusion in the Supplementary Report, Aviva provided actual new business sales for the first half of 2009 which showed that overall sales have been significantly reduced following Aviva's withdrawal of its Inflation Protected Guarantee (IPG) Bond. The policyholder advocate acknowledged that neither she nor anyone else can predict future new business levels. However, she pointed out that, following the withdrawal of the IPG Bond, even if Aviva were to meet its projected sales of remaining products for the rest of 2009, increase those sales by 30 per cent in 2010 and achieve 5 per cent annual sales growth thereafter (that is, in line with Aviva's post-2010 assumption), eligible policyholders' projected special distributions would be similar to those using the policyholder advocate's -5 per cent per annum decline in new business after 2010 (that is, special distributions substantially larger than under Aviva's new business assumptions as set out in the policyholder advocate's June 2009 report). Thus experience since writing the policyholder advocate's June 2009 report shows how fast new business projections can change, and with them future expected special distributions from the inherited estate for current policyholders, the latter being an unfortunate consequence of intergenerational transfer. After the reattribution any increased special distributions due to lower new business sales than Aviva assumed during the reattribution will not accrue to electors but to shareholders and non-electors².

The value of the combined CGNU Life and CULAC inherited estate

The policyholder advocate's Supplementary Report stated that, in arriving at the value of the combined inherited estate for the purpose of calculating the PIP, the FSA had agreed with KPMG that Aviva should make a £20 million addition to take account of Aviva's 2008 and 2009 new business subsidy. The policyholder advocate said that Aviva should also take some account of the balance of £54 million adjustments to the value of the estate as advised by

² There is a "clawback mechanism" in the Scheme if Aviva's new business sales reduce very significantly. If the amount of new business written in any year from 2009 to 2013 is less than 10 per cent of Aviva's new business projection used in the negotiation on the reattribution, Aviva has agreed to transfer up to £120 million to the asset shares of policies in the New WPSF for the benefit of electing policyholders. The amount transferred depends on the calendar year in which the significant reduction occurs and the proportion of eligible policies which are elected policies. See The Policyholder Advocate's Report, June 2009, para 26.33. The policyholder advocate considers that, given the terms of the clawback, it is highly unlikely ever to be used.

KPMG. The policyholder advocate's assessment of future special distributions took this additional amount into account. However, without FSA intervention, which the policyholder advocate requested, Aviva had no reason to agree to make any adjustment to the PIP in relation to the additional £54 million, and it did not do so.

Investment in strategic assets

As referred to in her June 2009 report, one of the FSA's permitted uses of the inherited estate is to invest in strategic assets which, while expected to make an acceptable investment return, are primarily motivated by the Aviva group's strategic objectives. The policyholder advocate had hoped that Aviva would agree not to allocate strategic assets to the Old WPSF after the reattribution, but it refused to do so.

2. Submission to the Court by counsel for the policyholder advocate

A submission to the High Court by Rhodri Thompson QC and James Ayliffe QC, for the policyholder advocate, in September 2009 dealt with the following matters. The full text of the submission is set out in attachment 2 of this report.

Regulatory context

The funds at issue in the reattribution are 90:10 funds in the sense that distributions are made 90 per cent to policyholders and 10 per cent to shareholders. The inherited estates appear to have emerged from under-distributions to previous generations of policyholders (rather than from contributions by shareholders or current policyholders). Thus they are funds that, had they been distributed, would have gone 90 per cent to policyholders and 10 per cent to shareholders.

A reattribution gives shareholders a 100 per cent interest in future special distributions from an inherited estate and it carries a serious risk that, in the absence of tight regulation, the outcome will be damaging to policyholders because:

If the company can obtain access to the inherited estate at too low a value, the company has a perverse incentive to minimise projected special distributions to policyholders in the expectation that the resulting inherited estate can be obtained below market value, and

During the reattribution, the company has an incentive to under-value the size of the inherited estate and likely future special distributions from it to reduce the payment it has to make to policyholders. After the reattribution, the incentive is the reverse: to minimise the need to retain the reattributed assets to maximise the funds available to shareholders.

However, the regulatory system leaves policyholders in a very weak bargaining position in a reattribution. The company owns the assets of the fund and has wide discretion in making special distributions. It is likely to start from the position that current policyholders have no legal entitlement to such distributions, so they should be satisfied with virtually any payment for agreeing to the reattribution. Without regulatory intervention, the company may be able to obtain control, for a very low price, over a substantial financial asset, to which it has made no contribution and to which, in the absence of a reattribution, it would have only a 10 per cent contingent entitlement.

The FSA established the role of policyholder advocate to strengthen the bargaining position of policyholders. But experience in this case shows that, whether or not the company's powerful negotiating position can be constrained depends on the regulatory stance of the FSA.

The role of the policyholder advocate in practice

The policyholder advocate's role as negotiator is determined by her terms of reference and also by the FSA's regulatory rules and their practical application. In principle, policyholders have two potentially enforceable sets of legal rights – private law rights conferred in contract or equity and rights derived from the regulatory rules and practices of the FSA. The policyholder advocate tried to establish the nature and extent of such rights.

Her legal advisers considered that, although the law is not clear, a principled analysis of private law rights indicates that a with-profits company's discretion in managing its fund is substantially constrained. A company is obliged to use the assets exclusively for the purposes of the fund, to provide guaranteed benefits and maximise profits to the benefit of policyholders and shareholders in the 90:10 ratio; assets in the fund not required for that purpose should be distributed in that same ratio; and the company is obliged to exercise its discretion rationally and fairly as between different categories of potential beneficiaries of the fund, and in particular between different generations of policyholders.

Aviva's legal advisers differed from the policyholder advocate's advisers on some important elements of the legal analysis, emphasising that the assets of a with-profits fund are the property of the company and arguing that the directors of a company have wide discretion and a duty to further the interests of the company subject to compliance with contractual obligations and the regulatory system. They relied also on the approach of the judge in the only previous reattribution case (AXA) in which some parts of the judgment appeared to treat policyholders as having no legally enforceable rights under their policies.

The difference of legal opinion was not of great significance in the negotiations, partly because there is little relevant legal authority so that neither party could be compelled to accept the other's analysis, but also because the policyholder advocate's legal advisers did not consider that their analysis gave a clear answer prohibiting "intergenerational transfer" (the largest single area of factual dispute).

In practice, a more important issue has been the stance of the FSA, particularly on two issues: "intergenerational transfer", and uses of the inherited estate that would not be permitted in relation to other assets of the fund and were not clearly set out for policyholders in readily available documents.

In terms of the FSA's stance, the principal points relevant to the negotiations were as follows:

Contrary to the apparent approach of the Court in AXA, the FSA indicated that its view is that policyholders have valuable legal rights, and

Despite the policyholder advocate's vigorous representations, the FSA indicated that it is willing to allow with-profits companies a) to write new with-profits business on terms that involve an "intergenerational transfer" of the inherited estate from current to future policyholders and b) to use estate assets to meet costs that would otherwise fall to shareholders.

In partial mitigation, the FSA also said that fairness to eligible policyholders requires that a company should offer them a share of the inherited estate over and above the likely value to them of future special distributions.

Implications for the policyholder advocate's ability to negotiate on behalf of policyholders

Under the FSA's COBS rules, the policyholder advocate has three main roles: to negotiate with the firm the benefits that policyholders will receive in exchange for the rights or interests they will be asked to give up; commenting to policyholders on various aspects of the reattribution; and telling policyholders, with reasons, whether the firm's proposals are in their interests. However, given the inherently weak bargaining position of policyholders, effective performance in the first role requires strong regulatory support from the FSA. The two main "successes" in the negotiations – the substantial special distribution independent of the reattribution, and the achievement of an offer in the reattribution substantially above what would have been likely to have been distributed to eligible policyholders in its absence – were both dependent on intervention by the FSA.

Moreover, the policyholder advocate's ability to negotiate effectively has been constrained by the FSA's acceptance of two aspects of the conduct of with-profits business that she considers contrary to sound principles of economic regulation:

the writing of new with-profits business on terms that lead to the "intergenerational transfer" of the benefits of the inherited estate from one generation of policyholders to another. An effect of the reattribution is therefore to allow the company, by making a payment to current policyholders, to release itself from the obligation to make special distributions to future policyholders out of the estate, and

the use of fund capital to discharge obligations that would otherwise fall to shareholders, thus reducing the projected value of the estate.

The FSA's position is paradoxical, in the policyholder advocate's view, because:

the effect of "intergenerational transfer" is that expectations of future distributions are very sensitive to expected levels of new with-profits business. More expected new business means less expected special distributions for current policyholders, both absolutely and as a percentage of the inherited estate. Perversely, current policyholders in a fund with a substantial inherited estate would benefit from the immediate closure of the fund to new business, and

allowing uses of estate capital that would not be permitted for the remainder of the fund means that the firm can deplete capital on activities that primarily benefit shareholders (who would otherwise have only a 10 per cent interest in that capital).

Tighter regulation of the above two elements would allow the policyholder advocate to negotiate more effectively on behalf of policyholders. The shareholders would then have to pay the full value of the benefits they obtained from the reattribution and would have to meet the full cost of their own liabilities out of their own funds.

In practice, the policyholder advocate has had to tell policyholders whether the firm's proposals are in their interests on the basis of the current regulatory position. Nevertheless, she feels that the issues above have played a significant part in the negotiation process and are systemic weaknesses in the with-profits regulatory regime which are of general importance and should be brought to the attention of policyholders and the Court.

The position adopted by the policyholder advocate in her guidance

The policyholder advocate's Policyholders' Guide, updated by her Supplementary Report, deals with two specific questions:

is the current Aviva offer in the interests of the majority of policyholders? She concludes that the majority of eligible policyholders would be better off by accepting

the offer in the sense that they can expect to receive an aggregate PIP that is a) greater than possible future aggregate special distributions on a wide range of assumptions and b) more than 50 per cent of the residual value of the inherited estates which would have been distributed to future policyholders without a reattribution (using Aviva's new business assumptions),

is the position of policyholders who do not accept the offer adequately protected? The policyholder advocate concludes that Aviva's amended proposals are an appropriate approach to ensuring that potential future special distributions will be broadly maintained post-reattribution. However, she still has some reservations about whether the proposed arrangements are entirely sufficient (as discussed below).

Specific issues for the consideration of the Court

These specific issues are primarily concerned with the protection of non-electing policyholders which the policyholder advocate would like to see improved in the following respects. Governance arrangements which would ensure good governance and transparency are particularly important, given the need to manage the conflicts of interests inherent in the company's exercise of its discretionary powers. Although the FSA is satisfied with Aviva's proposed arrangements, it has no objection to those enhancements proposed by the policyholder advocate but not accepted by Aviva.

The policyholder advocate also brought to the Court's attention that in her opinion the Scheme does not ensure that non-electors would benefit if the FSA rules change in the future to prevent the company's ability to pay tax on shareholder distributions from the inherited estate. She also drew attention to the ability to invest the Old WPSF in "strategic assets" using the inherited estate, which she considers inappropriate. In addition, she has some concerns about a provision in the Scheme that allows the continuation of pre-existing practices not yet identified that would otherwise be a breach of the Scheme.

Responses to principal objections

The policyholder advocate's QCs pointed out that in chapter 8 of her Supplementary Report the policyholder advocate outlined for the Court the principal objections she had received from policyholders since publication of her Policyholders' Guide and June 2009 Report, and her responses to them.

