

Business review

Capital management

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Capital management objectives

Aviva's capital management philosophy is focused on capital efficiency and effective risk management to support a progressive dividend policy and EPS growth. Rigorous capital allocation is one of our primary strategic priorities and is ultimately governed by the group Executive Committee.

Overall capital risk appetite is set and managed with reference to the requirements of a range of different stakeholders including shareholders, policyholders, regulators and rating agencies. In managing capital we seek to:

maintain sufficient, but not excessive, financial strength to support new business growth and satisfy the requirements of our regulators and other stakeholders, and thus give both our customers and stakeholders assurance of our financial strength;

optimise our overall debt to equity structure to enhance our returns to shareholders, subject to our capital risk appetite and balancing the requirements of the range of stakeholders;

retain financial flexibility by maintaining strong liquidity, including significant unutilised committed credit lines and access to a range of capital markets;

allocate capital rigorously across the group, to drive value adding growth in accordance with risk appetite;

increase the dividend on a basis judged prudent, while retaining capital to support future business growth, using dividend cover on an IFRS operating earnings after tax basis in the 1.5 to 2.0 times range as a guide.

Capital resources

The primary sources of capital used by the group are equity shareholders' funds, preference shares, subordinated debt and borrowings. We also consider and, where efficient to do so, utilise alternative sources of capital such as reinsurance and securitisation in addition to the more traditional sources of funding. Targets are established in relation to regulatory solvency, ratings, liquidity and dividend capacity and are a key tool in managing capital in accordance with our risk appetite and the requirements of our various stakeholders.

In February, the Standard & Poors (S&P) rating committee downgraded NU Life from AA to AA-, which is now aligned with the other 'core' group subsidiaries. At the same time S&P have changed the outlook on NU Life's ratings from "negative" to "stable". There are no changes to any of the group's other ratings or outlooks. The group's financial strength rating from Moody's is Aa3 ("excellent") with a stable outlook from AM Best.

Capital allocation

Capital allocation is undertaken based on a rigorous analysis of a range of financial, strategic, risk and capital factors to ensure that capital is allocated efficiently to value adding business opportunities. A clear management decision making framework, incorporating ongoing operational and strategic performance review, periodic longer term strategic and financial planning and robust due diligence over capital allocation is in place, governed by the Group Executive Committee and Group Asset Committee. These processes incorporate various capital profitability metrics, including an assessment of return on capital employed and internal rates of return in relation to hurdle rates to ensure capital is allocated efficiently and that excess business unit capital is repatriated where appropriate.

Different measures of capital

In recognition of the requirements of different stakeholders, we measure capital on a number of different bases, all of which are taken into account when managing and allocating capital across the group. These include measures which comply with the regulatory regimes within which we operate and those which the directors consider appropriate for the management of the business. The primary measures are:

(i) Accounting bases

We report our results on both an IFRS and a Market Consistent Embedded Value (MCEV) basis. The directors consider that the MCEV principles provide a more meaningful measure of the long-term underlying value of the capital employed in our life and related businesses. This basis allows for the impact of uncertainty in the future investment returns more explicitly and is consistent with the way the life business is priced and managed. Accordingly, in addition to IFRS, we analyse and measure the net asset value and total capital employed for the group on this basis. This is the basis on which group return on equity is measured.

(ii) Regulatory bases

Individual regulated subsidiaries measure and report solvency based on applicable local regulations, including in the UK the regulations established by the Financial Services Authority (FSA). These measures are also consolidated under the European Insurance Groups Directive (IGD) to calculate regulatory capital adequacy at an aggregate group level. We have fully complied with these regulatory requirements during the year.

(iii) Rating agency bases

Agency ratings are an important indicator of financial strength and maintenance of these ratings is one of the key drivers of capital risk appetite. Certain rating agencies have proprietary capital models which they use to assess available capital resources against capital requirements as a component of their overall criteria for assigning ratings. In addition, rating agency measures and targets in respect of gearing and fixed charge cover are also important in evaluating the level of borrowings utilised by the group. While not mandatory external requirements, in practice rating agency capital measures tend to act as one of the primary drivers of capital requirements, reflecting the capital strength required in relation to our target ratings.

