Sanlam Life Insurance Limited
Principles and Practices of Financial Management (PPFM) for Sanlam Personal Finance Reversionary Bonus Products

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Section 1 – Introduction

1.1 Background

Sanlam is a leading financial services group in South Africa, providing a broad range of financial products and services. Our vision is to be the leader in wealth creation and protection for our clients. Our business philosophy is captured in the traditional values of honesty, diligence, ethical behaviour, innovation, stakeholder values and strong ties with business partners.

In order to safeguard the interests of our clients, sound governance and strong financial backing are required. The PPFM forms part of the governance structure, and Sanlam's financial strength is illustrated, inter alia, by the level of its capital and assets under management and administration. These are disclosed in Sanlam's Annual Report that is available from Sanlam's website (www.sanlam.co.za).

The Sanlam Group conducts its business through the holding company Sanlam Limited, a corporate head office and three business clusters:

- Retail cluster
- Institutional cluster
- Short-term Insurance cluster

Sanlam Personal Finance (SPF) and Sanlam Developing Markets (SDM) are part of the Retail cluster. Sanlam Employee Benefits (SEB) is part of the Institutional cluster. SPF and SDM provide individual life insurance (including retirement annuities) and personal financial services and products. SEB provides life insurance, investment and annuity products for group schemes and retirement funds.

These business activities are conducted in the name of various legal subsidiaries such as Sanlam Life Insurance Limited, Sanlam Developing Markets Limited (previously African Life Assurance Limited), Sanlam Investment Management (Pty) Limited, etc.

1.2 Purpose of Principles and Practices of Financial Management

In order to manage *discretionary participation business*[1], long-term insurers must use their discretion in managing investments and allocating bonuses. Directive 147.A.i (LT) issued by the Financial Services Board requires insurers to define, and make publicly available, the Principles and Practices of Financial Management (PPFM) that are applied in the management of their discretionary participation funds. It should be noted, however, that a PPFM is neither a comprehensive explanation of the management of the *discretionary*

[1] ***Items in italics are defined in the glossary (Annexure 1)***

participation business nor of every matter that may affect a particular policy contract.

Sanlam Life Insurance Limited ("Sanlam Life") has published the following six documents covering the PPFM on its website, (www.sanlam.co.za):

- PPFM for SPF *smoothed bonus products*
- PPFM for SEB *smoothed bonus products*
- PPFM for SPF reversionary bonus products
- PPFM for Sanlam Life participating annuity products
- Principles of Financial Management (PFM) for Sanlam Life linked and market-related products
- PFM for SEB Provider pension products

Sanlam Developing Markets Limited has published the following document covering the PPFM on its website, (www.sanlam.co.za):

- PPFM for Sanlam Developing Markets Limited's *individual smooth bonus products.*

Please contact Channel Life (www.channel.co.za) if you require the PPFM for their *smoothed bonus products.*

All SPF's reversionary bonus products fall into the *discretionary participation business* (or *smoothed bonus products*) category. **This document comprises the PPFM for the SPF Reversionary Bonus product.**

1.3 Principles and Practices

The **Principles** define the overarching standards that have been adopted to manage Sanlam Life's smoothed bonus business and are not expected to change often. The Principles are the standards used to maintain the long-term solvency of the fund for current and future policyholders. They also describe the broad framework used:

- when discretion is applied in the management of *smoothed bonus products;* and
- in response to longer-term changes in the business and economic environment.

The **Practices** describe the current approach used to:

- manage *smoothed bonus products;* and
- respond to changes in the business and economic environment in the shorter term.

Practices are therefore expected to change more frequently than Principles.

1.4 Compliance

The Sanlam Life Insurance Limited Board ("Sanlam Life Board") is responsible for the governance of *smoothed bonus products written by Sanlam Life*, and it has tasked the Sanlam Customer Interest Committee to monitor compliance with the PPFM on its behalf.

The PPFM may change as the economic or business environment changes. Any change to a Principle or Practice will be approved by the Sanlam Life Board, on recommendation from the *statutory actuary* and the Sanlam Customer Interest Committee.

At least three months before a change to a Principle is implemented, the relevant policyholders and the Registrar of Long-Term Insurance will be informed and the proposed change will be published on our website. Any change to a Practice will be published on our website and policyholders will also be informed of such a change in the annual portfolio statement.

Section 2 – Overriding principles of financial management

The principles in Section 2 relate to the management of reversionary bonus products.