Conclusion

The QCs summarised the policyholder advocate's position in the following three points:

1. On the "narrow question" of financial interests, the policyholder advocate is satisfied that the reattribution is in the interests of the great majority of electing policyholders and that there is sufficient protection for non-electing policyholders.
2. The policyholder advocate has some specific concerns about the Scheme, principally about the arrangements to ensure good governance and transparency to protect non-electing policyholders.
3. The FSA's regulation of with-profits is inadequate in two respects: permitting firms to transfer capital support from an inherited estate from one generation of policyholders to another, and permitting firms to use the inherited estate in ways that deplete capital to the benefit of shareholders.

The policyholder advocate's Policyholders' Guide and Reports are intended to give guidance to policyholders and also to inform the FSA and the Court in deciding on whether the company's reattribution offer is "fair" and should be allowed to proceed.

3. Submissions and correspondence during the Court proceedings

The policyholder advocate submitted two supplementary notes to the Court on September 16 about the FSA's methodology regarding shareholder value and the calculation of return to shareholders, as set out in its second report.

The first note pointed out that the FSA had disclosed neither the method it had used to calculate the internal rate of return (IRR) to shareholders on the reattribution transaction nor the specific ranges or criteria it had used to assess fairness. The policyholder advocate was concerned that the FSA might have made a serious error in calculating the IRR because of the way it had treated future new with-profits business. It appeared to have reduced the IRR to take account of possible future investment decisions, but such decisions are irrelevant since, post-reattribution, future investments will only be made if they enhance shareholder value.

In the second note, the policyholder advocate regretted the FSA's lack of transparency in its IRR calculations and suggested the FSA should reconsider. The policyholder advocate could not be sure whether it disagreed with the FSA without further information. As well as the problems mentioned in the first note, the policyholder advocate said that there might be a similar flaw in the FSA's analysis of "clawback payments" (that is, provision in the Scheme for payments into electing policyholders' funds should Aviva's new business sales be much below its assumptions). Finally, the policyholder advocate said that the FSA's choice of comparators might be incorrect: the FSA seemed to be comparing the calculated IRR with the average cost of capital to Aviva instead of with the return the firm obtains by investing its capital in the fund itself.

In addition to the two notes mentioned above, on September 17 the policyholder advocate's legal advisers wrote on her behalf to the FSA to say that she was concerned that the FSA in its report may have given the Court the misleading impression that she considered Aviva's offer the "best deal available". Her view was that a better offer might well have been available, even under existing rules, if the FSA had given her more support and put more pressure on Aviva. The FSA replied on September 18 that it did not accept that it had misrepresented her views and added "...certainly that was not our intention." The FSA went on to say that the policyholder advocate had provided two reports and a witness statement and was represented by counsel. "In the circumstances we do not believe that the Court (nor any other interested person) can be in any doubt as to her views.

Chapter 2: Summary of High Court Hearing Transcripts

1. Introduction

As explained in the policyholder advocate's June 2009 report to policyholders, before Aviva can proceed to implement the proposed reattribution Scheme it must present it for approval at the High Court. The report (chapter 1) also explains the Court's discretion is limited: it is not to produce the best possible scheme but to assess whether the Scheme presented by Aviva is fair as between different classes of affected persons.

High Court proceedings took place in the week beginning September 14 before Mr Justice Norris. The first day (September 14) was largely taken up by the presentation of Aviva's case by Martin Moore QC, though one objector to the Scheme was also heard on that day. On Day Two (September 15), Mr Moore concluded his case and much of the rest of the day was occupied by Rhodri Thompson QC who appeared for the policyholder advocate. Day Two concluded with the first part of the case presented by the Norwich Union Policyholders' Action Group (NUPAG) which objected to Aviva's Scheme. NUPAG continued its case on Day Three (September 16), followed by two individual policyholders who also had objections to Aviva's Scheme, Tom Weitzman QC for the FSA, and further statements by Mr Moore and Mr Thompson³.

On the fourth day (September 18), Mr Justice Norris gave his verdict which was to approve the Scheme. His reasons were given later, on October 16.

Inevitably, the major issues that were considered in the High Court proceedings were similar to those discussed in the policyholder advocate's two summer 2009 reports. However, as these proceedings are the culmination of the reattribution process and as there were differences of emphasis as compared with the policyholder advocate's reports, a review of the

³ The full list of appearances was: Martin Moore QC and Ceri Bryant for Aviva, Tom Weitzman QC and Robert Purves for the FSA and Rhodri Thompson QC and James Ayliffe QC for the policyholder advocate.

principal themes that arose before the High Court is set out below for the benefit of policyholders.

2. Aviva's case

Aviva's arguments before the Court, as presented by Martin Moore QC, were as follows.

The complexity of the reattribution

On Day One of the hearing, Mr Moore described the reattribution Scheme as "...one of the most complex transactions ever attempted in the life assurance industry." It is the first reattribution under 2005 FSA rules which require the appointment of a policyholder advocate to negotiate the terms and conditions of the reattribution with Aviva on behalf of the relevant with-profits policyholders.

The two Aviva offers

An agreement was reached between Aviva and the policyholder advocate at the end of July 2008, on the condition (not made public at the time) that the FTSE 100 share index remained in the range 5000-7000. After the sharp decline in asset values in the late summer and autumn of 2008 which took the FTSE 100 share index well below 5000, negotiations were resumed and a new offer was made by Aviva in February 2009, with the size of the PIP linked to the value of the inherited estates on 1 October 2009.

Mr Moore explained that the value of the inherited estates fell by about £1.2 billion during 2008 because a slight rise of £0.2 billion in the excess of assets over liabilities was more than offset by an increase of £1.4 billion in the cost of options and guarantees (calculated in accordance with FSA rules and standards laid down by the Board for Actuarial Standards). Between 2003 and 2006 the inherited estates had grown quite rapidly but, according to Mr Moore (quoting the Independent Expert), that was not because of under-payments to policyholders: it was an effect of strong investment returns which reduced the cost of options and guarantees.

The number of policyholders eligible to receive the PIP, according to Mr Moore, is 852,000. As at 21 August 2009, the turnout was about 83 per cent⁴. Of the voters, 663,000 voted yes to the reattribution offer and 24,000 voted no.

The proportion of the inherited estates accruing to policyholders, taking into account the deferred special bonus as well as the reattribution PIP, is 72 per cent on Aviva's calculations⁵.

The inherited estate and its purposes

Mr Moore discussed the policyholder advocate's guidance to policyholders and then explained the purposes of an inherited estate which, he said, is essentially working capital which increases the company's investment freedom, provides the potential for higher returns, allows the funds to grow and provides security. The existing inherited estates have arisen as the funds have been run over many years: they do not result from additional capital paid in by shareholders, nor is it likely that current policyholders have contributed. An inherited estate is owned, legally and beneficially, by the company. Policyholders have no proprietary rights in it. Nevertheless, the company must comply with its contractual arrangements with policyholders and with relevant regulations, including the FSA's principle of Treating Customers Fairly (TCF). Policyholders do not, by contract, get an interest in a with-profits fund. Their interest is in the profits that the directors decide to distribute. The advantage to policyholders of investing in a with-profits fund is that they obtain the advantages of risk-spreading and smoothing of returns in a large pool of money, and in most cases there is a guaranteed minimum return.

The PPFM

Under the present FSA regulatory regime, a company has to produce a Principles and Practices of Financial Management (PPFM) document and also a consumer-friendly version of the PPFM (CFPPFM). Mr Moore explained that the PPFM sets out various charges that can

⁴Aviva's statement of 1 October 2009 gives the turnout as 87 per cent. See chapter 4, section 2 of this report

⁵ Aviva's statement of 1 October 2009 says "about 70 per cent"

be made to the inherited estate, such as taxes associated with shareholder transfers, new business support and strategic investments. Until recently, mis-selling compensation payments had also been deductible from the inherited estate but, following representations from the policyholder advocate, the FSA has stopped that practice.

The inherited estate and “excess surplus”

Mr Moore argued that policyholders do not have any expectation, at the time they take out their policies, that the inherited estate will be distributed to them rather than applied for the purposes set out in the policyholder literature. If there is an “excess surplus” and to retain it would be a breach of TCF, present FSA regulations oblige a company to distribute it or carry out a reattribution. However, according to Mr Moore, following the special bonus from the inherited estates (announced in February 2008) there is currently no excess surplus. The “mere existence of the inherited estate” does not entitle current policyholders to believe that there should be a distribution for their benefit. In the proposed reattribution, policyholders are trading off an immediate PIP payment against the possibility of an excess surplus emerging.

In determining whether or not there is an excess surplus, two factors are critical – the firm’s “risk appetite framework” (the degree of risk it is prepared to take) and the assumptions made about future new with-profits business (because of the “strain” it imposes on the company’s finances). According to Mr Moore, a conservative approach to risk-taking is justified in present circumstances, leading to an increased capital requirement. As regards new business, Mr Moore said that the policyholder advocate had used very pessimistic assumptions (compared with Aviva’s) and still concluded that the reattribution offer is in the interests of the great majority of policyholders.

The role of the policyholder advocate and its effect on the FSA

Mr Moore said that the role of policyholder advocate had been introduced, following the AXA case, to provide a formal structure for representation of the interests of policyholders. The policyholder advocate had obtained at least two important assurances from the FSA. The first was that the FSA would consider the fairness of a reattribution to policyholders compared with their waiting for possible future 90:10 distributions (of uncertain amounts at

uncertain times). The FSA expected a value to be placed on such possible future distributions: it said therefore that the interest of a policyholder in the inherited estate was not zero. The second important statement from the FSA concerned the “intergenerational transfer” of the inherited estate from one generation of policyholders to their successors. The FSA said that it expected the reattribution negotiations to result in some sharing, between current policyholders and shareholders, of the value that would, in the absence of a reattribution, be passed on to future policyholders.

Aviva’s approach to the reattribution

Aviva chose to undertake a voluntary reattribution in the sense that policyholders could either take the PIP or await possible future special distributions from the inherited estates without their choice affecting their security or their benefit expectations. The election process naturally followed.

In calculating the appropriate PIP, Aviva considered the best approach was to assess the value the shareholder unlocked compared to the price it paid. However, the policyholder advocate was concerned that the company was in a strong position to obtain big benefits for its shareholders with only a modest outlay on their part. According to Mr Moore, the policyholder advocate therefore attempted to value what policyholders are giving up, to see whether the PIP is likely to exceed the value of potential future distributions of excess surplus. She also assessed whether the offer exceeded 50 per cent of the residual value of the future policyholders’ share of the estate (its value after allowing for costs, tax and risks). She found that Aviva’s PIP offer of £500 million passed both tests, the first by “a country mile”.

Design of the reattribution

Mr Moore went on to list the main “design features” of Aviva’s Scheme. Policyholders who elect for the reattribution payment are allocated to the New With-Profits Sub Fund (New WPSF) and those who do not so elect or fail to respond go into the Old With-Profits Sub Fund (Old WPSF). The allocation of assets to the two funds is designed to ensure that the policyholders whose policies go into the Old WPSF have the same interests in potential future distributions as they had before and there is a “safety net” of up to £100 million which both

Aviva and the policyholder advocate have concluded is sufficient to safeguard against the effects of particular voting patterns. There is also provision for an adjustment (the “effective date benefit security factor”) to avoid a difference between the two funds as regards security of more than 0.5 per cent. Finally, there is a “new business clawback” provision in case Aviva’s assumptions about future new with-profits business are unduly optimistic.

