Building competitive advantage through risk and capital management

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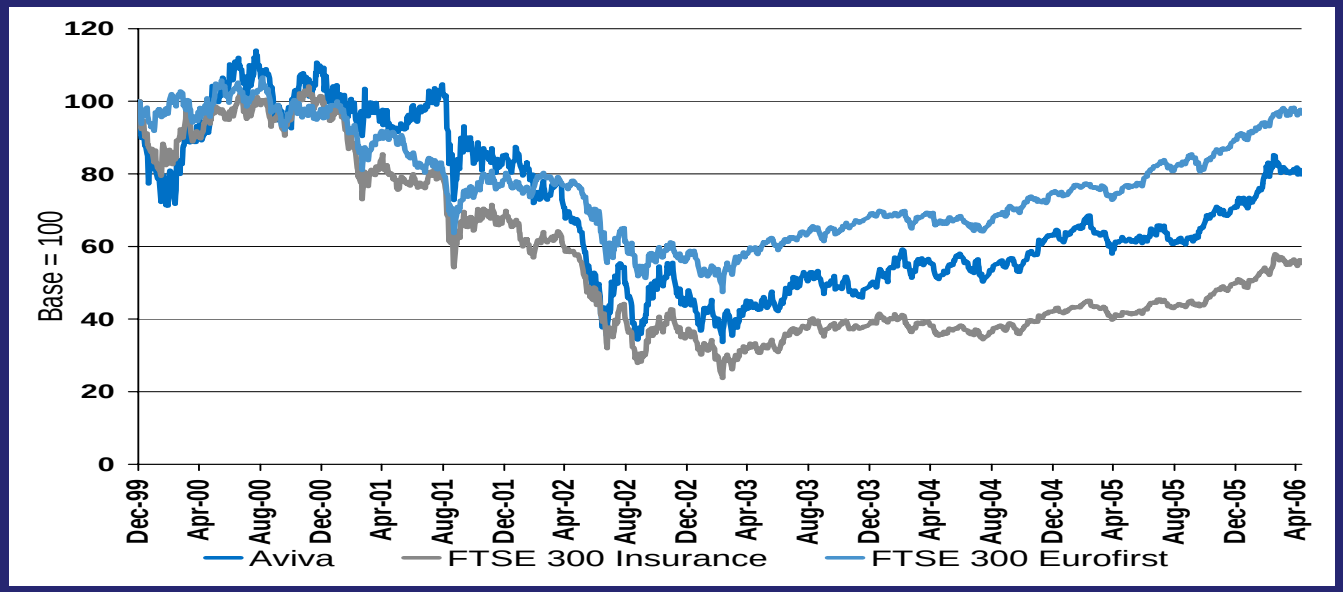


The last bear market highlighted capital weaknesses and the importance of strong risk and capital management practices across the industry, leading to significant under-performance.

Following the wider market recovery and the deployment of significant resources to enhance risk and capital management capabilities, the industry has been re-rated.

Performance however still trails the market. Continued focus on risk and capital optimisation, not least to facilitate growth financing, will be critical to close the performance gap.

Drivers of market underperformance

Under performance driven by falling equity market acting as a catalyst for concerns over risk and capital issues within the industry

Risk and capital management weaknesses

- Market failures
- Emergence of operating risk issues (e.g. miss-selling)
- Impact of product guarantees and guaranteed annuity options

Uncertainty =

Sector valuation haircut

Capital strength concerns

- Dividend cuts
- Rights issues
- Bonus cuts
- Simplistic, risk insensitive capital regimes

Clarity of financial and risk disclosures

- Distrust of AP methodologies
- Inconsistency across companies

Sector is rebuilding confidence through strengthened risk and capital management – driven partly by regulatory and market pressure but also recognition that strong risk management delivers commercial advantage

Significant developments in capital management

2000 — 2006 — 2010

Rebuilding capital strength

Risk mitigation

GROWTH FINANCING

Risk and return optimisation

Economic risk and capital management

External regulatory and market drivers

IGD/ FGD

Prudential sourcebook

EEV

IFRS phase 1

Solvency II

IFRS Phase 2

Rating agency models?

Risk and Capital Management has moved from risk mitigation and capital adequacy to risk and capital optimisation to facilitate the efficient financing of growth

Economic capital

Historic rules/ factor based models used by regulators and rating agencies create competitive distortions:

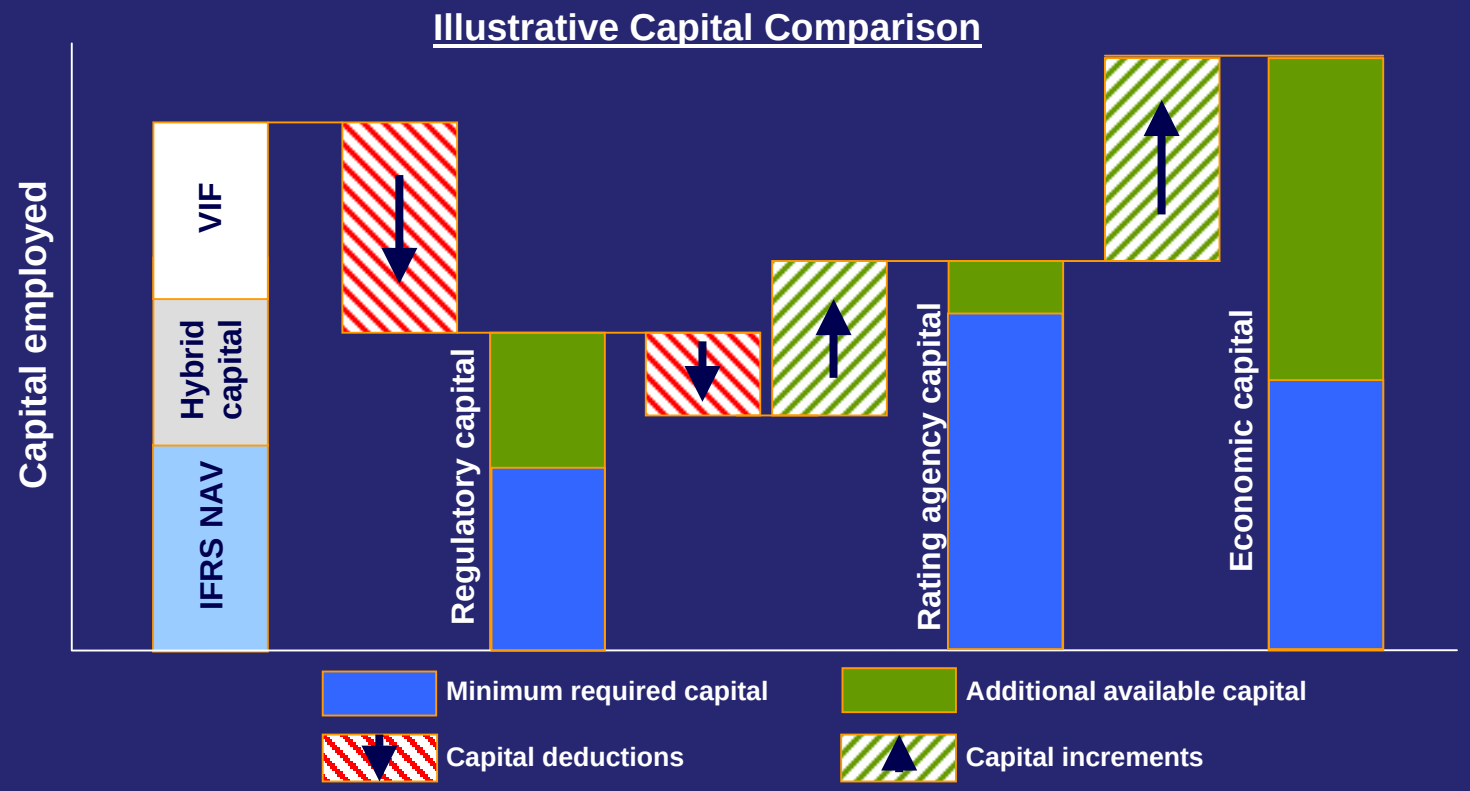
- **Risk insensitivity**
- **Inconsistency across different sectors and jurisdictions**
- **Limited recognition of the significant benefits of diversification**
- **Management of multiple, often significantly different, capital definitions**

Economic capital models address these weaknesses. This is increasingly accepted by the industry and our regulators:

- **Solvency II**
- **UK ICA**
- **IFRS phase 2**
- **Increasing qualitative recognition by rating agencies**
- **Industry co-operation through e.g. CFO Forum, CRO Forum, CEA**

The benefits of economic capital are becoming widely accepted and rapid change is taking place. Models are however complex and there is still much to do.

Traditional capital measures vs economic capital



Regulatory:

Recognise hybrid (subject to limits)

Disallow certain assets with economic value including VIF

Rating agency:

Rules differ by agency, examples include:

- More restrictive hybrid recognition
- Partial recognition of additional economic capital (e.g. VIF, reserve discounting)

Economic capital:

Models being developed across the industry:

- Full recognition of economic capital including diversification
- Increasing recognition by regulators and rating agencies

The industry faces inefficiency through management of multiple capital measures. The longer term objective is to converge to economic capital

Capital and risk management governance structure in Aviva

Aviva's Asset Liability Management Committee responsible for integrating risk and capital disciplines across the Group

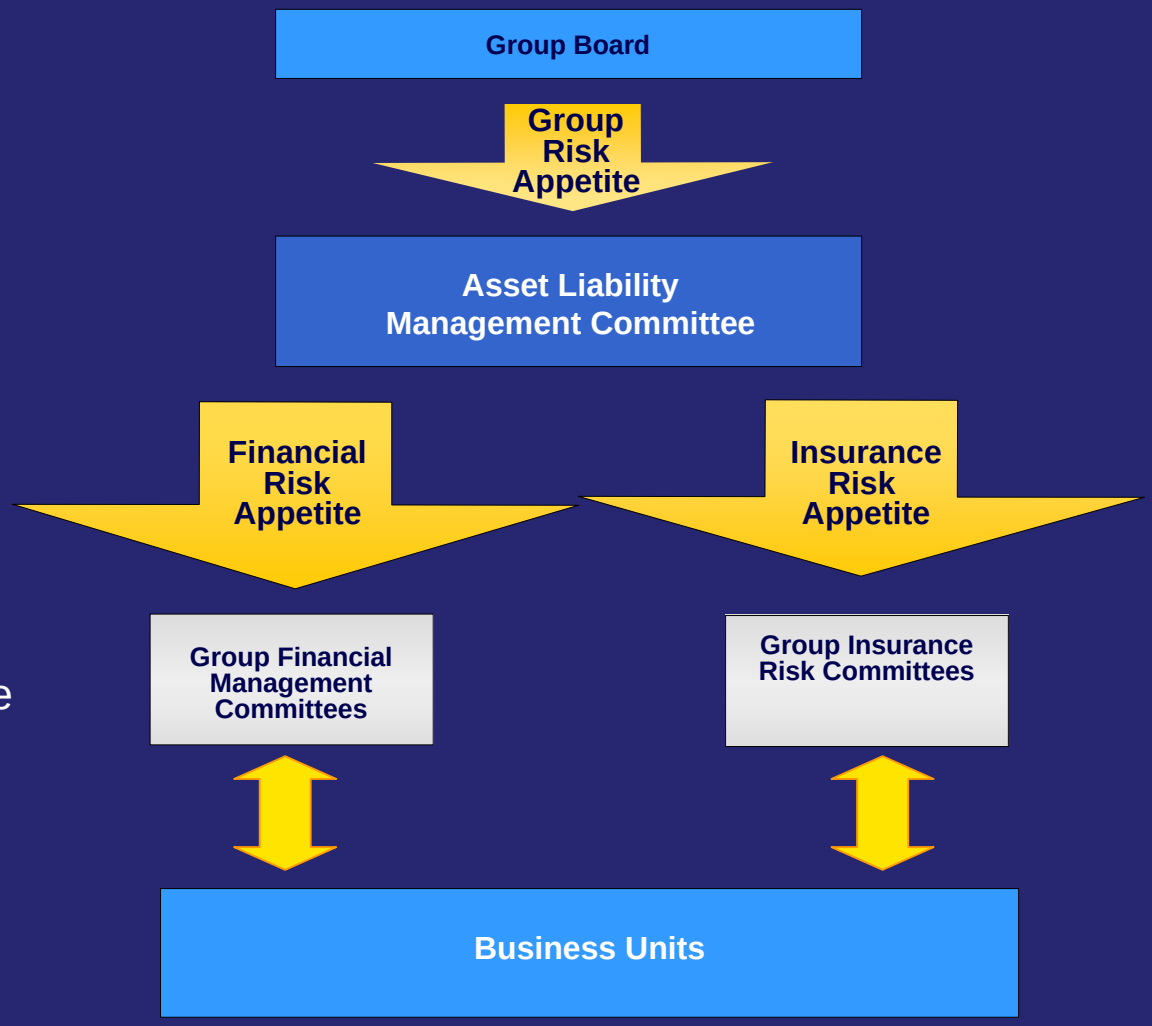
- Authoritative action oriented committee comprised of Executive Management team