(iv) Economic bases

We also measure capital using an economic capital model that takes into account a more realistic set of financial and non-financial assumptions. This model continues to be developed and is increasingly relevant in the internal management and external assessment of our capital resources. The economic capital model is used to assess capital strength in accordance with the Individual Capital Assessment (ICA) requirements established by the FSA. Further developments are planned to meet the emerging requirements of the Solvency II framework.

Accounting basis and capital employed by segment

The table below shows how our capital, on an MCEV basis, is deployed by segment and how that capital is funded.

	2008 £m	2007 £m
Long-term savings	19,250	22,397
General insurance and health	5,516	5,594
Fund management	340	355
Other business	(326)	831
Corporate*	(30)	(31)
Total capital employed	24,750	29,146
Financed by:		
Equity shareholders' funds	12,912	19,998
Minority interests	3,013	2,501
Direct capital instrument	990	990
Preference shares	200	200
Subordinated debt	4,606	3,054
External debt	919	1,257
Net internal debt	2,110	1,146
	24,750	29,146
Net asset value per share – MCEV basis	486p	763p

* The "Corporate" net liabilities represent the element of the pension scheme deficit held centrally.

At 31 December 2008 we had £24.8 billion (31 December 2007: £29.1 billion) of total capital employed in our trading operations, measured on an MCEV basis. Net asset value per ordinary share, based on equity shareholders' funds, has decreased to 486 pence per share (31 December 2007: 763 pence per share).

Total capital employed is financed by a combination of equity shareholders' funds, preference capital, subordinated debt and borrowings. In addition to our external funding sources, we have certain internal borrowing arrangements in place which allow some of the assets that support technical liabilities to be invested in a pool of central assets for use across the group. These internal debt balances allow for the capital allocated to business operations to exceed the externally sourced capital resources of the group. Although intra-group in nature, they are included as part of the capital base for the purpose of capital management. These arrangements arise in relation to the following:

Certain subsidiaries, subject to continuing to satisfy standalone capital and liquidity requirements, loan funds to corporate and holding entities, these loans satisfy arm's-length criteria and all interest payments are made when due.

Aviva International Insurance (All) Ltd acts as both a UK general insurer and as the primary holding company for our foreign subsidiaries. Internal capital management mechanisms in place allocate a portion of the total capital of the company to the UK general insurance operations. These mechanisms also allow for some of the assets backing technical liabilities to be made available for use across the group. Balances in respect of these arrangements are also treated as internal debt for capital management purposes.

Net internal debt represents the balance of the above amounts due from corporate and holding entities, less the tangible net assets held by these entities.

On 13 May 2008 we issued £0.8 billion equivalent of Lower Tier 2 hybrid in a dual-tranche transaction (£400 million and €500 million). £0.6 billion of the proceeds was used to repay short-term commercial paper borrowings. On 8 August 2008 we issued a further £0.2 billion of Lower Tier 2 hybrid. These transactions had a positive impact on group IGD solvency and economic capital measures.

Financial leverage, the ratio of external senior and subordinated debt to MCEV capital and reserves, was 34.7% (31 December 2007: 19.2%). Fixed charge cover, which measures the extent to which external interest costs, including subordinated debt interest and preference dividends, are covered by MCEV operating profit was 9.2 times (31 December 2007: 9.2 times).

Regulatory bases

Regulatory basis – Group: European Insurance Groups Directive

	UK Life funds £bn	Other business £bn	2008 £bn	2007 £bn
Insurance Groups Directive (IGD) capital resources	5.7	9.8	15.5	16.2
Less: capital resource requirement	(5.7)	(7.8)	13.5	13.3
Insurance Group Directive (IGD) excess solvency	–	2.0	2.0	2.9
Cover over EU minimum (calculated excluding UK Life funds)			1.3 times	1.5 times

We have a regulatory obligation to have positive solvency on a regulatory IGD basis at all times. Our risk management processes ensure adequate review of this measure. At 31 December 2008, the estimated excess regulatory capital was £2.0 billion (31 December 2007: £2.9 billion). This measure represents the excess of the aggregate value of regulatory capital employed in our business over the aggregate minimum solvency requirements imposed by local regulators, excluding the surplus held in the UK and Ireland with-profit life funds.