The Reattributed Inherited Estate External Support Account (RIEESA) is that part of the inherited estate that is attributed to shareholders. Its objective is to ensure that policyholders in both the New WPSF and the Old WPSF have an acceptable level of benefit security. The Scheme PPFM requires the AVLAP Board to adopt consistent principles for the management of with-profits business as between the two funds.

The purpose of the With-Profits Committee (WPC)

The existing WPC has been “beefed up”, according to Mr Moore, to ensure the firm complies with the PPFM and that conflicts of interests between policyholders and shareholders are properly addressed. It is obliged to see that with-profits policyholders are treated fairly and it can “whistle-blow” to the FSA if its advice on compliance with Aviva’s Scheme is not followed.

Capital releases

Mr Moore explained the circumstances in which capital can be released from either the Old WPSF or the RIEESA which depends on whether the “triple-A capital threshold” (the amount projected over 25 years as the minimum required to ensure the fund has sufficient assets to meet its liabilities) is exceeded over a period of time. Capital coverage is to be assessed annually for the Old WPSF to determine whether it exceeds the maximum permitted. If coverage exceeds the maximum for three consecutive periods, a distribution will in almost all circumstances be required. There is a similar process for the New WPSF to determine whether there is a capital release point, above which a release may be made. The maximum permitted coverage is 120 per cent of the threshold for the Old WPSF and the capital release point for the New WPSF or RIEESA is 110 per cent. In the first case, the distribution is “...mandatory in nearly all respects”. In the second case, capital release is voluntary.

Sources and size of the inherited estates

Mr Moore said that the Independent Expert had confirmed that it was extremely unlikely that current policyholders had contributed to the inherited estates. The size of the combined estate as at 30 May 2009 was used as the basis for its value in calculating the PIP. There were some disagreements between Aviva and KPMG (advisers to the policyholder advocate) about the appropriate size of the estate for the purpose of the reattribution. KPMG considered that levels of prudence it had assessed in Aviva's calculations should be added to the value of the estate for the purpose of calculating the PIP

Rights and interests in the inherited estate

The policyholder advocate's legal advisers had, said Mr Moore, "taken a tilt" at the "generally accepted legal position as set out by Aviva". They had constructed a "theoretical model that is perhaps detached from the reality of the way in which with-profits has developed". However, said Mr Moore, it does not matter because the policyholder advocate's legal advisers accept that their conclusions are very different from those applied in the AXA case and that they are not a "conventional view of the law in this area". They also conclude that intergenerational transfer cannot be said to be in breach of their principles. Mr Moore said that it was right to conclude the negotiations on the basis of "the position as it is accepted to be now".

Uses of the inherited estate

Mr Moore said that the financial impact of FSA permitted uses can be profound. Aviva and the policyholder advocate used different assumptions when assessing the effects of new with-profits business and capital release points on the value of potential future distributions to policyholders. Aviva and the policyholder advocate also arrived at different conclusions about the internal rate of return (IRR) to shareholders from the reattribution but the FSA has concluded that the likely IRR is within the range of reasonable returns on the transaction.

Role of the Court

According to Mr Moore, it is not the Court's function to produce the best possible Scheme. "...the details of the scheme are not a matter for the court provided the scheme as a whole is

found to be fair”. There is a hierarchy of roles. The design of the Scheme is the responsibility of the Directors. The Independent Expert’s report is the most important document in assisting the Court to decide whether to sanction the Scheme. The FSA’s view is entitled to “very great weight” and it is assisted in its task of assessing value to policyholders by the policyholder advocate. The Court does not have to consider differences in legal opinions or details such as the value of the inherited estate or the likely value of new with-profits business: the question is whether “...this particular structure has produced a fair scheme that it is appropriate to sanction, not that this is the only or even the best way to do it.”

The Independent Expert’s reports

Mr Moore reviewed the Independent Expert (IE)’s reports which, he said, endorsed the fairness of the election process, the allocation of the PIP and the eligibility criteria. The IE accepted the proposed governance arrangements as capable of protecting transferring policyholders’ interests and not reducing their security significantly. The IE also concluded that the proposed allocation between various funds is reasonable and that the capital support provisions are appropriate.

Changes as a consequence of the policyholder advocate’s Supplementary Report

Mr Moore pointed out a number of changes to the Scheme made by Aviva as a result of the policyholder advocate’s Supplementary Report – in particular, to the size of the estate and to the safety net mechanism (where the policyholder advocate had been concerned about the lapse rates that Aviva had assumed).

Proposals made by the policyholder advocate that Aviva has not accepted

Several proposals which the policyholder advocate made for improvements to Aviva’s Scheme, particularly concerning governance, were not accepted by the company for reasons which Mr Moore explained as follows. For example, the policyholder advocate suggested an annual report by the WPC to policyholders in the Old WPSF. Aviva rejected the proposal on the grounds that it would be costly and there was no evidence it would be useful. The policyholder advocate also expressed concern about the role of the With-Profits Actuary but that, said Mr Moore, is a matter for the FSA. Other proposals made by the policyholder

advocate (for example, concerning payment of shareholder tax from the Old WPSF inherited estate, the continuation of pre-existing practices as yet unidentified by Aviva that would otherwise be a breach of the Scheme and the charging of industry levies to asset shares without WPC approval) are, in Mr Moore's view, not appropriate because they concern changes to a Scheme which is accepted by the FSA to be fair.

Governance

At the beginning of Day Two of the hearing (September 15), Mr Moore made a number of comments on the policyholder advocate's proposals about governance, concluding by saying that Aviva's governance arrangements have the approval of the Independent Expert and that the FSA is not convinced that the policyholder advocate's proposals would enhance the protection of policyholders.

Which, NUPAG and other representations

Mr Moore also commented on a submission from *Which?*, saying that it had no standing to make representations to the Court. He commented at more length on the submission by the Norwich Union Policyholders' Action Group (NUPAG) (see below) which argued, in particular, that current policyholders are entitled to 90 per cent of the inherited estate, that in the case of segmented policies each segment should have a vote, and that the CGNU Life and CULAC with-profits funds are closed funds. Taking these points in turn, Mr Moore argued that the assets in question are owned legally and beneficially by the company; that both the Independent Expert and the Eligibility Panel accepted that the treatment of segmented policies was appropriate; and that the Independent Expert agreed that the funds in question are not closed.

On a complaint made by Mrs Budd (see below), who experienced a mortgage endowment shortfall, Mr Moore argued that since under the Scheme Aviva was removing the previous "affordability condition" attached to the mortgage endowment promise, policyholders such as Mrs Budd would be beneficiaries.

Why the Scheme should be approved by the Court

Mr Moore concluded that the Court should sanction the Scheme which "...gives effect to a perfectly reasonable and rational commercial objective". The Independent Expert's view is that affected policyholders will not experience any significant reduction in security of their guaranteed benefits, no group will experience a material reduction in its reasonable expectations, and the Scheme is equitable as between classes and generations of policyholders. The policyholder advocate negotiated robustly and conducted a strong challenge to aspects of the with-profits business with which she disagreed. She concluded that the PIP offer is in the interests of the great majority of policyholders. The FSA does not object to the Scheme, being satisfied that shareholders are paying fairly for the benefits they will receive from the reattribution. The level of dissent is very low: there were 127 objectors out of 3.3 million policyholders who were involved.

Mr Moore's final submission, in which he dealt further with the cases made by the policyholder advocate, NUPAG and other objectors is summarised in 6 below.

3. The policyholder advocate's submissions

On Day Two Rhodri Thompson QC presented the submissions made by the policyholder advocate. He said that the policyholder advocate was concerned not only to promote the interests of policyholders in this case but to create a good precedent for future cases.

The role of the policyholder advocate

Mr Thompson said that, according to the COBS rules, the policyholder advocate should balance the benefits to policyholders from a reattribution against the rights and interests they are asked to give up. Rights and interests are therefore inherent in the rules. The terms of reference of the policyholder advocate require that she report not only on specific matters relative to the reattribution but also on such other matters as relevant policyholders should be made aware of. She has taken seriously the latter aspect of her role which has been confirmed by the FSA since it has indicated that she can challenge any part of the operation of a with-profits fund. Mr Thompson disagreed with Mr Moore's argument that, since the Court is

constrained to either granting or refusing the company's application, the policyholder advocate is similarly bound. The policyholder advocate's witness statement shows that she has felt constrained by the regulatory regime. She has recommended acceptance of the PIP, specifically on the basis that the current regulatory regime remains in operation for the foreseeable future. But her view is that, under a more robust regime, "...policyholder interests would be larger than they currently are." Finally, on the role of the policyholder advocate, Mr Thompson said that there is an important issue of how prudence should be addressed in the negotiations. The policyholder advocate's view is that, in valuing the estate for the reattribution, excess prudence should be avoided so there is no downward pressure on the size of the inherited estate. That is a separate issue from the question of the degree of prudence the company uses in the management of its business. The policyholder advocate's approach does not involve any pressure on the company to adopt any form of imprudent management.

Rights and interests of relevant policyholders

Rights and interests arise, Mr Thompson said, from contractual equity and from regulation. He cited legal precedents in support of his case that Mr Moore had over-stated his argument that the policyholder advocate's legal advisers' analysis involved "some sort of aberration or assault on the conventional position". That analysis assumed that the whole fund, including the inherited estate, should be managed in the same way and that the whole fund "...should be managed, first of all to provide guaranteed benefits, secondly to maximise profits and therefore returns to policyholders and shareholders in their 90:10 ratios and should be distributed if those assets are not required for those basic purposes and that the distribution should take place in a fair and non-discriminatory manner".

Legal principles and the AXA case

According to Mr Thompson, Aviva placed considerable reliance on the AXA case but that case should be viewed with caution. It preceded the House of Lords guidance in the Equitable Life case, the with-profits review by the FSA and the COB and COBS rules, and it was really inconsistent with the FSA's guidance. There has been a "root-and-branch" overhaul of with-profits since AXA, shifting from the pure PRE (policyholders' reasonable expectations) approach to reliance on the principles of treating customers fairly and the need

to manage conflicts of interest. Mr Thompson said that, in addition, there was a strong case for regarding the AXA result as not fair. The policyholder advocate and Aviva have agreed to disagree on the private law position and, in practice, regulation has been agreed as decisive. The policyholder advocate has reluctantly accepted that negotiation must be conducted under the FSA's current rules but she feels strongly that policyholders should be aware of her critique of those rules and that it should be on the FSA's agenda for regulation of with-profits.

Uses of the inherited estate: new with-profits business

Four key regulatory issues were listed by Mr Thompson, of which the first is uses of the inherited estate. The first matter which concerns these uses is new with-profits business which is related to "intergenerational transfer", a term first used by the FSA. In Mr Thompson's view, Aviva's description of the intergenerational transfer problem was confusing and inaccurate. The problem is not direct subsidy to new business, nor is it the spreading of upfront costs over the lifetime of a policy. The problem arises because of a failure to charge new business for use of the inherited estate to provide a capital buffer for the fund. The failure to charge is the reason why capital is tied up by new business and transferred from generation to generation. For that reason, a large amount of the inherited estate is tied up for future distribution rather than being distributed to the current generation of policyholders. The intergenerational transfer is very large. With an estate value of £1.2 billion, expected distributions to current policyholders (on Aviva's new business assumptions) are estimated to be about £55 million so, even though the funds are 90:10, in practice the interest appears to be only about 5 per cent.