- Supported by governance structures and processes

- Business unit and Group risk profiles and capital assessments are challenged and aggregated

- Concentration of risks managed / diversification benefits assessed

Risk and capital management is part of regular performance review and planning cycles



Robust governance structure and process established for risk and capital management

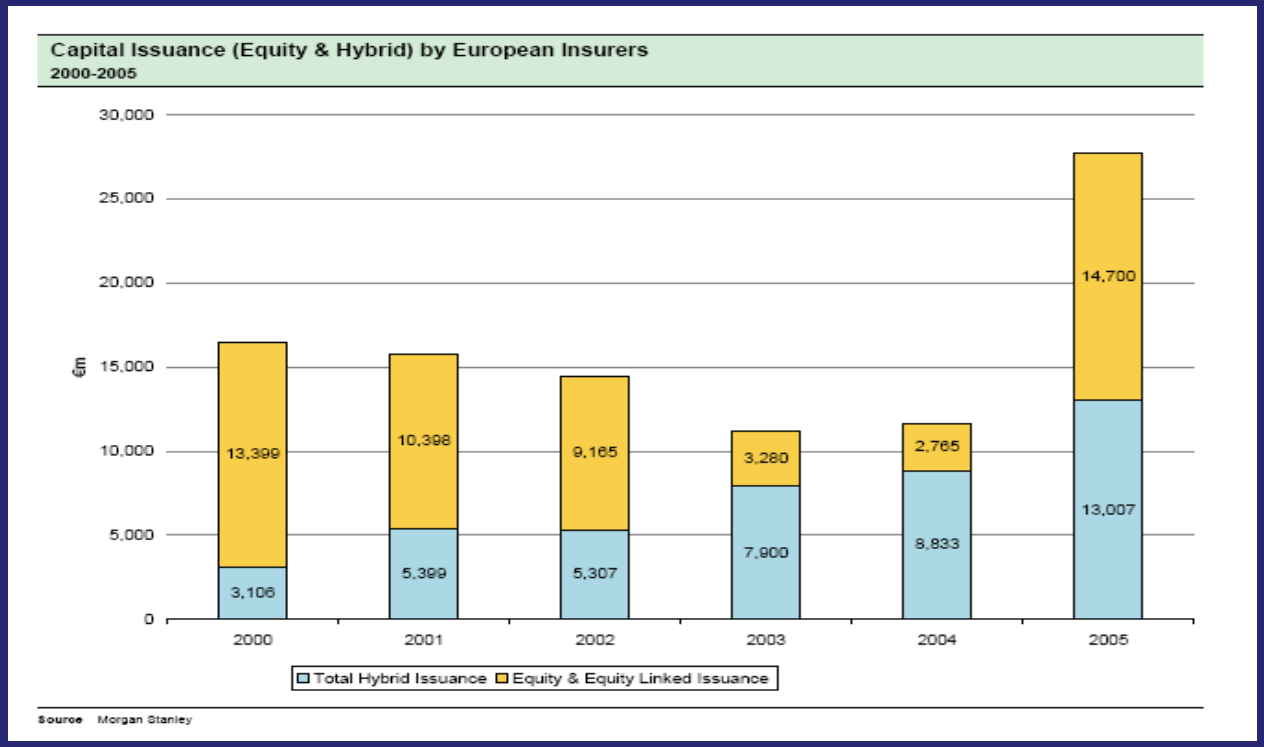
Financing Growth

The insurance industry is very competitive and advantage can be gained through optimising use of capital to enhance returns and finance growth:

- Efficient capital structures
  - Utilising efficient forms of financing
  - Diversified business model
  - Organic capital generation
- Pricing for risk
- Effective ALM
- Alternative financing techniques

Increasingly, economic capital and risk management will drive pricing and ALM. In the current world of multiple capital constraints, we must also continue to manage overall capital within these constraints.