2.1 Principle regarding legal and contractual obligations

Sanlam Life is committed to comply with the requirements of all contractual obligations and other legal and regulatory requirements, including the *demutualisation rules* (for policies in force at demutualisation). These requirements apply if there is any inconsistency between them and the PPFM.

2.2 Principles regarding the general management of the reversionary bonus business

Sanlam Life applies the following key principles to its reversionary bonus business.

a) The reversionary bonus business has separate assets that are used to support the benefits of the policyholders as a group. The assets are adjusted by premiums and investment returns, which can be positive or negative. It is reduced by benefit payments, terminations, expenses, applicable taxes and a profit charge, which are deducted from the portfolio. The value of the underlying assets of the reversionary bonus business is also called the market value.

At maturity, the benefit payment equals the vested plus the non-vested benefit. The vested benefit is calculated as the sum assured plus reversionary bonuses on the sum assured plus further reversionary bonuses on the accumulated reversionary bonuses. The non-vested benefit is calculated as the non-vested terminal bonuses on the sum assured and on the reversionary bonuses. The non-vested benefit may be reduced under adverse circumstances. The *book value* is calculated on a prospective basis and equals the discounted value of the projected vested benefit plus the discounted value of the projected non-vested benefit less an adjustment to allow for the loss of expected future premiums. In this calculation provision is made for future bonuses that are expected to be declared to ensure policyholders shall receive reasonable benefits compared to the assets underlying their policies. As bonuses are smoothed, changes in the market value of the assets are not reflected in the *book value* immediately.

The surplus or deficit in a portfolio is the difference between the market value and the *book value*. This is called the *Bonus Stabilisation Reserve (BSR)*. A product's *funding level* is the ratio of the market value to the *book value*.

Reversionary bonus policyholders share in the investment return of their respective underlying portfolios as well as the profits or losses resulting from differences between market value and the value of the benefits paid. Reversionary bonus policyholders also share in other experience profits and losses, for example those arising from mortality benefits, *surrenders* and expenses. This means that policyholders are exposed to the investment risk (including credit risk), mortality risk, *surrender* risk and expense risk.

Sanlam Life may leverage the assets in the underlying portfolios for transactions such as scrip lending. Any income or losses arising from these transactions will be for Sanlam Life shareholders' own account, and therefore do not affect the benefits to which policyholders are entitled.

b) It is important for the various elements of product design to fit together. Particular attention is therefore paid to the following elements during the ongoing management of our reversionary bonus products:
- reserving for smoothed bonus benefits;
- investment policy;
- the nature of bonuses declared – vested or non-vested, reversionary or terminal;
- policyholder expectations, in particular with regard to bonuses, through marketing material, policy contracts and other communications that are accurate and easy to understand; and
- early withdrawal benefits, where *market value adjusters* (*MVA*s) are used to protect the interests of remaining policyholders;

2.3 Principles regarding bonuses

a) Sanlam Life's bonus philosophy is that the underlying assets for the group of reversionary bonus policies will, over time, be used for the benefit of those policyholders, subject to the charges recovered from the portfolio.

b) The bonus philosophy further aims to provide a reasonable compromise between smoothing the volatility of investment returns on the one hand and ensuring equity among different generations of policyholders on the other. The approach used when determining bonus rates is as follows:
- The starting point is the net expected long-term investment return, taking into account the asset composition of the particular portfolio.
- This return is adjusted to eliminate surpluses or deficits in the portfolio over a suitable period.

c) Policyholders' reasonable benefit expectations are also taken into account when discretion is applied to bonus declarations.

d) The Sanlam Life Board approves the bonus philosophy on the advice of the *statutory actuary*. A committee of the Sanlam Life Board approves the bonus rates that are determined in accordance with the bonus philosophy.

e) Bonuses are a combination of vested and *non-vested bonuses*. Declared vested reversionary bonuses are added to the policy and cannot be removed. Declared non-vested terminal bonuses (or a portion thereof) may, however, be removed or reduced to maintain the solvency of the policyholder fund. Non-vested terminal bonuses will only be removed or reduced by the Sanlam Life Board, based on a recommendation from the *statutory actuary*, when the *funding level* becomes unacceptably low.

f) Bonuses are declared annually in arrear for the last *policy year*. Interim bonus rates apply to the period from the previous policy anniversary (for which the last bonus was declared) to the claim date.