Other uses of the inherited estate

Mr Thompson listed three other uses of the estate which, in the policyholder advocate's view, should not be permitted: mis-selling compensation costs (which the FSA will not allow in future), shareholder tax and investment in "strategic assets" (that is, in equity or debt of companies in which Aviva has a strategic interest). All the assets of a fund, including any inherited estate, should be used to meet guarantees and to maximise profits. Mr Thompson said that the Consumer-Friendly version of the PPFM does not make clear, as it should, that

the inherited estate is being used for these other purposes which are for the benefit of shareholders.

Who assesses fairness?

Mr Thompson said that, though Aviva states that its February 2009 offer (which the policyholder advocate assessed and to which she responded) was conditional on its being fair to both policyholders and shareholders, it is for the FSA, not the policyholder advocate, to determine whether or not an offer is fair.

The IRR and fairness

Mr Thompson also discussed on Day Three of the hearing the use of the Internal Rate of Return (IRR) in the FSA's assessment of fairness. He said that the policyholder advocate was concerned about lack of transparency because the FSA would not reveal its method of calculating the IRR nor the results of its calculations, save that they were in the range the FSA considered fair to policyholders and shareholders. Mr Thompson said that Mr Weitzman's explanation of how the FSA had calculated the IRR confirmed the policyholder advocate's fears that the FSA's approach was mistaken because of the way it had taken into account new business: "...after the reattribution has taken place the firm will have no incentive to continue with the practice of allowing capital support to be made available to new business without charge."

Governance

The policyholder advocate is dissatisfied with the proposed governance arrangements, particularly as they relate to the Old WPSF, according to Mr Thompson. Non-electors need to be confident that they will be treated fairly, given that they have been assured in literature published by Aviva and the policyholder advocate that they will keep their rights to any future special distributions. The policyholder advocate proposes a "modest extension of transparency", in the form of annual reports to policyholders dealing with several specific topics, so that the WPC and the With-Profits Actuary are subject to some external scrutiny. In addition, Mr Thompson pointed to the danger, also identified by the FSA, that a company will apply a high risk appetite before a reattribution so as to retain capital but, after the

retribution, will lower its risk appetite and distribute the resulting excess surplus to shareholders. Other governance issues proposals made by the policyholder advocate are the need for the WPC to have to approve changes of two sorts – those favouring shareholders which are said to comply with the TCF principle and those that involve the charging of industry levies to asset shares.

Valuation of the inherited estate

Mr Thompson said that various adjustments had been made to the size of the inherited estate for the purposes of the policyholder advocate’s appraisal of Aviva’s offer. However, a sum of £54 million was in dispute and had not been taken into account by Aviva in valuing the estate for the purpose of setting the PIP, as the policyholder Advocate had requested.

Narrower issues

Three narrower issues were highlighted by Mr Thompson. One is Aviva’s unwillingness to commit not to charge shareholder tax to the Old WPSF should the FSA decide to change its rules in the future and prohibit such a charge, the second is its unwillingness to commit not to use the Old WPSF for strategic investments and the third is Aviva’s wish to preserve a right to persist in unidentified pre-existing practices. Mr Thompson said that Aviva’s unwillingness to accept the policyholder advocate’s position on these “rather trivial demands” illustrates that she is not in a “particularly strong negotiation position”.

4. Objections made by policyholders

Mrs Budd

Mrs Budd is a joint policyholder of a mortgage endowment policy who has paid premiums for over 22 years. On Day One she complained of “...poor corporate governance of the NU board, mismanagement, bad judgment and failure to discharge its legal obligations.” Aviva had “...not discharged its duties to its with-profits policyholders, specifically mortgage endowment policyholders.” The proposed Scheme primarily promotes the interests of the company and its shareholders. She asked the court to turn down the retribution and “...direct Aviva to initiate a process of fund distribution.”

NUPAG

NUPAG made a detailed submission, starting on Day Two (September 15) of the hearing and continuing into Day Three. Mr Meadowcroft and Dr Pilkington, who presented the case, made six fundamental points of objection to Aviva's Scheme.

1. The relationship between each policyholder and the company is a legally-binding contract which does not provide for a reattribution but only for a distribution of at least 90 per cent of the profits on the with-profits funds of which the inherited estates are an integral part. The company's Articles of Association, a 1995 Ministerial statement and a statement by the chief executive of the FSA all accept policyholders' 90 per cent share. Moreover, the majority of policyholder contracts predate FSA regulations and the latter should not supplant contractual rights. The proposed reattribution is not only outside the contractual relationship between the policyholder and the company, it "seeks materially and unjustifiably to alter the 90:10 proportionate allocation" as well as breaching the TCF principle.
2. The declared voting procedure and eligibility rules are being ignored by Aviva, making for a "rigged ballot". In the case of portfolio bonds, Aviva is giving each policyholder one vote even though the policy documents make clear the policyholder has more than one individual and distinct policy. This is a breach of contract by Aviva. Eligible policyholders with policies that matured since the announcement of the reattribution in November 2006 but before voting for the reattribution began do not get a vote but they suffer from the decline in the value of the inherited estates to only 24 per cent of what they were when the reattribution began.
3. Aviva's extension to the closing date for voting from August 21 to September 25 is unfair to policyholders who had already voted. The latest value of the combined inherited estate (£1.2 billion) "completely dashes policyholders' reasonable expectations", given the recent recovery in markets. Policyholders have been misled and misinformed by Aviva, encouraging them to vote in favour of a reattribution. NUPAG therefore considers that votes for the reattribution should be null and void.

4. Aviva and the policyholder advocate are misinforming policyholders to coerce them to vote yes. The offer is said to be “good value” for nearly all policyholders, but if Aviva complied with its contractual obligations it would not amass a large inherited estate and it would regularly distribute any excess in bonuses with at least 90 per cent going to policyholders.
5. The CGNU Life and CULAC with-profits funds are effectively closed funds and the reattribution seeks to avoid the distribution to which policyholders are contractually entitled. In accordance with the FSA’s rules, Aviva should have prepared a run-off plan and arranged for a distribution of the closed fund and its inherited estate.
6. Aviva’s reattribution offer is based on the use of the inherited estates to support projected new business, even though policyholders were informed this usage ceased on 1 January 2008.

The NUPAG submissions also cast doubt on the independence and thoroughness of the Independent Expert who, NUPAG says, has relied on information provided by Aviva without probing it in depth and who has been employed in another capacity by Aviva. NUPAG also questions the independence of the policyholder advocate who operates from Aviva’s premises, is funded by Aviva, has some staff seconded from Aviva and relies on Aviva’s call centre and mailing facilities. The policyholder advocate, according to NUPAG, also failed to highlight the FTSE100 share index condition attached to the July 2008 Aviva offer.

Mr Ryan

On Day Three, Mr Ryan made a number of objections, based on his reading of past Articles of Association and his product particulars, which centred on his view that policyholders would not receive their rightful share of the inherited estates under the Aviva proposals. The money should be in a closed fund rather than being reattributed.

Mr Baker

Mr Baker, who is a policyholder and a shareholder, expressed concern (also on Day Three) whether there would in the long term be enough money to meet all the guarantees Aviva has made without making inroads into the Aviva Life Pensions WPSF in which he has a large exposure via with-profits policies. He said also that he hoped that those who had voted yes to the reattribution would not regret selling their future security for “a mess of potage”.

5. The views of the FSA

The FSA’s views on Aviva’s proposals were given on Day Three of the hearing by Tom Weitzman QC who said that, after listening carefully to the various objections made, the FSA remained of the view that it should not object to the present Scheme.

The role of the FSA

The FSA’s key criteria, according to Mr Weitzman, are whether the proposed Scheme materially affects the interest of any relevant party and whether it is fair in all the circumstances. The second criterion arises from the FSA’s principle of treating customers fairly. The FSA cannot determine the terms of a Scheme. It expresses its view as to whether a proposed Scheme falls within the range of proposed Schemes that are fair and acceptable. Nor does it negotiate the terms. Instead it satisfies itself that the policyholder advocate has properly discharged her duties. The FSA is, however, willing to offer general guidance to both parties, if requested. Any guidance given must reflect its existing rules and regulatory regime.

Key issues

1. Mr Weitzman said that benefit security is the first key issue – the ability of the fund to meet policyholders’ existing benefit entitlements and their bonus expectations (capital adequacy). The FSA has concluded that the Scheme “...does not materially weaken the capital adequacy of the fund in those respects.” Another aspect of benefit security is whether there is a risk of contagion to other policyholders (the risk referred to by Mr Baker). The FSA agrees with the Independent Expert that there is no significant contagion risk in this case.

2. Choice is also a key issue for the FSA. Policyholders should have a real choice whether or not to accept the firm's offer. The FSA has concluded that policyholders have such a choice, that they have been offered appropriate advice and that the rights of non-electors are safeguarded.
3. The third key issue is fairness to policyholders and shareholders. The FSA accepts the policyholder advocate's view that the vast majority of policyholders will be better off by accepting Aviva's offer and also accepts that the policyholder advocate's advice to policyholders is fair and accurate. Fairness to shareholders is assessed by examining the internal rate of return (IRR) on the transaction which, in the FSA's view, is "within the band of reasonableness". The policyholder advocate had questioned why the FSA had not revealed what that band is and the results of its calculations of the IRR. Mr Weitzman said that the FSA might prejudice future negotiations if it revealed the band or its results. The policyholder advocate had also questioned the method used by the FSA to calculate the IRR. On that issue, Mr Weitzman said that the FSA had made its calculations by comparing the position with a reattribution with the position without a reattribution, taking into account its own estimates of likely new with-profits business.
4. Mr Weitzman said that, in making its decision about whether it should object to the proposed Scheme, the FSA had taken into account the deferred special bonus from the inherited estates of £2.3 billion which had three effects. It increased the FSA's confidence that existing policyholders have not contributed to the inherited estates; it increased its confidence that the inherited estates represent working capital rather than excess surplus (which, it might be argued, should be distributed); and it made unlikely another distribution of surplus from the inherited estates in the near future.

Criticisms of the FSA's rules

Mr Weitzman said that the FSA noted that the policyholder advocate did not ask the Court to reject the Scheme on the basis of her criticisms of the regulatory regime nor did she ask for it

to make findings as to policyholders' rights. The FSA does not accept that the criticisms are well-founded and it feels that in the present context any debate about the rules would be "sterile and academic" in the sense that the rules are not being formally challenged. However, in the FSA's review of the implementation of the current with-profits regime it will have regard to the points made by the policyholder advocate.

Policyholder objections

On the point made by NUPAG about the relevant funds being closed, Mr Weitzman said that as far as the FSA is concerned, "...the funds are not closed to new business and continue to effect new contracts of insurance." The FSA does not accept NUPAG's criticisms of the election process, which is unlike a conventional election in that the decision of one policyholder does not bind any other policyholder, and it considers that communications to policyholders were fair and not misleading. On NUPAG's argument about the clustering of policies, the FSA's view is that it is not relevant to the election process because of the nature of that process as just described. Mr Weitzman said also that if each segment of a cluster policy was given a separate minimum payment, the FSA would have to reconsider whether the apportionment between policyholders was fair and reasonable: it might be regarded as unfair to policyholders without cluster policies. In addition, Mr Weitzman said that the FSA did not agree that the Independent Expert's independence had been compromised, as suggested by NUPAG.