Utilising efficient forms of financing



Significant capital issuance across the industry over last 5 years (€45.4bn Equity, €38.3bn hybrid), driven by a number of factors including:

- rebuilding capital following challenging equity markets
- introduction of IGD and increased regulatory capital requirements

Growth in hybrid issuance facilitated by:

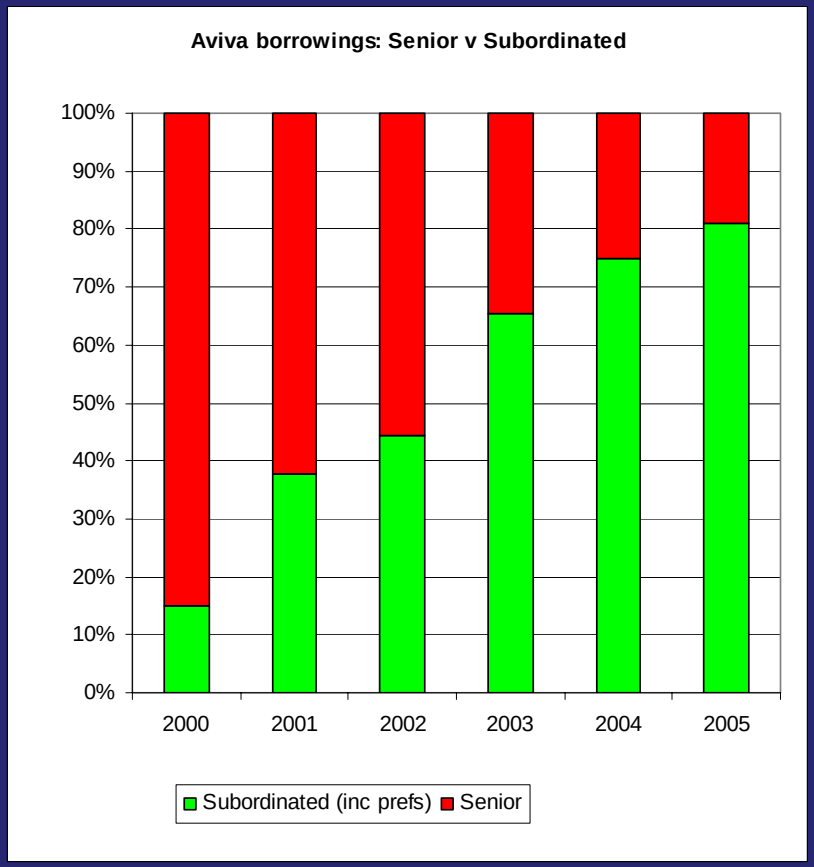
- alignment of regulatory capital regime for banks and insurers
- strength of demand for fixed income product

Capital Raising: Aviva's position

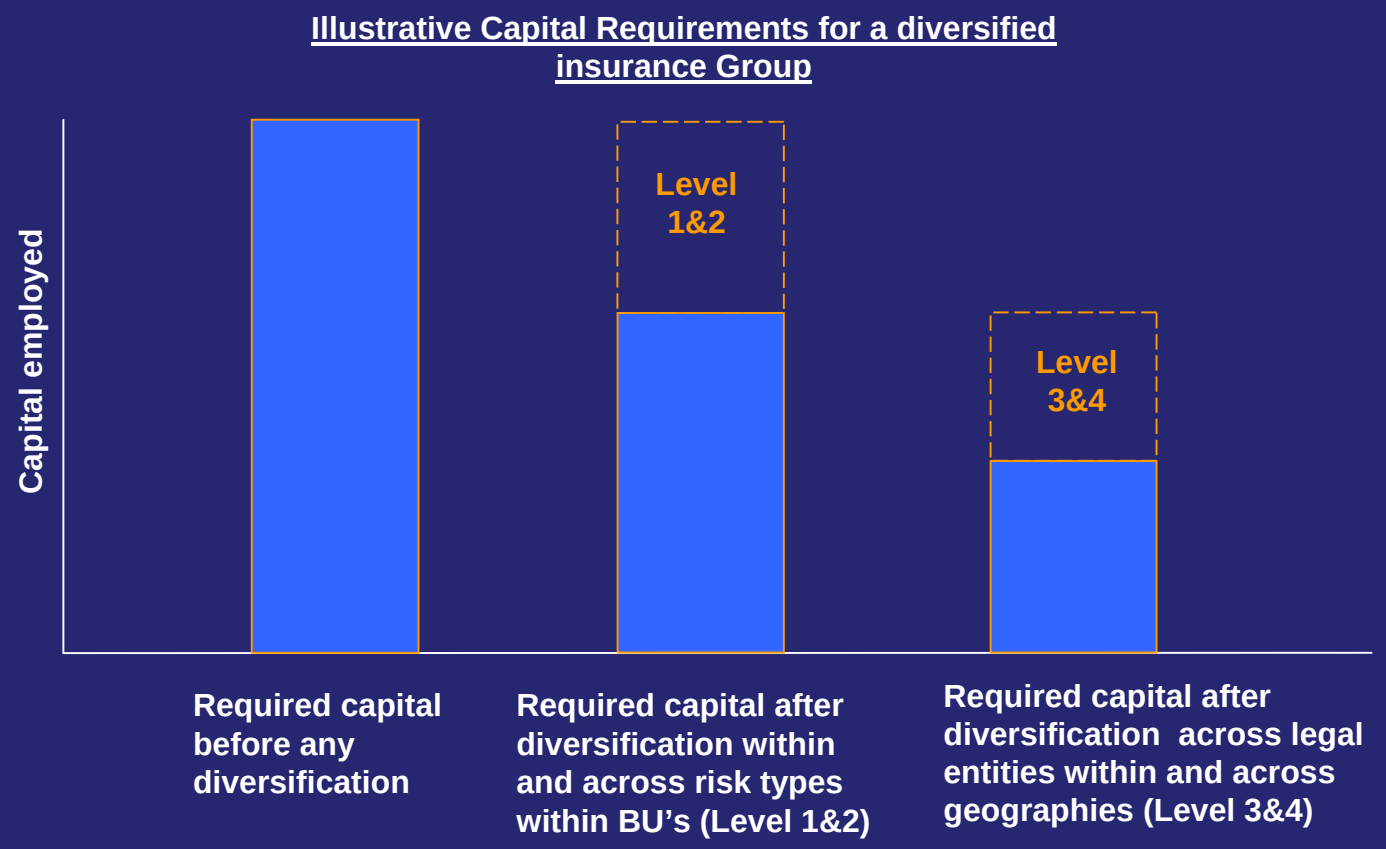
Since the NU/ CGU merger in 2000 Aviva has raised £3.8bn of hybrid capital, with the objective of optimising its capital structure through issuance of cost efficient regulatory capital