2.4 Principles regarding investment strategy

a) An *Asset-liability committee (ALCO)*, comprising Sanlam Life employees with actuarial, investment and client solution backgrounds, oversees the investment policy for the reversionary bonus portfolio.

b) The aim is to find the optimum balance between attractive investment returns and stable investment returns, given the need to meet smoothed benefits and to support the granting of bonus rates in line with the product design.

c) Policyholders' funds are managed separately from shareholders' funds.

d) The requirements for the investment management are set out in investment guidelines, with a view to managing risk through:

- limits on exposure to *volatile assets*;
- limiting credit risk to investment grade or higher rated debt instruments. Adequate diversification is also ensured by setting limits for any single counter party. There is no limit on exposure to the RSA government, since this is considered risk free;
- limits on asset concentration – particularly with regard to *strategic investments* and Sanlam Limited shares. The exposure of policyholders' portfolios to these investments is based on portfolio investment considerations and is restricted with reference to a specific counter party's weight in the *benchmark portfolio*;
- limits on exposure to some types of assets, such as assets that cannot be easily liquidated and unlisted equities; and
- compliance with regulatory constraints.

e) The guidelines contain benchmarks for the performance measurement of each asset class and limits on deviations from these benchmarks to help manage returns on portfolios.

f) Feedback on the investment policy, its implementation and the performance of the smoothed bonus portfolios is provided regularly to the Asset Liability Committee and the Sanlam Life Board.

g) Some portfolios may invest in one or more of the managed asset classes in order to improve the diversification of these portfolios. Managed asset classes include amongst others: *hedge funds*, *exchange-traded funds*, property investments, private equity investments, *derivatives*, credit conduits, etc. The managers of these managed asset classes, which may include companies within the Sanlam Group, deduct their management fees and expenses directly from the investment returns. These deductions are in addition to the charges contained in the *actuarial basis*.

h) *Derivative* instruments may be utilised:

- to hedge the portfolio against unforeseen circumstances;
- for strategic and tactical asset allocation; and
- to take advantage of anomalies or inefficiencies in the *derivative* market pricing in order to enhance returns.

Derivatives may not be used to speculate.

2.5 Principles regarding surrender values and other early terminations benefits

Sanlam Life aims to pay out amounts that do not have a materially adverse effect on continuing policies. When the market value of a reversionary bonus product is less than the *book value*, *market value adjusters* (MVAs) will normally be applied to the *book value* to reduce the amount paid to members who choose to leave the reversionary bonus product early.

2.6 Principles regarding charges

a) Expenses are recovered from policyholders' funds for, inter alia:
- administration and marketing;
- tax; and
- other regulatory charges.

b) A profit charge equal to $1/9^{th}$ of the value of the bonuses that vest that year, is charged to the reversionary bonus portfolio. This provides reasonable rewards to shareholders given the need for capital to operate life insurance business (and reversionary bonus business in particular) and the need for fair compensation for risks assumed.

c) Expenses are recovered mindful of the need to provide competitive products that provide value for money to policyholders.

d) Reversionary bonus policies were issued prior to Sanlam Life's demutualisation. Therefore, the *statutory actuary* has to certify that changes in expenses are fair in relation to expenses charged in the market and inform the Financial Services Board of such changes.

2.7 Principles regarding new business and portfolio mergers

a) The Reversionary Bonus product is closed to new business.

b) It may be in the best interest of policyholders in a *diminishing mature portfolio*, to have their diminishing portfolio combined with a larger portfolio. This will entail a transfer of the market value, including the *Bonus Stabilisation Reserve*, from the diminishing portfolio to the larger portfolio. This will only be done if equity is achieved between the portfolios being combined.

2.8 Principles regarding financial assistance

It is a statutory requirement to provide financial support to *under-funded* portfolios if the deficit in the portfolio is not expected to be eliminated within the next three years. The Sanlam Life Board may also decide to provide support under other circumstances if it is deemed to be in shareholders' interests. The support will normally be in the form of interest-free loans that may be recovered from the portfolio if the loans are no longer considered necessary.

2.9 Governance

A sound governance structure is needed to manage *discretionary participation business*, which forms a substantial proportion of Sanlam Life's liabilities. The Sanlam Life Board is ultimately responsible for the governance of *discretionary participation business*, but a number of parties assist in this regard, including:

- the Sanlam Audit, Actuarial and Finance Committee;
- the Sanlam Customer Interest Committee;
- the Asset Liability Committee (ALCO);
- the *statutory actuary*; and
- the external auditors and their actuarial resources.