6. Aviva's conclusions

At the end of Day Three, Mr Moore replied to the policyholder advocate's arguments and those of the objectors, as follows.

The role of the policyholder advocate

Mr Moore said that the policyholder advocate's role was to be an advocate for Aviva policyholders, not with-profits policyholders in general.

Legal issues

According to Mr Moore, whereas the policyholder advocate's legal advisers argue for a public and a private law approach, he sees no need for a "dual key". The contract, the duties of directors and the overlay of regulation are sufficient. Moreover, Aviva, unlike the policyholder advocate, sees the AXA case as "...in point and ..right".

The policyholder advocate's proposals

Mr Moore reiterated that the Court's choice is between sanctioning and not sanctioning the Scheme rather than agreeing to changes suggested by the policyholder advocate. The reason for not accepting changes suggested by the policyholder advocate regarding shareholder tax and industry levies is not their cost: it is because Aviva does not know how any rules made by the FSA would be expressed and it might be placed at a competitive disadvantage. As regards the additional report suggested by the policyholder advocate, there is no evidence policyholders would find it useful.

Internal rate of return

Mr Moore said that the FSA had been able to see the work of both Aviva and LECG (for the policyholder advocate) in making its IRR calculations and "...it is the FSA that is in charge of assessing fairness as regards the shareholders' value in a reattribution."

The views of NUPAG and Mr Ryan

On the 90:10 profits division issue, Mr Moore said that it is clear from the customer-friendly PPFM that the amount of profit is at the discretion of the directors. Mr Ryan's historical analysis, though interesting, is "...simply beside the point" and, in trying to show the source of the inherited estates he took the wrong starting point. As regards the various points made about cluster policies, Mr Moore said that Aviva believed it had approached the issue of payment in a systematic and fair way and there are good reasons for having a minimum PIP.

EEA regulators

Mr Moore and Mr Weitzman discussed how to deal with the situation in which the relevant Portuguese regulator had not yet given consent (or said it did not object) to the Scheme, thus

preventing the FSA from issuing the necessary certificate required under the Financial Services and Markets Act 2000 that the scheme had clearance from EEA regulators.

7. The judgment

Mr Justice Norris gave his decision on September 18. He said that, having considered the evidence and the objections, “I have reached the clear view that I should sanction the main scheme”. He also said that he would give reasons for the decision in a judgment at the beginning of next term. The “Portuguese question” would be dealt with by a direction from the judge to the FSA to issue the necessary certificate.

We understand from Aviva that the transcripts are not going to be made publicly available.

Chapter 3: Review of High Court Judgment

The judge's function

In his judgment, Mr Justice Norris explained that he could not undertake some of the functions suggested by objectors to the Scheme, such as to enquire into the past conduct of business by the company, to enquire into individual cases, to direct that a distribution should be made, to tinker with the Scheme or to review the conduct of with-profits business generally. His function was "...to judge whether, in all the circumstances of the case, the Main Scheme or the Alternative Scheme⁶ is as a whole `appropriate`, that is to say promoted for a proper purpose and operating fairly as between those classes of person whose rights are affected by it." He is not required to be "...satisfied that no better scheme could be devised", nor does it require that he "...assess whether the present schemes might be improved by further negotiation." However, if a judge forms a clear view that a particular provision or group of provisions is manifestly unsatisfactory, and is of such fundamental importance that sanction might be withheld on that account, it would be right to draw it to the attention of the applicants and give the opportunity for amendment. The judge said that he had borne that possibility in mind when considering this case.

The Independent Expert

The legislation provides that the company's application must be accompanied by the report of an independent expert, approved by the FSA. Mr Dumbreck, the Independent Expert in this case, was generally satisfied with the proposals: for example, that the proposed governance arrangements were adequate, that policyholders will not experience any significant reduction in the security of their guaranteed benefits, that no policyholder group will experience a material reduction in its reasonable benefit expectations, that the schemes are equitable to all

⁶ The Main Scheme covered both the reattribution and the fund transfers. The Alternative Scheme covered only the fund transfers and would have been proposed by Aviva if the reattribution had not been approved.

classes and generations of policyholders, that the eligibility rules are consistent with Aviva's statements, that the allocation of incentive payments is fair, that the allocation of policies and liabilities between the new funds is reasonable and the allocation of long term insurance assets is fair.

Mr Justice Norris explained the place of the Independent Expert's report. Some of the Independent Expert's evidence is highly technical and the court depends on it. Other parts of it are expressions of judgment but "...informed by a depth and breadth of specialist knowledge, so that the court would not be entitled to reject the judgment of the Independent Expert unless unpersuaded by the reasoning in the expert report, or satisfied that there was some manifestly unreasonable assumption or that there were strong grounds for supposing that the opinion lacked a factual basis." Mr Justice Norris said some objectors had attacked Mr Dumbreck on the grounds that he lacked competence or integrity but said that he accepted Mr Dumbreck as trustworthy and as having acted "...fully in accord with his declarations to the Court."

The Financial Services Authority and the policyholder advocate

Mr Justice Norris said the FSA is satisfied that the Main Scheme is "...within the range of reasonable and fair schemes available to Aviva to achieve its objectives" and that the fund transfers are "...unlikely materially adversely to affect the interests of policyholders and other affected persons."

Under the FSA's COBS rules, a firm undertaking a reattribution must appoint a policyholder advocate to negotiate with the firm on behalf of relevant with-profits policyholders. The FSA has said that the policyholder advocate can challenge "...any part of the operation of the with-profits fund in the course of negotiations with the firm". These broad terms of reference encouraged the policyholder advocate to review the with-profits business generally. Mr Justice Norris said that the policyholder advocate had been afforded a special insight into the business, she had been assisted by leading groups of advisers and it is "...healthy that public debate should be informed" by the policyholder advocate's views on these wider issues, even though these views are not a "circumstance" relevant to be taken into account at the sanction

hearing. The judge explained what is material to his consideration is the nature of the report by the policyholder advocate to the FSA and to eligible policyholders, the conclusion reached on the reattribution offer and the reasons for that conclusion. He rejected claims by objectors that the policyholder advocate lacked independence and was incompetent. “She has, it seems to me, if anything gone to greater lengths than her appointment strictly required to ensure that her duties were performed in a complete and transparent way. The distillation of an extremely complex proposal contained in her Guide to Policyholders, and the comprehensiveness of her report, give me confidence that the FSA’s view (that the Main Scheme is fair) is soundly based.”

The judge commented that Mr Thompson told him that the policyholder advocate was anxious to create a good precedent and to put pressure on FSA policy. The judge considered, but dismissed the possibility that her consideration of the position of with-profits policyholders generally had distracted the policyholder advocate from her role of negotiating the terms of the reattribution offer and advising policyholders or had delayed the process. He said “...the advice she has received has been well balanced, being firmly grounded in reality yet with an element of judicious speculation about where current arguments might ultimately lead: and I am satisfied that this advice has been used to advantage in the negotiations.”

Mr Justice Norris said that the policyholder advocate had concluded that the offer she obtained substantially exceeds what current policyholders could reasonably expect by way of future special distributions from the inherited estate under the present regulatory regime. She had also concluded that she might have been able to negotiate a better deal in a redrawn regulatory landscape. However, Mr Justice Norris said that he had to decide this case on the law as it is.

Features of the Scheme

Mr Justice Norris described the main features of the Scheme and said that those which had impressed him were: it follows a distribution, it is voluntary, the payment to policyholders reflects not only “their hope of future participation but also their present negotiating position as holding the key to a redeployment of capital”, the costs are not borne by the inherited

estate, and the choice made has “...no impact upon security, benefit expectations or the prospect of future distributions for non-participants.” As regards governance, Mr Justice Norris said that the policyholder advocate had laid out for him the negotiating points on which she had failed to secure agreement with Aviva. He could not force Aviva to change the details of its offer. In any case, his view was that it is the responsibility of the Aviva board as a whole, rather than the With-Profits Committee, to see that TCF principles are applied.

The nature of with-profits

Mr Justice Norris explained some of the underlying principles of the with-profits business. A key feature is smoothing with the objective of providing stability in payouts. Current thinking is that a policyholder is treated as having a notional asset share in a fund, which is the accumulation of past premiums, plus investment return but less such costs as administration, death and other benefits and taxation. But that does not mean that a policyholder has “any actual property interest in any part of the ‘with profits’ fund”. A with-profits policyholder has a contractual right to participate (normally by at least 90 per cent) in “...distributable profits identified by the board” but has no right to require the board to make a distribution or to declare a particular level of profits. Nevertheless, the board’s discretion in such matters is not unfettered and is governed by regulation.

Inherited estates

The FSA’s rules in COBS 20 are designed to avoid the use of a firm’s discretion leading to unfair benefits to shareholders, for instance in decisions leading to the declaration of profit and distributable profit attributed to policies. Mr Justice Norris said that the cumulative effect of these decisions could lead to the build up of an inherited estate (the excess of the realistic value of a fund’s assets over the realistic value of its liabilities). But “...no prudent insurer could regard the excess over those liabilities as surplus to the requirements of the fund” because the values of assets and liabilities can change dramatically. Retention of the excess provides security for policyholder benefits and meets reasonable benefit expectations if future events are adverse.

According to Mr Justice Norris, retention of the excess has other benefits. For example it provides working capital which permits a fund to invest in riskier and potentially higher yielding assets than would otherwise be possible. In Aviva's case, its "risk appetite" is such that it tries to maintain a risk rating between AA and AAA, retaining an excess that is consistent with maintenance of that range.

The inherited estate and new business support

The fund can also grow by writing new with-profits business. "The full benefits of a policy apply from inception. So the initial capital and other costs of writing new business can be significant. The insurer will seek to recoup those costs by the premium stream received over the life of the policy. But if the initial strain can be borne by the excess (or inherited estate), then the upfront cost of the product to the policyholder can be reduced (or a higher proportion of the early premiums can be invested). This was referred to in some of the material before me as the 'intergenerational transfer': the benefits conferred upon current and prospective policyholders by the returns ultimately derived from the contributions of previous generations of policyholders". The judge noted that the FSA regards intergenerational transfer as an intrinsic part of the operation of a with-profits fund, provided the business is managed with a view to recovering the initial costs and repaying them to the inherited estate over a reasonable period. But the policyholder advocate is concerned that intergenerational transfer means that the expectations of current policyholders about future distributions are very sensitive to assumed levels of new business. "She would prefer a significant change to occur. Whilst the current generation of policyholders themselves benefited from the 'intergenerational transfer', she would prefer that they be enabled to charge future generations of policyholder for bearing the initial costs of their new business (in exactly the same way as if the initial costs were funded by a third party finance provider)." The judge said that this "...does not immediately strike me as fair, but in any event I have to assess the Main Scheme on the law as it is". Mr Justice Norris noted that there is an incentive for an insurer to produce optimistic new business forecasts to justify the maintenance of an inherited estate (to avoid identifying a surplus). He said that, in the Aviva case, new business assumptions have been vigorously debated and their effects rigorously analysed.