Hybrid issuance has significantly enhanced the quality of Aviva's debt capital:

- senior debt replaced with deeply subordinated regulatory capital
- debt maturity profile extended
- diversified the investor base

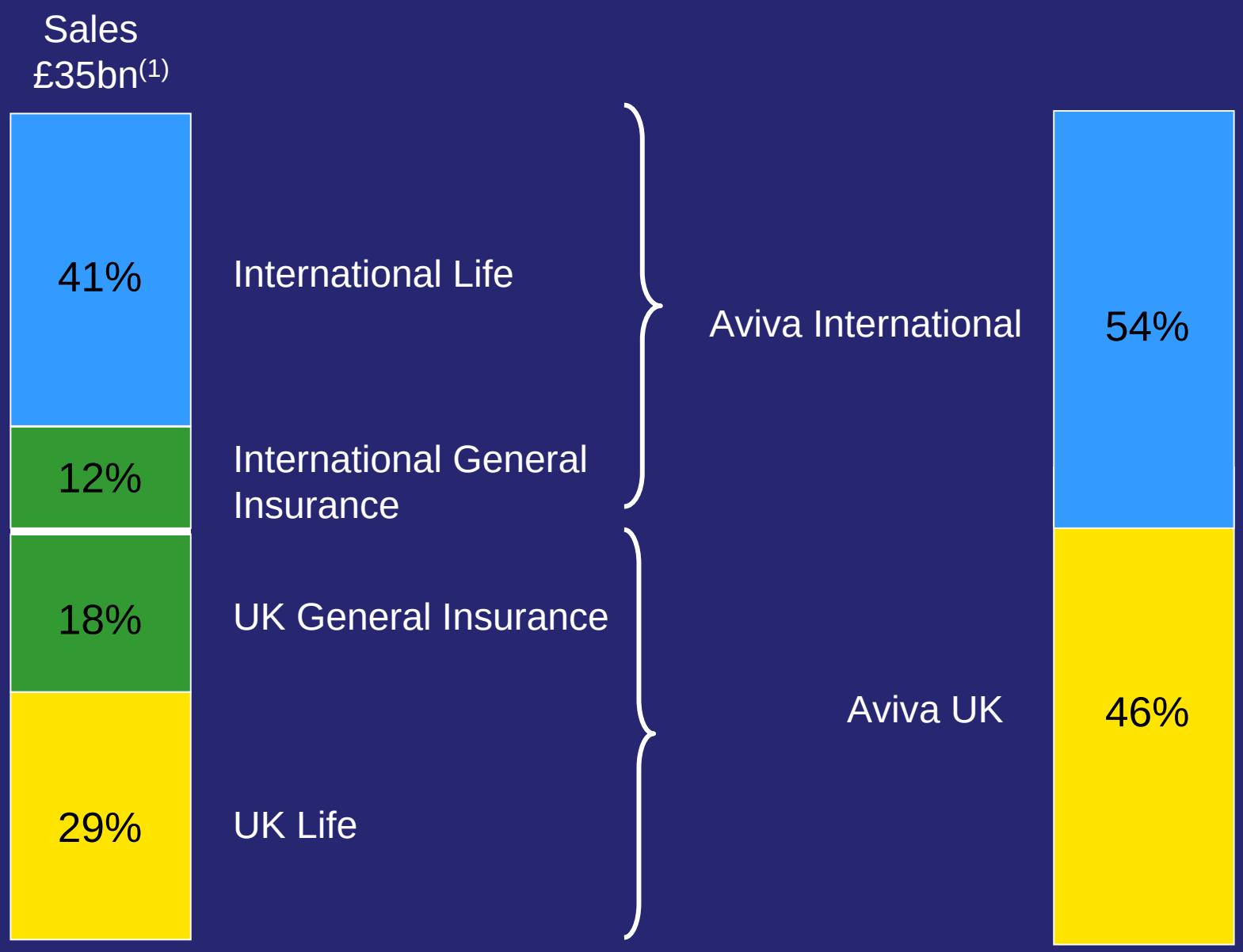


Diversification Benefits



- Insurance, by its nature, involves the pooling of risk to share the benefits of diversification
- Economically, there are significant capital benefits from product, sector and geographic diversification which are incompletely recognised under historic capital regimes
- Recognition by regulators, rating agencies and investors is key to delivering the value of diversification to customers and shareholders