Section 3 – Reversionary Bonus Portfolio

3.1 Overview of the Reversionary Bonus Portfolio

This is a portfolio where investment returns are smoothed by way of annual bonus declarations. The vested benefit and the non-vested benefit are paid on maturity.

If the market value of the assets in the portfolio is greater than the *book value*, a positive *bonus stabilisation reserve* is created, which will be used to enhance future bonuses. Conversely, if the market value of the assets is less than the *book value*, a negative *bonus stabilisation reserve* is created, which will be eliminated by lower bonuses in the future.

3.2 Principles of managing the Reversionary Bonus Portfolio

The benefit under a Reversionary Bonus policy consists of various parts:

- the vested sum assured as chosen on the inception date of the policy,
- vested reversionary bonuses on the sum assured,
- vested reversionary bonuses on reversionary bonuses accumulated to date,
- non-vested terminal bonuses as a percentage of the sum assured,
- non-vested terminal bonuses as a percentage of reversionary bonuses accumulated to date.

Reversionary bonuses on the sum assured and accumulated reversionary bonuses vest immediately. All other bonuses are non-vesting and can be removed if financial conditions change.

Vested and non-vested benefits are payable on the maturity date but not at early termination.

The *demutualisation rules* determine that reversionary bonus rates have to exceed specified minimum rates set by reference to the bonus rates that applied at the time of demutualisation, and the change in the expected long-term future rate of return (net of tax) since demutualisation.

3.3 Practices of managing the Reversionary Bonus Portfolio

3.3.1 Practices regarding bonuses:

a) Bonuses are declared annually in arrears for the period 1 October of the previous year to 30 September.

b) Bonuses are declared net of charges and tax.

c) Interim bonus rates are reviewed regularly and may be changed retrospectively between bonus declaration dates, based on the investment returns actually earned. Interim bonuses would normally be equal to the last declared bonus.

d) Reversionary bonus rates have to exceed specified minimum rates as determined by the *demutualisation rules*. Given this requirement, the starting point for a bonus declaration is to calculate the *funding level* before declaration, which are a function of the current bonuses on the policy (assuming the previous reversionary bonus rates apply in the future) and the expected long-term rate of return on the assets underlying the policy. In the calculation of the *funding level,* provision is made for future bonuses that are expected to be declared to ensure policyholders shall receive reasonable benefits compared to the assets underlying their policies.

- If the *funding level* is between 100% and 103%, the declared reversionary bonus rates are equal to the maximum of the previous year's reversionary bonus rates and the minimum rates according to the *demutualisation rules*. The non-vesting claim bonuses are kept unchanged.
- If the *funding level* is above 103%, 1/5th of the surplus above 3% is used to increase non-vested terminal bonuses.
- If the *funding level* is significantly above 103% (in the region of 110% or more) after the increase in non-vested terminal bonuses have been declared, a portion of the surplus above say 110% may (depending on market conditions) be declared as an additional non-vested bonus.
- If the *funding level* is lower than 100%, the non-vesting terminal bonuses may be reduced or removed in order to remove the shortfall. The difference between the actual *funding level* and 100% is removed over a period, depending on the number of consecutive years during which the *funding level* was lower than 100%

3.3.2 Investment practices

a) Sanlam Investment Management (SIM) manages most of the assets.

b) The current investment guideline limits the maximum exposure to *volatile assets* to 59% of the portfolio.

c) Credit risk is limited to investment grade debt instruments. Fixed-interest instruments with any counter party, other than the RSA government, may not comprise more than 20% of the market value of RSA fixed interest and RSA cash components of the portfolio.

d) The maximum offshore exposure is subject to limits prescribed by the regulatory authorities.

e) ALCO can increase or decrease the above limits, subject to regulatory requirements, by up to 10% as circumstances change. For example, it can increase the maximum exposure to *volatile assets* from 59% to 69%.

3.3.3 Practices regarding charges

a) Tax and any other statutory charges are levied according to the applicable policyholders' fund.

b) The implicit fund charges (including any investment management performance charges) are taken into account when bonuses are declared and are contained in the *actuarial basis*.

c) Any changes to charges are subject to:

- the *demutualisation rules* permitting such changes;
- the *actuarial basis* permitting such changes; and
- approval by the *statutory actuary*.