Another form of new business support mentioned by Mr Justice Norris was the use of the inherited estate to provide a permanent subsidy so that some products were sold as loss leaders. This had been true of both CGNU Life and CULAC in 2007. The policyholder advocate had succeeded in negotiations in having the subsidy written back into the inherited estate for the purpose of calculating the PIP and repaying the Old WPSF.

Other uses of the inherited estate

Mr Justice Norris said that, in addition to providing benefits to policyholders (security, adjustment of risk and spreading of cost over time) the inherited estate has historically been used as part of a with-profits firm's working capital to meet certain costs and hold certain assets. Until July 2009 (when the FSA's rules were changed) it was permissible to charge mis-selling compensation costs to the inherited estate. It is still permissible, and in accordance with normal market practice, to charge to the inherited estate the tax liability incurred on the transfer to shareholders of their 10 per cent entitlement to distributions. As to the assets held, in terms of "strategic assets" (equity or debt of companies in which Aviva has a strategic interest) which "... are retained for the value of their connection rather than their value as investments", the practice "...is entirely permissible under the current regulatory regime: but their allocation between particular with-profits funds will raise questions of fairness."

Excess surplus

Mr Justice Norris explained the circumstances in which an insurer may declare an "excess surplus" over and above the working capital it requires. Any such excess is "legally and beneficially an asset of the company, managed and controlled by its directors" but the directors are constrained by statute (which limits the way in which transfers can be made), by contractual obligations to policyholders and by regulation. The FSA's regulations about the treatment of excess surplus are a "working out of the TCF principle". If a board's annual review concludes that a firm has an excess surplus and that retaining it would be a breach of TCF, the board is obliged to consider making a distribution or carrying out a reattribution. Mr Justice Norris said that, in 2007, Aviva hedged some of the investment risks to which the inherited estate is exposed, thereby reducing the realistic value of the liabilities and creating

an excess surplus. A Deferred Special Bonus was paid over three years, leading to a “very large distribution of the inherited estate”.

According to Mr Justice Norris, a distribution and a reattribution are “fundamentally different processes”. To present them as alternatives, as the FSA’s COBS rules do, is “...not entirely accurate”. A distribution is a unilateral act by the insurer, applying to all with-profits policyholders, the funds are truly surplus to requirements, and the distribution is 90 per cent to policyholders and 10 per cent to shareholders. A reattribution is a bilateral act, it may affect working capital not truly surplus but which can be better employed if freed from the conditions attached to an inherited estate, and it results in a bargained-for payment to policyholders in exchange for their giving up certain expectations regarding the reattributed estate: that reattributed estate is “not necessarily immediately and freely available to shareholders, being retained as part of the working capital”.

The Aviva case

In Aviva’s case, according to Mr Justice Norris, “an estate capable of being reattributed has been identified”. It is “...working capital which is not presently available for immediate division between policyholders and shareholders, but which could be more efficiently employed if the respective expectations concerning it were adjusted by agreement.” The present generation of policyholders does not appear to have contributed to this reattribution estate which constitutes “...accumulated investment returns and excess reserves and provisions funded by past policyholders and held (in part) for the benefit of future generations of policyholder.”

Aviva has to pay to gain access to this estate. The policyholder advocate has tried to achieve a fair price, using modelling techniques to estimate the level and timing of possible future distributions and has also looked for a proportionate division of the residue of the reattributed estate. Aviva sought to offer a fair price by calculating the internal rate of return (IRR) on the transaction. “For the purpose of its negotiations Aviva adopted a rate of 8.9 % , but in a briefing to analysts it suggested a rate as high as 13.5 % . I am satisfied that this substantial discrepancy has been explained in the evidence, and that the key variable (the anticipated

level of new business) is the subject of an appropriate ‘clawback’ mechanism.” The FSA has focussed on the IRR in its fairness assessment,”...asking whether (on the FSA’s independently supported assumptions upon key questions such as levels of new business) it falls outside the reasonable range of returns that the firm could expect to receive from alternative uses of its capital. It would be plainly imprudent of the FSA to disclose what it regards as a reasonable range”. But “I accept and rely on the FSA’s opinion that the bargain struck is within the reasonable range of outcomes”.

Responses to objections

Mr Justice Norris then set out specific responses to objections he had received, based on the issues discussed in the earlier part of his judgment. These responses, which are in paragraphs 61-87 of his judgment, are given in full below.

61.... I can now address the objections. For convenience I have collated them. Though I deal with them relatively shortly they have merited careful consideration: and it is my endeavour to understand them fully and consider them fairly that has caused me to set out the present proposals and the background to the objections at the length I have.

62.“The inherited estate belongs to the policyholders and they should obtain 90% of it”. The inherited estate is part of the working capital of and belongs to the company. Policyholders have no property interest in it. They have the right to participate in any annual profits that are declared and made available for distribution: they otherwise have only the hope that during the remaining term of their policy there may be an excess surplus that might be distributed. The reattribution does not relate either to annual profit or a distributable excess surplus. The PIP is not a distribution: it is the price (financed from outside the “with profit” funds) that Aviva is willing to pay for something.

63.“The PIP should represent 90% of the profits made by the fund”. The PIP does not reflect a policyholder’s contribution to the inherited estate. It represents the price the company is willing to offer to obtain less restricted access to part of its working capital. What the policyholder is being asked to give up in return is the hope of participation in any future distribution of that working capital, uncertain as to time and amount. The price has been fixed

both by reference to the “hope” the policyholder is giving up and by reference to the greater freedom over capital that Aviva gains.

64. “It has not been conclusively proved as a matter of fact that the part of the inherited estate which is being dealt with does not result from the contribution of current policyholders”. This is not a matter of conclusive proof. The court acts on the balance of probabilities. All expert opinion is united in the view that the reattributed estate does not derive from the current generation of policyholders. There is no credible evidence of equal weight that suggests otherwise. I accept that fact as proved on the balance of probabilities. In any event the PIP is not a return of contributions: it is an externally funded price.

65. “It has not been established conclusively as a matter of law what are the precise rights of a policyholder in the inherited estate”. The decision of the PHA not to mount a test case is entirely rational. She had no funding. Her advisers recognised that the position for which they were arguing was not that currently accepted as orthodox: the outcome was therefore uncertain. The process would have been protracted. It was possible to deploy (and obtain value for) the arguments in the course of negotiation, and in the face of some of the arguments Aviva made concessions and adjusted the Main Scheme.

66. “There should be a distribution and not a reattribution”. There has already been a distribution. A distribution and a re-attribution are very different things. The fact that there can be a reattribution does not mean that there could be a distribution. The PHA has demonstrated that a further distribution is only a realistic possibility many years hence. I cannot compel the board to make a distribution. The management of the company’s capital is something entrusted by the Articles to the board: I am not entitled to substitute my commercial judgment for theirs.

67. “The re-attribution is a breach of the Articles”. The Articles limit the right of a shareholder to participate in distributions of profit. The Articles do not prohibit the company from making bilateral arrangements with individual policyholders. The reattribution is entirely voluntary. It does not involve a distribution.

68. “The reattribution is a breach of contract”. The expectations of a particular policyholder to participate in any future distribution of the inherited estate are only varied with the consent of that policyholder. It is a consensual variation. Policyholder A (an objector) has no contractual right to prevent policyholder B (an eligible policyholder who elects to take a PIP) varying his policy contract as he wishes.

69. “The Court should not sanction anything that is not a 90/10 split”. A distribution and re-attribution are different things. Just because a distribution would result in a 90/10 split it does not follow that a re-attribution must do. The PHA considers that Aviva’s offer is in the interests of the great majority of policyholders; and in fact the great majority of policyholders wish to take it up. The question is whether the court should deprive them of the opportunity.

70. “Aviva is only paying £500 million to obtain access to assets worth £1 billion and that is not fair.” The assets already belong to Aviva. Aviva is paying to obtain greater freedom to deal with them. It is paying the current generation of policyholders (to whom it is currently making a phased distribution of £2.1 billion). On the PHA’s view it is paying that generation a sum considerably greater than the value of its present expectations. It can do so because what is effectively happening is that the expectations of future generations of policyholders to participate in distributions from the reattributed estate that might be made in (say) 2018 are being acquired for nothing and divided up between the current generation of policyholders and the shareholders.

71. “CGNU and CULAC are both closed funds so that there ought to be an immediate distribution of the entire inherited estate and no question of any new business”. This objection of the Norwich Union Policyholders Action Group is founded upon a misunderstanding. The entirety of the expert evidence is to the effect that these are not closed funds: and this is also the view of the FSA. According to the independent expert in 2008 the funds wrote new business with an annual premium equivalent of £223 million.

72. “The offer should not assume that Aviva can use the inherited estate to subsidise new business”. This is a use to which the inherited estate is currently put, by meeting the initial costs of new business and recouping that out of the premium stream over the term of the

policy. The “intergenerational transfer” (from which the current generation of policyholders themselves benefited) is an intrinsic part of the “with profits” business model, and recognised by the FSA as such. The PHA is personally opposed to the practice, but nonetheless recognises that the offer is for the benefit of the vast majority of policyholders. Sanction must be granted or withheld by reference to the law as it is.

73. “The offer should not assume that the inherited estate can be used to support new business because both CGNU and CULAC said that the practice had stopped”. This objection confuses two different sorts of support. The “intergenerational transfer” continues. Writing loss-leading business (where the premium stream will not during the term of the policy recoup the initial costs borne by the fund) which is supported by a specific subsidy has rightly stopped.

74. “The offer assumes too high a level of new business in order to overstate the capital requirement (so inflating the inherited estate that has to be retained and depressing the prospect of a distribution)”. The offer has been assessed by the PHA and by the FSA by reference to their own assumptions as to the growth (or indeed the decline) in new business. The assumptions used by Aviva in the negotiations are in fact below the levels currently being achieved (though it would not be safe to predict that this will necessarily continue). “Clawback” provisions have been negotiated. The WPC exists to monitor the fair treatment of policyholders as regards inter alia the inherited estate. The FSA has an ongoing supervisory role to see that there is proper compliance with COBS 20.2.21.

75. “The offer should not assume that the inherited estate can be used to pay mis-selling costs”. At a time when the offer was formulated such use was permissible and normal market practice. That is no longer the case, but the change is prospective and not retrospective. The offer is now on the basis that mis-selling costs from activities or events after the 31 July 2009 will not be charged to the inherited estate, but there is no reimbursement in respect of pre- 31 July 2009 costs. That arrangement cannot itself be described as unfair or improper so as to justify withholding sanction; and it is not my role to tinker with individual terms of the offer.

76. “The offer should not assume that Aviva can use the inherited estate to pay shareholder tax”. This is a use to which the inherited estate is currently put. It is permitted by the FSA. An

offer cannot be described as “unfair” because it is based on the continuation of a current lawful practice: nor could sanction be withheld in those circumstances. In any event this relates to one assumption in an extremely complex calculation. It is not my function to tinker with the offer.

77. “The offer should not proceed on the footing that the inherited estate can be used to house strategic assets, because that is to use the inherited estate for shareholders’ purposes and not for policyholders’ purposes”. The offer reflects current practice. The FSA has taken the practice into account in deciding whether the present proposals are fair. The scheme contains detailed provisions as to the allocation of assets to the Old WPSF and the New WPSF so as to replicate the present position. Both the WPC and the FSA have continuing monitoring roles. The proposed arrangement cannot be described as improper or unfair so as to justify withholding sanction. It is not my role to tinker with the terms of the offer.