Aviva's diversified business model

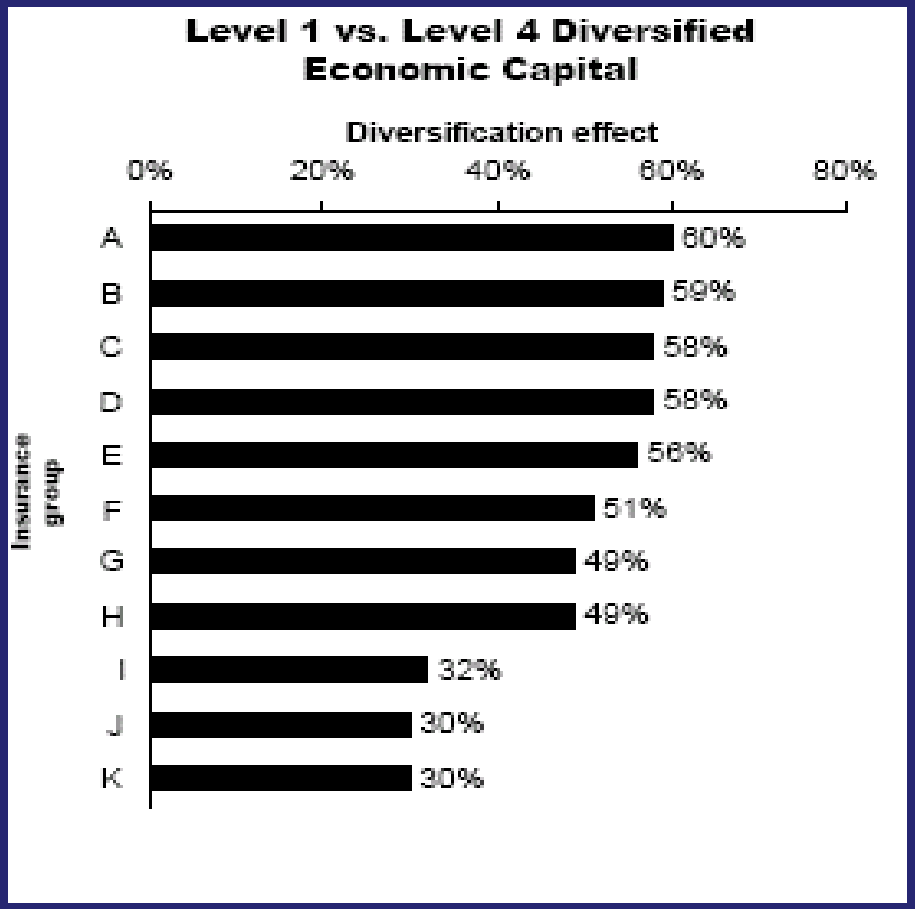


(1) 2005 total long-term savings new business sales and GI and health new business premiums
(2) Excluding Corporate Costs and Unallocated Interest Charges

Diversification benefits: Industry view

- The CRO Forum is an industry technical Group formed to focus on developing and promoting industry best practice in risk management
- A key element of this is to contribute to shaping the Solvency II regulatory framework
- Recognition of diversification benefits is a key theme across this group
- Large, diversified group's, such as Aviva, will increasingly gain competitive advantage as capital regimes align to economic capital models.
- Many complex issues remain unresolved, including the extent to which economic diversification benefits may be restricted in practice through fungibility considerations

Measured diversification effects, Chief Risk Officer Forum member companies



Organic Capital Generation

- The ability to self generate capital organically to support dividends and finance growth remains an important consideration for both investors and the Group's capital regulators
- Net of financing, Aviva has consistently strong operational capital generation, supported by its diversified, composite business model

	2005 £m	2004 £m
New business strain	(536)	(520)
Life inforce profits	1,250	848
Non life profits after interest costs[1]	729	486
Normalised operating profits after tax	**1,443**	**814**
Dividend including preference shares and DCI	(710)	(598)
Benefit from scrip dividend[2]	100	103
Normalised profits post tax retained to fund growth	**833**	**319**

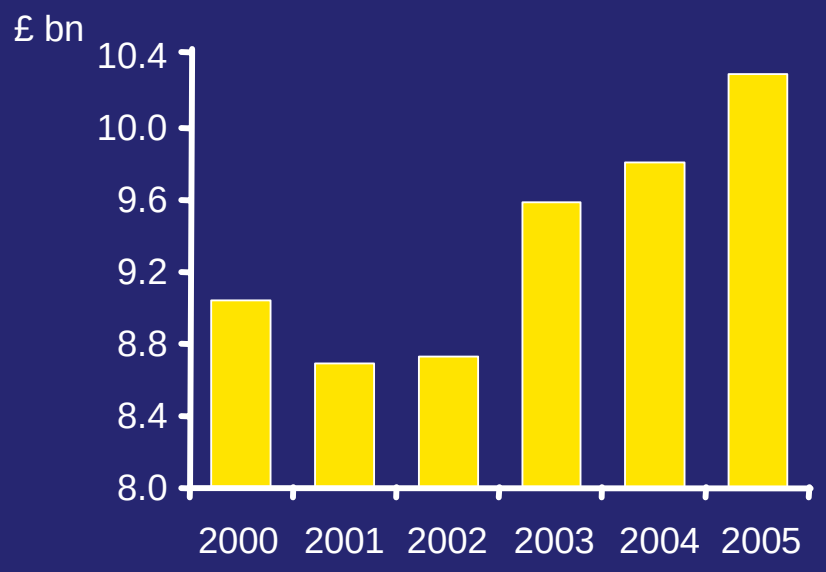
The increase in the capital requirements on a realistic basis is £278m

(1) 2004 restated for IFRS
(2) 2004 adjusted for actual take up

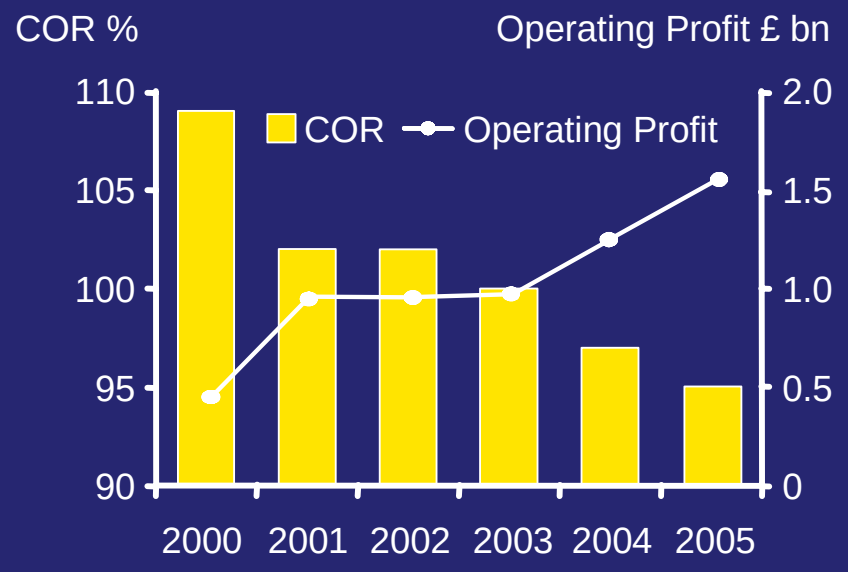
Profitable growth – optimising returns: General Insurance

Aviva General Insurance:

Growing premium income ...