The minimum solvency requirement for our European businesses is based on the Solvency I Directive. In broad terms, for EU operations, this is set at 4% and 1% of non-linked and unit-linked life reserves respectively and for our general insurance portfolio of business is the higher of 18% of gross premiums or 26% of gross claims, in both cases adjusted to reflect the level of reinsurance recoveries. For our major non-European businesses (the US, Australia and Canada) a risk charge on assets and liabilities approach is used. The IGD is a pure aggregation test with no credit given for the considerable diversification benefits of Aviva.

Our excess solvency of £2.0 billion reflects a net decrease of £0.9 billion since 31 December 2007 reflecting the prevailing challenging market and general insurance trading conditions offset by various capital initiatives undertaken during the year including the issue of hybrid debt. Following individual guidance from the FSA we now recognise surpluses in the non-profit funds of our UK life and pensions business which is available for transfer to shareholders of £0.4 billion, the benefit of which is offset by reserve strengthening elsewhere in the group.

In the current economic conditions we are proactively managing balance sheet risk. In addition to the de-risking exercise we undertook in 2007 we have taken out further equity hedges during 2008 and continue to actively manage our equity risk exposures. We expect our IGD surplus would be approximately £1.2 billion in the event of a 40% fall in equity markets from the 31 December 2008 position.

Business review

Capital management continued

Regulatory basis – Long-term businesses

For our non-participating worldwide life assurance businesses, capital requirements, expressed as a percentage of the EU minimum, are set for internal management and embedded value reporting purposes as the higher of:

Target levels set by reference to internal risk assessment and internal objectives, taking account of the level of operational, demographic, market and currency risk.

Minimum capital level (ie level of solvency capital at which local regulator is empowered to take action).

The required capital across our life businesses varies between 100% and 325% of EU minimum or equivalent. The weighted average level of required capital for non-participating life business, expressed as a percentage of the EU minimum (or equivalent) solvency margin has remained stable at 142% (31 December 2007: 141%).

These levels of required capital are used in the calculation of embedded value to evaluate the cost of locked in capital. At 31 December 2008 the aggregate regulatory requirements based on the EU minimum test amounted to £6.0 billion (31 December 2007: £4.6 billion). At this date, the actual net worth held in our long-term business was £9.5 billion (31 December 2007: £9.4 billion) which represents 157% (31 December 2007: 205%) of these minimum requirements.

Regulatory basis – UK Life with-profit funds

The available capital of the with-profit funds is represented by the realistic inherited estate. The estate represents the assets of the long-term with-profit funds less the realistic liabilities for non-profit policies within the funds, less asset shares aggregated across the with-profit policies and any additional amounts expected at the valuation date to be paid to in-force policyholders in the future in respect of smoothing costs, guarantees and promises. Realistic balance sheet information is shown below for the three main UK with-profit funds; CGNU Life, Commercial Union Life Assurance Company (CULAC) and Norwich Union Life & Pensions (NUL&P). These realistic liabilities have been included within the long-term business provision and the liability for insurance and investment contracts on the consolidated IFRS balance sheet at 31 December 2008 and 31 December 2007.

	2008					2007
	Estimated realistic assets £bn	Estimated realistic liabilities ^{**} £bn	Estimated realistic inherited estate [†] £bn	Estimated risk capital margin [‡] £bn	Estimated excess £bn	Estimated excess £bn
CGNU Life	12.8	(12.1)	0.7	(0.4)	0.3	1.1
CULAC	12.4	(11.7)	0.7	(0.4)	0.3	0.8
NUL&P [#]	21.4	(20.2)	1.2	(0.7)	0.5	1.3
Aggregate	46.6	(44.0)	2.6	(1.5)	1.1	3.2

* These realistic liabilities include the shareholders' share of future bonuses of £0.8 billion (31 December 2007: £1.2 billion). Realistic liabilities adjusted to eliminate the shareholders' share of future bonuses are £43.2 billion (31 December 2007: £48.8 billion).

**These realistic liabilities make provision for guarantees, options and promises on a market consistent stochastic basis. The value of the provision net of charges included within realistic liabilities is £1.4 billion, £1.5 billion and £4.1 billion for CGNU Life, CULAC and NUL&P respectively (31 December 2007: £0.7 billion, £0.8 billion and £3.0 billion for CGNU Life, CULAC and NUL&P respectively).

† Estimated realistic inherited estate at 31 December 2007 was £1.4 billion, £1.2 billion and £1.9 billion for CGNU Life, CULAC and NUL&P respectively.