78. “The inherited estate increased between 2003 and 2006 but has sharply reduced since the original offer was made. This must be due to under payment of bonuses to current policyholders between 2003 and 2006 followed by a transfer of value to shareholders, or mismanagement”. The inherited estate does not exist as a cake available to be sliced up in portions to policyholders and shareholders. It is the constantly varying difference between two assessed values. Movements in market prices affect both sets of values. A fall in the value of assets or a drop in interest rates can reduce the value of the fund and at the same time increase the costs of guaranteed benefits. Likewise a rise in the value of assets or in interest rates can increase the value of the fund and reduce the cost of providing guaranteed benefits. The view of the independent expert is that market movements entirely account for variations in the size of the inherited estate, and do not indicate improper treatment of net investment returns or transfers of value to shareholders. This is also the view of the PHA.

79. The objection of NUPAG is based on performance of the FTSE 100 (they say that a fall of 4.17% between 31 December 2008 and 30 June 2009 cannot translate into a 20% fall in the value of the inherited estate over the same period, which they say has occurred). The FTSE 100 is a poor proxy for the asset mix in a “with profits” fund. Moreover, concentrating on the

value of the fund overlooks the fact that the inherited estate is the difference between two values (the other being the cost of meeting the liabilities)..

80. “Present market conditions are adverse. The court should refuse sanction and require Aviva to make an offer at a more favourable time”. I have no power to direct the board to make a new reattribution offer. My function is to decide whether to sanction the offer which the board has chosen to make as “appropriate”. The factual basis for saying that things will be better in the near or medium term is not made out.

81. “It is unfair to make the payment only to current policyholders when past policyholders must have contributed in some way: the offer should be backdated”. The PIP does not represent a repayment of contributions made to the inherited estate. It represents the price that Aviva is willing to pay to acquire the future expectations of current policyholders. Someone whose policy has already matured (with its accrued annual and terminal bonuses) has no expectation of any future distribution: Aviva does not have to acquire their “expectations” and is consequently not offering to make a payment.

82. “There cannot be a distributable surplus when annual bonuses are small”. The reattribution does not involve the identification of a distributable surplus. It involves the identification of working capital which needs to be retained for the time being but which can be more effectively used. Annual bonuses are small principally because in the period 2000 to 2003 and in 2008 investment returns were low, the projected investment returns continue to be low, and the costs of providing guaranteed benefits are high. The inherited estate is used for the purposes of “smoothing”, that it is levelling out the total investment returns over the life of the policy. It is not used for the purpose of enhancing the total investment returns so that they exceed the actual returns over the life of the policy in order to accord more with the expectations that existed at the inception of the policy. Redeployment of working capital and the declaration of annual bonuses involve different considerations: and they are the responsibility of the board.

83. “There cannot be a distributable surplus when mortgage endowment policies are in shortfall”. The previous answer applies. Mortgage endowment policies are not producing their

hoped-for values because of depressed investment returns (both in the past and in the foreseeable future) and an increase in the cost of providing the guaranteed minimum benefits. But in addition Aviva has made a “mortgage endowment promise” to enhance returns in respect of “with profit” policies connected with endowment mortgages. When it was made this promise was subject to an “affordability condition”: but it is part of the Main Scheme that this condition should be waived. This group of policyholders is therefore already favourably treated: the PHA detected resistance from the general body of policyholders to further favourable treatment for this particular class. She did not seek to negotiate further special terms. It is not my function to do so.

84. “It is unfair to expect policyholders to consider an offer when so many legal factual and regulatory issues relating to the inherited estate have not been conclusively determined.” This is a variation of the objection concerning legal interests in the inherited estate. It is perfectly possible to conduct negotiations by reference to potential arguments and their respective strengths: and the PHA has approached her task by testing the offer against various scenarios which allow for realistic changes to the FSA rules. Even on that approach her view is that it was not in the general interests of the policyholders to refuse to consider any offer in the hope (a) that the FSA decided to change its rules and (b) that Aviva then decided to make a further and better offer. That is entirely rational.

85. “It is unfair to larger policyholders to offer a minimum PIP” and “ It is unfair to the holders of cluster policies not to give a minimum PIP for each individual policy”. Views may legitimately differ about the existence and size of any minimum PIP: holders of single policy investment products and holders of cluster policy investment products might well differ in their view as to what is the “fair” treatment of the investment product they purchased. (In fact fewer than a dozen of the 300,000 policyholders to whom the “cluster policy” point was open chose to pursue it). The present arrangements cannot be described as obviously unfair: and in any event they are the only ones that Aviva is prepared to offer and the PHA to recommend. No policyholder is obliged to accept them: and the choice whether to accept or reject them is perfectly clear cut. If the holder of a large policy considers that the existence of a minimum PIP has reduced the price offered for the surrender of his spes below an

acceptable level he will not accept the offer. If the holder of a cluster policy does not consider that a PIP which treats it as a single investment policy does not offer him enough he will not accept the offer.

86“The behaviour of Aviva and of the PHA has coerced policyholders and produced a rigged ballot”. It is important at the outset to understand the true nature of the “election” that has occurred. Each policyholder is involved in an “election” in that each policyholder has to choose (or “elect”) between alternative courses: no policyholder is involved in an “election” in the sense that they are voting for a result that will be binding on other people (so how many “votes” a cluster policy carries is not an issue). Save in one respect numbers are irrelevant. There has to be a sufficient number of policyholders who elect to take the PIP to release a worthwhile amount of working capital and to produce a New WPSF that is cost-effective and workable. But once that threshold is passed numbers are irrelevant. I would have sanctioned this scheme even if those electing to take the PIP had not been a majority, because I would have seen no proper ground to deprive electing policyholders of a choice they wished to make. Participation is voluntary. The interests of non-participants are entirely protected.

87. But in any event I consider the accusations of coercion or of misinformation to be unfounded. There is simply no evidential basis for characterising the vast numbers of policyholders who have elected to take the PIP as ignorant dupes who do not know what is good for them and are incapable of exercising free choice. I consider that the likelihood is that they are ordinary intelligent investors who, with the benefit of an explanation of what is undoubtedly a complex proposal, understand the nature of the choice which faces them (if not the intricacies of what lies behind it) and are able to judge for themselves where their individual best interests lie. They judge that a bird in the hand is worth two in the bush: and they accept the advice of those far more highly qualified than themselves that the bird is sufficiently plump to be attractive. It cannot be said that such advice was wrong. It seems to me that Aviva and the PHA have gone to enormous lengths to put relevant information in a comprehensible form to the policyholders who have to make the choice. To extend the deadlines within which the choice has to be made does not compel anyone to choose one way or the other: it simply affords an opportunity.

The decision

Mr Justice Norris concluded that “...I reached the clear view that this was a scheme that I could properly sanction; and I saw no reason to deprive the many policyholders who had elected to take the PIP of the opportunity so to do.”

On the outstanding matter relating to the Portuguese regulator (chapter 2, section 7 above), Mr Justice Norris said that he judged that “...the conditions for the issue of the certificate had been satisfied” and that it ought to be issued.

The full text of the judgment is available on the policyholder advocate’s website and at <http://www.bailii.org/ew/cases/EWHC/Ch/2009/2521.rtf>

Chapter 4: Subsequent Developments

1. KPMG's review of Aviva's valuation of the Reattribution Estate

The policyholder incentive payments (PIPs) made to policyholders who elected to accept Aviva's reattribution offer will equal the initial minimum amounts offered in the policyholders' offer letters (which were based on a face value of the combined inherited estate of £1.2 billion) multiplied by a uniform uplift which reflects the extent to which the average of the combined inherited estates of the CGNU Life and CULAC with-profits funds on 30 June 2009, 31 July 2009 and 28 August 2009 exceeds £1.2 billion. The unweighted average of these three values, increased to allow for two months of interest using the two month LIBOR rate applying on 31 July 2009, will be used by Aviva to value the estates for the purposes of calculating the PIP (the Reattribution Estate).

In Annexe 1B of the policyholder advocate's Supplementary Report, KPMG noted that the provisional values of the combined inherited estate at 30 June 2009 and 31 July 2009 were £1,174 million and £1,257 million respectively. At the date of writing the Supplementary Report, Aviva was not able to finalise its review of these provisional results, and it was noted that the results above may be different from those which are actually used in the calculation of the value of the Reattribution Estate. The provisional 28 August 2009 value was made available by Aviva during the High Court hearing and was stated to be £1,342 million.

At the time of writing the policyholder advocate's Supplementary Report, the policyholder advocate's view was that Aviva should make an additional positive adjustment of £74 million once the value of the inherited estates used to determine the PIP using the methodology set out above had been established. The £74 million was the sum of £20 million for the 2008/09 new business subsidy which has made policyholders who choose to elect worse off as a direct consequence of the sale of new business in those years, and £54 million in respect of the prudence identified by KPMG in its analysis of the inherited estates which had not been taken into account by Aviva. Aviva agreed, at the request of the policyholder advocate and the FSA, to an addition of £20 million but not to the further £54 million adjustment which the policyholder advocate had also requested.

Following on from Aviva's review of its provisional results, Aviva proposed a number of adjustments to the provisional valuations of the combined inherited estate, as set out in the table below:

Table 1 Aviva's final valuation of the Reattribution Estate (£ million)

	30 June 2009	31 July 2009	28 August 2009
Initial Estate Estimate (based on May roll-forward)	1,174	1,257	1,342
Adjustments for final review of figures	(46)	(41)	(41)
Adjustment for NB subsidy	20	20	20
Adjusted estate	1,148	1,236	1,321
		Average	1,235

Aviva's final review adjustments shown above are a consequence of items such as the quantification of known underestimates of the cost of meeting policyholders' guarantee payments and correction of errors.

The FSA asked KPMG to confirm whether or not overall there had been an increase in the level of prudence used in Aviva's May 2009 Realistic Balance Sheet valuation of the combined inherited estate as compared to the 2008 year end. Working from table 1.2 in the policyholder advocate's Supplementary Report annexe 1B, KPMG considered each item of prudence in turn to determine whether there has been an increase or decrease in the level of prudence. At the year end 2008 there were some items identified but not quantified, due either to the fact they were considered immaterial or because no quantification was available. Aviva provided figures for these items, and it is correct to consider these in order to compare the final 2008 year end valuation with the May 2009 valuation. The table below shows the impact of changes in areas of prudence highlighted in the KPMG report over the period from end 2008 to end May 2009, allowing for the items previously unquantified.

Table 2 KPMG's review of Aviva's end 2008 and end May 2009 RBS valuations (£mln)

Item	31 December 2008	31 May 2009	increase in prudence
Adjust mortgage endowment mis-selling reserve.	10	5	-2.5*
Add back contingency prudence	33	29	-4
Adjust "other compensation" liabilities onto a market consistent embedded value (MCEV) basis	4	8	+4
Adjust non-profit annuity value of in-force (VIF) - (as a result of Aviva's review of the results)			+30
Adjust persistency assumptions to MCEV on insurance bonds	6 (estimate at YE was wrong at 12)	6	0
Adjust persistency assumptions on endowments	8	0	-8
Prudence in projected equity backing ratio (EBR)	5	5	0
Adjust persistency assumptions to MCEV on CULAC conventional pensions with guaranteed annuity options (GAOs).	10	10	0
Adjust GAO take-up and mortality to MCEV	10	10	0
Sub total			£19.5

*note that the reserves for mis-selling reduced due both to a reduction in the level of prudence, and as a general reduction in the reserves on which the estimate is based. KPMG has assumed that 2.5 of the 5 reduction is due to a reduction in the prudence levels.