... whilst increasing profitability



Focus on scale personal and SME business lines

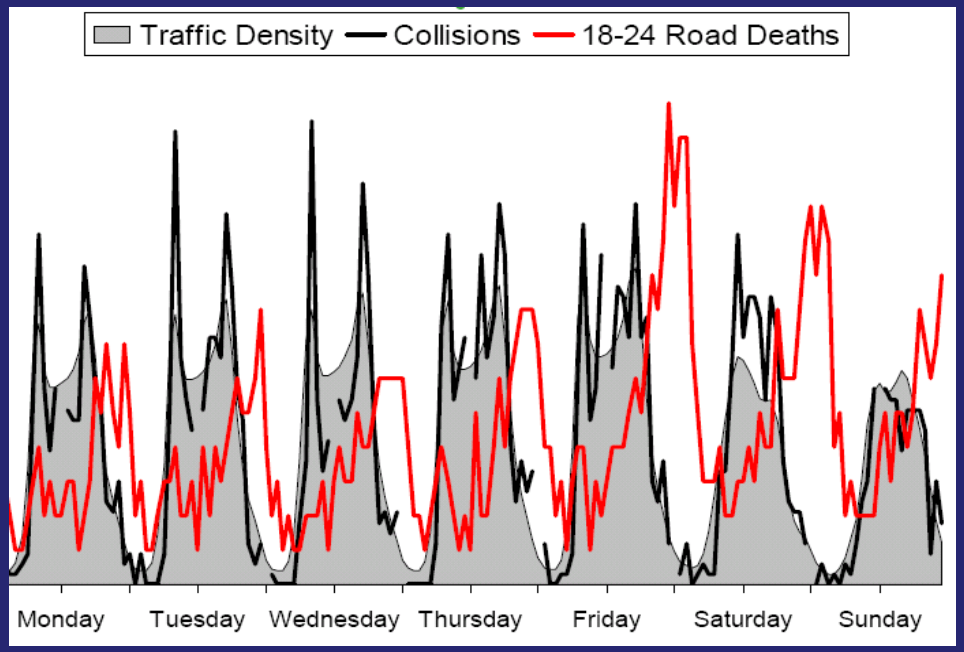
- Maximise diversification benefits
- Enhances understanding of risk

Exit from businesses which do not meet strategic fit and desired risk/ return profile

Pricing informed by sophisticated risk measurement tools

Creating competitive advantage through increasingly sophisticated and market leading risk measurement and selection techniques e.g.

- Economic modelling of catastrophe exposures
- Flood mapping
- Telematics



Telematics:

Pilot started 2 years ago

Major, world leading initiative for 2006 and beyond

Benefit to customers and shareholders:

- allows sophisticated tailoring of risk selection and premiums
- increased driver choice and reward for reduced driving risk

NU viewed as an independent authority on telematics, driver behaviour and road safety

Profitable growth – optimising returns: Life insurance

- Focus on optimising both capital efficiency and value creation
- Pricing and product decisions increasingly influenced by economic capital and improved understanding of risk
- Economic modelling supporting enhanced ALM to reduce risk and optimise returns
- Improved EEV reporting and disclosure practices including stochastic modelling of option and guarantees

	New business contribution [1]		New business margin [1]	
	2005 £m	2004 £m	2005 %	2004 %
Aviva UK	**213**	**215**	**2.4**	**2.3**
France	91	54	2.6	1.9
Ireland	13	16	2.0	2.9
Italy	36	34	1.6	1.9
Netherlands	57	43	2.4	2.0
Spain	155	121	7.7	5.7
Other countries	47	33	2.1	1.6
Aviva International	**399**	**301**	**3.0**	**2.6**
Total	**612**	**516**	**2.8**	**2.5**

[1] Post effect of required capital, pre tax and minorities

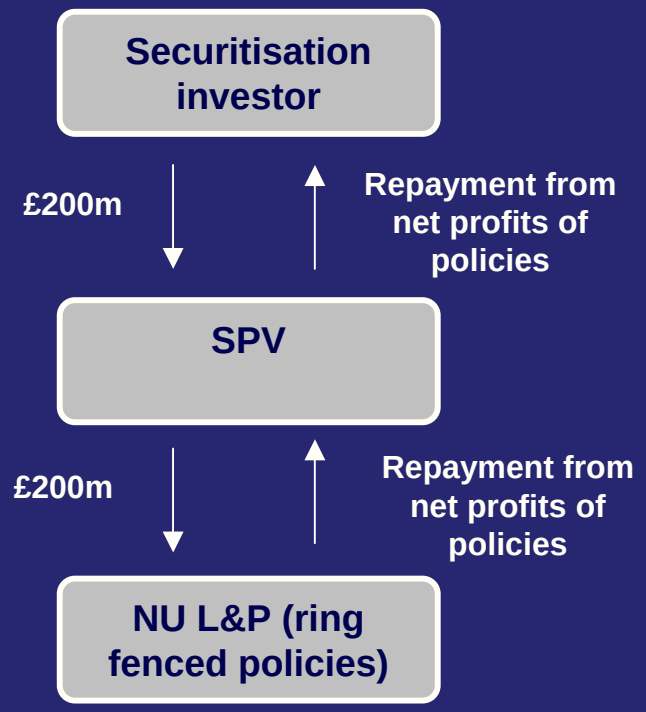
New business IRR for the Group of 12.5% (2004: 12.3%)

Utilising alternative financing techniques

Enhanced understanding of economic capital requirements and benefits of demonstrating/ achieving fungibility will lead to increased use of alternative sources of financing such as securitisation.