‡ The risk capital margin (RCM) is 1.8 times covered by the inherited estate (31 December 2007: 3.5 times).

The NUL&P fund includes the Provident Mutual (PM) fund which has realistic assets and liabilities of £1.8 billion and therefore does not impact the realistic inherited estate.

Investment mix

The aggregate investment mix of the assets in the three main with-profit funds at 31 December 2008 was:

	2008 %	2007 %
Equity	24%	37%
Property	12%	13%
Fixed interest	56%	37%
Other	8%	13%
	100%	100%

The equity backing ratios, including property, supporting with-profit asset shares are 57% in CGNU Life, CULAC and NUL&P. With-profit new business is mainly written through CGNU Life.

Proposed reattribution of inherited estate

In July 2008 following extensive discussions with the Policyholder Advocate, Norwich Union announced a £1 billion offer to one million eligible policy holders in return for giving up the right to the £2.1 billion inherited estate of CGNU Life Assurance Ltd and Commercial Union Life Assurance Company Ltd. Since then, investment market performance has caused the value of the estate to reduce to £1.4 billion meaning that the offer made in July no longer meets our criteria of being fair to both policyholders and shareholders. As a consequence, we are working closely with the Policyholder Advocate to see how we can restructure our offer and expect to be in a position to provide an update to policyholders in the next few months. These developments do not affect the entitlement to receive a £2.1 billion special distribution that we announced in early 2008.

Regulatory basis – Solvency II

Solvency II represents new EU legislation which totally redefines prudential supervision of EU insurers. It aims to establish a new economic risk sensitive approach to capital and solvency calculation and a new harmonised EU supervisory regime which places importance on effective internal governance and risk management practices. Aviva has already recognised that Solvency II offers a blueprint for industry best practice and is fully prepared to meet the challenge that offers. To that end we are an active participant in the key European industry working groups who provide the voice of industry in ongoing negotiations in Brussels.

It is possible that the first stage of the Solvency II project will reach conclusion by June 2009 if the EU Parliament, Council and Commission are able to reach agreement on the "Level 1 Framework Directive". If this happens, it is envisaged that full implementation of Solvency II requirements could be imposed on EU insurers in the first quarter of 2013.

Rating agency bases

Agency ratings are important in supporting access to debt capital markets and in providing assurance to business partners and policyholders over the financial strength of the group and our ability to service contractual obligations. In recognition of this, we have solicited rating relationships with a number of rating agencies. Rating agencies generally assign ratings based on an assessment of a range of financial (eg capital strength, gearing and fixed charge cover ratios) and non-financial (eg competitive position and quality of management) factors. Managing our capital and liquidity position in accordance with our target rating levels is a core consideration in all material capital management and capital allocation decisions.

Economic bases

We use a risk-based capital model to assess economic capital requirements and to aid in risk and capital management across the group. This model is also used to support our Individual Capital Assessments (ICA) which are reported to the FSA for all UK regulated insurance businesses. The model is based on a framework for identifying the risks to which business units, and the group as a whole, are exposed. A mixture of scenario based approaches and stochastic models are used to capture market risk, credit risk, insurance risk and operational risk. Scenarios are specified centrally to provide consistency across businesses and to achieve a minimum standard. Where appropriate, businesses also supplement these with additional risk models specific to their own risk profile. When aggregating capital requirements at business unit and group level, we allow for diversification benefits between risks and between businesses, with restrictions to allow for non-fungibility of capital when appropriate. This means that the aggregate capital requirement is less than the sum of capital required to cover all of the individual risks.

For internal management purposes, our economic capital model is calibrated to our target capital adequacy rating. Financial modelling techniques enhance our practice of active risk and capital management, ensuring sufficient capital is available to protect against unforeseen events and adverse scenarios. Our aim continues to be the optimal usage of capital through appropriate allocation to our businesses. We continue to develop our economic capital modelling capability for all our businesses as part of our development programme to increase the focus on economic capital management.

The FSA uses the results of our ICA process when setting target levels of capital for the UK regulated insurance businesses. In line with FSA requirements, the ICA estimates the capital required to mitigate the risk of insolvency to a 99.5% confidence level over a one year time horizon (equivalent to events occurring in 1 out of 200 years) against financial and non-financial tests.