The above does not take account of the impact of the increase in the liquidity premium which Aviva has used (1 per cent to 1 ¼ per cent) for the non-profits value of the in force business. We understand that the positive impact of this on the inherited estates would be higher than the £19.5million increase in prudence identified in the table above. Therefore KPMG can

confirm that, on balance, the level of prudence in the RBS to May 2009 has not increased from 31 December 2008.

Notwithstanding the above conclusion, KPMG did not agree with all of Aviva's post review adjustments. The areas which KPMG considered inappropriate for including in the valuation of the combined inherited estate used to calculate the PIP were -£23million for changing the discount rate for the non-profit value of in force business, and -£7million for allowing for the cost of tax and expenses payable on the investment income generated by the capital required to be held for the non-profits business in the realistic balance sheet, which totalled £30million and are shown in the last column of the above table. Aviva said that both changes were driven by the fact that the original approach was not in strict compliance with the FSA rules. However, this update to Aviva's methodology effectively makes changes at the mid year which under normal circumstances would not be made mid year. KPMG would expect such changes to be made at the year end.

KPMG notes also the important fact that the non-profit value of in force business before these changes was broadly equal to the MCEV figure and as such was on a fully realistic basis and appropriate for a transaction such as the reattribution. It is KPMG's view that valuing the non-profit value of in force business on the pre-adjusted method was appropriate, particularly since the value placed on the estates for the purposes of the reattribution should not be constrained by FSA rules.

KPMG's conclusion was therefore that, although there had been no overall increase in prudence over the half year, it still did not agree with £30million of the proposed adjustments which served to reduce the combined inherited estate.

This £30million remained an area of disagreement between KPMG and Aviva and it was agreed that a compromise would be to split the difference, reducing the £30 million to £15 million. The table below shows the final value of the combined inherited estate, using the compromise figure of £15 million in calculating the final review adjustments which will be used to determine the PIP.

Table 3 Final value of the combined inherited estate (£ million)

	30 June 2009	31 July 2009	28 August 2009
Initial Estate Estimate (based on May roll-forward)	1,174	1,257	1,342
Adjustments for final review of figures	(31)	(26)	(26)
Adjustment for NB subsidy agreed with FSA	20	20	20
Adjusted estate	1,163	1,251	1,336
		Average	1,250
Reattribution Estate Value (including interest)			1,251

The subsequent reattribution payments are around 7 per cent higher than shown in the offer letter, and this increase reflects both the fact that the Reattribution Estate Value is higher than £1,200 million and the fact that some policyholders have left the fund in the meantime and the total PIP offered is spread amongst fewer policyholders.

2. Aviva's statement about completion of the reattribution

On 1 October 2009, Aviva issued a statement that confirmed that it had completed the reattribution of the inherited estates of its CGNU Life and CULAC with-profits funds. The total value of the combined inherited estate for the reattribution is £1.25 billion.

According to Aviva,

87 per cent of eligible policyholders voted in the election, of which 96 per cent chose to accept the offer.

90 per cent of payments to eligible policyholders will be between £214 and £1230.

Customers will start to receive their payments by early November and most will receive them by the end of the year.

These payments are in addition to the special bonus of £2.1 billion allocated to policyholders at the beginning of 2008 and being paid in three instalments (the first two of which have already been paid).

All policyholders will continue to receive their normal bonuses and the reattribution will have no impact on the security or performance of their investment.

The special bonus and the reattribution will in total have allocated the equivalent of about 70 per cent of the value of the inherited estates to customers.

The reattribution will bring significant financial benefits to shareholders. In return for a payment of £470 billion to electing policyholders, shareholders are expected to gain access to around £650 million of additional capital over five years.

3. Communications with policyholders after the High Court approval of the Aviva plc reattribution and fund transfer.

Overview

On conclusion of the High Court hearing the policyholder advocate's main role was complete, but she retained a responsibility to policyholders in the early phases of Aviva's reattribution payments programme. Policyholders continued to make use of the call centre facilities and to correspond by letter and email about various payment issues. Aviva agreed that it was important to continue to provide a policyholder advocate service, albeit on a much reduced scale, until 31 December 2009. The arrangements put in place to cover this period are set out below.

Call-centre operations

During the negotiations and the election phase of the reattribution, the Office of the Policyholder Advocate operated a call centre capability from Chennai, India. After the High Court hearing, as anticipated, calls reduced in volume and the call centre capability was relocated to the Office of the Policyholder Advocate's correspondence centre in Norwich on 30 September 2009. Members of staff in Norwich, who have been seconded to the Office by Aviva from the beginning of the reattribution, were retrained in call centre techniques. Facilities were put in place to permit the recording of calls with policyholders and to continue to collect management information. The call centre facility will continue until 31 December 2009.

Correspondence Office

The correspondence office will also remain available to deal with policyholder inquiries until 31 December 2009, with one exception, which is that if a case remains "live" after that date, the office will continue to deal with it. If any correspondence (or matters referred through calls or emails) are unresolved by the end of January 2010 they will be passed to Aviva to conclude. Staffing of the correspondence office is being reduced progressively.

The policyholder advocate website

The website is being kept up to date by including this report as well as the written judgement of the High Court case from Mr Justice Norris. Policyholders registered for updates receive notifications of new material posted in the site. The introductory page and other relevant sections have been edited to ensure that readers will appreciate the context within which the site should be viewed, that is, that the reattribution and fund transfer have been sanctioned by the High Court. It is intended that the website will remain "live" until the end of 2010, although the email contact facility will be disabled at the end of December 2009.

Thereafter Aviva has agreed to host the site as an archive and inquiries are being made of the National Archives to establish whether it would also host the site due to its research interest.

Record keeping

The Office of the Policyholder Advocate is required to maintain records of policyholder correspondence (including emails) and telephone calls for a period of six years. These materials will be held in secure storage and will be accessed only if required by courts or another authority. As the Office of the Policyholder Advocate will no longer exist, authority to access the material will be devolved to Freshfields Bruckhaus Derringer, currently legal advisers to the office. At the end of 2016, provided there is no requirement to retain any of the material, it will be destroyed securely. Freshfields will confirm the position with Aviva before giving the authorisation to destroy the material.

4. The FSA's With-Profits Review

The FSA's response to the Treasury Committee's Report on Inherited Estates

The Treasury Committee published its Twelfth Report of Session 2007-08, *Inherited Estates*, on 19 June 2008. The FSA's response to this Report was received by the Committee on 6 October 2008 and published on 27 October 2008.

In its response, the FSA welcomed the Committee's report into inherited estates, responded to the Committee's detailed points and set out the work which the FSA is planning or already undertaking to review aspects of the with-profits regime. The FSA said that where future work is planned it will keep the Committee informed about developments.

The FSA said that it recognises that the supervision of the with-profits regime generally, including in relation to inherited estates, remains an area of significant interest for a wide range of stakeholders and said it remains high on the FSA's agenda. Although new with-

profits business has significantly reduced, the FSA said that as at end 2007 some 31 million with-profits policies were still held by consumers, supported by £400 billion of assets, and the FSA continued to believe that with-profits products are a useful part of the savings market.

The FSA went on to explain that it embarked on a major reform of the regime for the regulation of with-profits in 2001-02. At the time, the FSA recognised that the management of with-profits funds was too opaque and allowed firms too much discretion. The FSA stated that it introduced the current regime to increase the transparency of the operation of the funds and introduced new limits on management's discretion to deliver protection for holders of with-profits policies on a day-to-day basis across all the firms in the sector.

According to the FSA, it regards the current regime as a great improvement on what went before but, as with all FSA regulation, it does seek to provide clarification and further guidance as necessary.

Whilst noting the Committee's detailed recommendations, the FSA's response to the Committee's report had two key elements. First, the FSA set out in its response the lessons it had learned about the process of reattribution, including from its experience during the ongoing Aviva reattribution and how it believed these will lead to process improvements in the future. Second, the FSA explained in its response that three years into its new regime it planned to conduct a review of how senior managements of with-profits firms have implemented the FSA's new regulatory framework. The FSA said that it will therefore be conducting a comprehensive review, with the aim of publishing the results of this review by the end of 2009. The FSA said that the review would enable it to focus its supervisory attention on areas of concern and consider whether aspects of the rules need amendment or clarification.

FSA comments at the High Court hearing

On Day Three of the High Court hearing, Mr Tom Weitzman QC, together with Dr Purves, appeared for the FSA. During the course of his address, Mr Weitzman said that various parties had referred in their submissions to the FSA's regulatory regime and made criticisms of it. He said the FSA agrees that the regulatory regime and its rules necessarily form part of the context in which the present reattribution falls to be negotiated and the terms of that reattribution are judged by the Court.

Mr Weitzman also noted that formally no party had sought to challenge the validity of the FSA's regulatory regime and pointed out that Mr Thompson had explained to the Court that the policyholder advocate's reasons for describing in her witness statement some of her criticisms of that regime included ensuring that those criticisms would not be ignored in any review of the regime the FSA might carry out in future. Mr Weitzman also pointed out that Mr Thompson, for the policyholder advocate, had discouraged the judge from making any comment which might undermine those criticisms and in some way foreclose the scope of any future review. Against that background, Mr Weitzman said that the stance of the FSA, as foreshadowed in its Report and supplemental skeleton, is that it would be inappropriate at the present hearing to debate the correctness of the present rules. He reaffirmed that those are the rules in force by which the parties and the Court are bound and no party seeks formally to challenge the rules or have them set aside. For the avoidance of doubt, Mr Weitzman made clear that the FSA does not accept that the criticisms made of its rules are well founded, the rules themselves being the result of a consultation process and representing the striking of a balance between competing interests and a policy decision on how such a balance should best be struck.

According to Mr Weitzman, the judge should also be aware that, as stated at paragraph 97.4 of its second report, the FSA is currently undertaking a review of the implementation of the current regime and that, when carrying out that review, the FSA will have regard to the points that have been made by the policyholder advocate. He said it has been suggested that the policyholder advocate should, if she so wishes, communicate with the FSA following the conclusion of the present hearing. However, the FSA clearly cannot

prejudge its own review and will wait to see what responses and information it receives as a result of the review.

The policyholder advocate's response

In response to the FSA's invitation, the policyholder advocate contacted the FSA's with-profits review team, following the conclusion of the High Court hearing. The FSA said that the with-profits review is under way but is not due to report until the second quarter of 2010. Although it had intended to publish findings by the end of 2009, the FSA said it had been forced to delay publication of its findings until June 2010 as a result of a need to prioritise resources to deal with issues arising from the global financial crisis.

The FSA reaffirmed that the review is intended to be a comprehensive look at how firms' senior managements have implemented its with-profits regime. If the FSA's conclusions following the review are that the rules do need amendment or clarification, then the consultation process will follow in the usual way. The FSA reaffirmed that it is interested in having the policyholder advocate's views. The policyholder advocate was subsequently invited to meet and discuss what she considers to be the key issues with the FSA's with-profits review team. The policyholder advocate has also confirmed to the FSA that she will be making a written submission. She expects to make the submission before the end of 2009 and will also publish it on the policyholder advocate's website.