Aviva has already undertaken a number of securitisation transactions:

- **NU Equity Release**
- **NU Term Assurance**

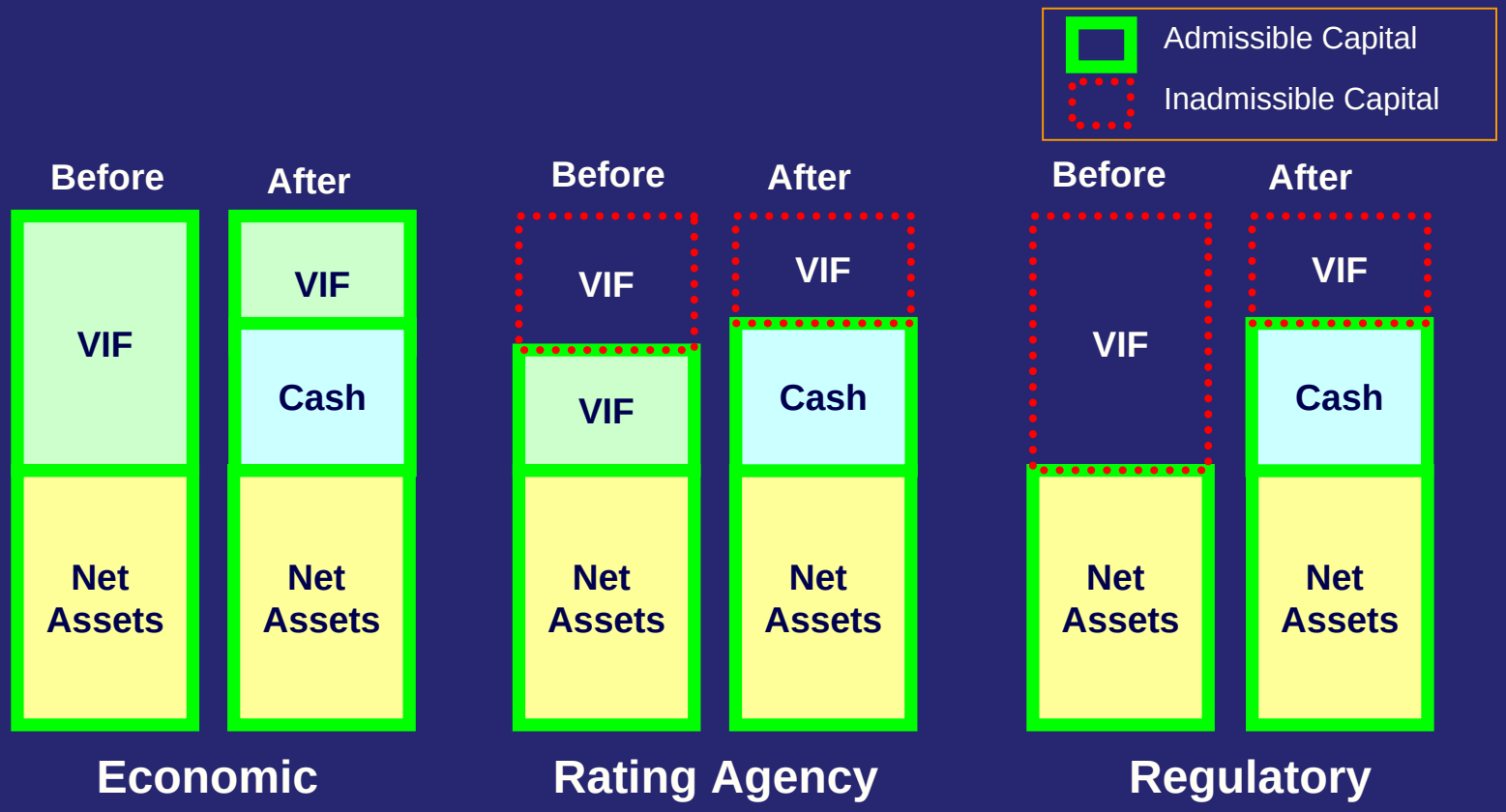


NU Term Assurance example:

- Securitisation of term life and mortgage protection policies in October 2004.
- Securitised future surplus to finance new business strain
- Loan repayment contingent on surplus arising – therefore not a statutory liability
- Shareholder capital requirements reduced and return on capital increased

Securitisation

- Securitisation can be used to align regulatory and rating agency capital positions more closely with the “true” economic capital position.
- For example a VIF Monetisation converts intangible VIF capital to cash which improves the quality of capital and enhances the rating agency and regulatory capital positions.



No Change in Economic Capital Position

Modest change in Rating Agency Capital Position

Significant change in regulatory position

Conclusions

Much progress has been made across the industry in recent years and continued development will further enhance the position.

- capital strength rebuilt
- risk management processes significantly improved
- important advances already made in regulatory capital regime and significant further enhancements under development (Solvency II)
- further reporting developments in progress (IFRS 2)
- Rating agencies increasingly looking to include economic capital within their rating criteria (qualitatively and/ or quantitatively)

The focus has moved from rebuilding and consolidating to pursuing growth. Optimising capital and risk management will be key determinants of successful companies in the future:

- pursuing economic capital metrics with capital regulators, including substantive recognition of diversification credit
- Utilising sophisticated risk and capital modelling techniques to enhance product mix and pricing decisions
- Increased use of innovative forms of financing such as securitisation