According to the *demutualisation rules*, the unit costs charged to the portfolio may not exceed the previous year's actual unit costs increased by inflation. The *statutory actuary* should be satisfied that any change to charges is reasonable, based on actual past and expected future experience.

3.3.4 Practices regarding movements out of the fund (other than benefit payments on maturity)

On early termination, the *book value* (which allows for the loss of future premiums) is payable. But if the market value is less than the *book value*, *market value adjusters* (MVAs) will be applied to the *book value* to reduce the amount paid to policyholders.

Annexure 1 – Glossary

Actuarial basis – In relation to a policy, this means the underlying actuarial rules, specifications and formulae in terms of which the policy operates, which:

a) in compliance with the Long-Term Insurance Act, 1998 are approved by the *statutory actuary* of the insurer, in particular for the purposes of sections 46 and 52; and

b) if and while the Insurance Act, 1943 applied to the policy, in compliance with that Act, were approved by the valuator of the insurer, in particular for the purposes of sections 34 and 62(2) of that Act.

Asset-liability committee (*ALCO*) – A committee of investment and actuarial professionals that determines the investment strategy for the asset portfolios underlying the *discretionary participation business.*

Benchmark portfolio – The portfolio against which performance is measured.

Bonus Stabilisation Reserve (BSR) – The difference between the market value and the *book value* of a portfolio.

Book value – The *book value* is calculated on a prospective basis and equals the discounted value of the projected vested benefit plus the discounted value of the projected non-vested benefit less an adjustment to allow for the loss of expected future premiums. In this calculation provision is made for future bonuses that are expected to be declared to ensure policyholders shall receive reasonable benefits compared to the assets underlying their policies. The vested benefit is calculated as the sum assured plus reversionary bonuses on the sum assured plus further reversionary bonuses on the accumulated reversionary bonuses. The non-vested benefit is the non-vested terminal bonuses on the sum assured and on the reversionary bonuses. Declared bonuses are net of charges and tax.

Demutualisation Rules – Restrictions on changes to charges as set out in Sanlam's demutualisation proposal. These restrictions are applicable to policies in force on the demutualisation date. In the case of the pre-demutualisation policies, the *statutory actuary* has to certify that changes in charges are fair in relation to charges in the market and inform the FSB of such changes.

Derivative – a contract whose value is derived from that of other investment instruments.

Diminishing mature portfolio – A mature portfolio (often closed for new business) is one where the claims paid out are greater than the new premiums being received. The portfolio becomes so small that it is difficult to manage on its own.

Discretionary participation business – Any business that allows discretion to be used in the way bonuses are declared. All Sanlam Life's *smoothed bonus products* fall into this category.

Exchange traded funds – ETFs are investments that try to replicate a stock market index such as the ALSI40.

Funding level –The *funding level* is the ratio of market value to *book value* of a portfolio.

Hedge fund – A portfolio which uses any strategies or takes any positions that could result in the portfolio incurring losses greater than its total market value at any point in time, and which strategies or positions include but are not limited to short positions. A short position is where a seller for delivery sells an asset at a future date or time, and the seller does not own such asset at the time of the sale. Though *hedge funds* do not necessarily hedge their investments against adverse market moves, the term is used to distinguish them from regulated retail investment funds, for example collective investment schemes.

Market value adjuster / adjustment – This is the reduction of early termination values, based on the current level of the market, to protect remaining policyholders.

Non-vested bonuses – Bonuses that can be removed under certain circumstances.

Policy year - The 12 month period from one policy anniversary to the next policy anniversary.

Smoothed Bonus products – Sanlam Life's business that allows discretion to be used in the way bonuses are declared.

Statutory actuary – The actuary whose main role is to certify that in his (or her) professional actuarial opinion a life insurance company is conducting business on a financial sound basis.

Strategic investments – Sanlam Life's investments in subsidiary and associated companies.

Surrender – When a policy is terminated on request of the policyholder before the policy's maturity date.

Under-funded – When the liabilities are more than the assets in the portfolio, i.e. when the portfolio is less than 100% funded. The *Bonus Stabilisation Reserve (BSR)* will then be negative.

Vested bonuses – Bonuses that may not be taken away.

Volatile assets – The value of these assets is expected to vary considerably over time. Volatile asset classes include equities and international investments.