Principles of Financial Management for Sanlam Corporate Participating Annuity Products

Sanlam Corporate: Investments

Contents Page

Introduction

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), Sanlam Corporate (SC) and Sanlam Developing Markets (SDM) are part of the Retail cluster. SPF and SDM provide individual life insurance (including retirement annuities) and personal financial services and products. SC provides life insurance, investment and annuity products for group schemes and retirement funds as well as medical aid solutions.

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

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 not a comprehensive explanation of the management of the *discretionary participation business* or 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 SC *smoothed bonus products*
- PPFM for SPF reversionary bonus products
- PPFM for Sanlam Life participating annuity products
- PFM for Sanlam Life linked and market-related products
- PFM for SC Provider pension products

Note

Items in italics are defined in the glossary (Annexure 1)

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 Sanlam Life's *participating annuity products* fall into the *discretionary participation business (or smoothed bonus products)* category.

This document comprises the PPFM for the following participating annuity products:

- Bonus Pensions
- Bonus Annuities
- Quantum Pensions

The Quantum Pensions range was launched in 2002 with higher guarantee premiums than Bonus Pensions. These were reduced in 2005 to align with those of Bonus Pensions. All *participating annuity* products are therefore treated as one in this document.

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.

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 its Policyholders' 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 Policyholders' 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.

Principles of Financial Management

The principles in section 2 cover all the *participating annuity products*.

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.

Principles regarding the general management of smoothed bonus business

Sanlam Life applies the following key principles to its *participating annuity products*.

a) *Participating annuity products* have separate assets that are used to support the benefits of the particular policyholders as a group. The assets are increased by *net premiums* and adjusted with investment returns earned, which can be positive or negative. It is reduced by pension payments, *terminations*, charges and applicable taxes, which are deducted from the portfolio. The value of the underlying assets of the participating annuity products is also called the market value of these products.

   The *book value* is calculated on a prospective basis on the valuation date, as the discounted value of the expected future income benefit payments (including an allowance for future charges). Both the expected future increases and discount rate used in this calculation are based on the expected long-term rate of return on the assets underlying the product. The current income used to determine expected future income benefit payments depends on the policyholders' initial pension and the past declared bonuses up to the valuation date.

   As bonuses are smoothed, changes in the market value of the assets are not directly or immediately reflected in changes to the *book value*. 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 market value to *book value*.

   Participating annuity policyholders share in the investment returns of their underlying portfolio. They also share in the profits or losses, resulting from differences between market value and *book value* when benefits are paid, as well as experience profits and losses arising from mortality. This means that policyholders are exposed to the investment risk (including credit risk) and mortality risk, but not to the other *business risks*. Sanlam Life shareholders are exposed to the risks and rewards associated with those *business risks*.

   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 and pricing to fit together. Particular attention is therefore paid to the following elements during the design and ongoing management of our *smoothed bonus products*:

   - pricing and reserving for smoothed benefits provided;
   - investment policy;
   - the nature of bonuses declared – declared annually in advance for *participating annuity products*;

- policyholder expectations, in particular with regard to bonuses, through marketing material, policy contracts and other communication that are accurate and easy to understand; and
- benefits payable in case of *terminations*.

Principles regarding bonuses

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

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 various smoothed bonus portfolios.

b) The aim is to find the optimum balance between attractive investment returns and stable investment returns, given the need to meet guaranteed benefits and to support the granting of stable 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 manage 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's weight in the *benchmark portfolio*;
- limits on exposure to certain types of assets, such as assets which 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.

Principles regarding *terminations* and *partial termination* benefits

Sanlam Life aims to pay out amounts that do not have a materially adverse effect on continuing policies. *Book value* (less the allowance for future charges) is paid out immediately, unless it is considered not to be in the interests of remaining policyholders, in which case either market value is paid or the payment may be deferred over a number of years.

Principles regarding charges

a) Charges, as applicable, will be recovered from the policyholders' funds for, inter alia:

- marketing and administration expenses;
- investment activities and other guarantees;
- tax (if applicable); and
- other regulatory charges.

b) The charges are set mindful of the need to provide competitive products that provide value for money to policyholders and reasonable profits to shareholders. Charges also take into account the need for capital to operate a life insurance business (and smoothed bonus business in particular) and the need for fair compensation for risks assumed.

c) No explicit profit charges are taken, but profit will arise from the difference between charges taken and expenses incurred.

d) The charges are specified in the *actuarial basis* that applies to a specific policy.

e) Rand based charges are increased in line with the declared bonus rate, as specified in the *actuarial basis*.

f) Charges are used, inter alia, to pay for policy expenses. Policy expenses may change in the long term. If the *actuarial basis* permits it Sanlam may, in addition to the inflationary increases, also change the charges. The *statutory actuary* should be satisfied that any change to charges is reasonable, based on actual past and expected future experience.

g) In the case of policies issued prior to Sanlam Life's demutualisation, the *statutory actuary* has to certify that changes in charges are fair in relation to charges in the market and inform the Financial Services Board of such changes.

Principles regarding new business and portfolio mergers:

a) The *participating annuity products* are closed to new clients.

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.

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 3 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.

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 Board's Audit, Actuarial and Risk Committee;
- the Board's Policyholders' Interest Committee;
- the Asset Liability Committee (ALCO);
- the *statutory actuary*; and
- the external auditors and their actuarial resources.

Participating Annuities

Overview of Participating Annuities

This is a portfolio where investment returns are smoothed by way of annual bonus declarations. The annual increase that pensioners receive is based on the bonus declared and the *purchase rate*.

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.

The Participating Annuity portfolios are closed to new clients.

Principles

Bonuses vest fully for future income benefit payments and may not be taken away by declaring negative bonuses.

Practices

Practices regarding bonuses

a) Bonuses are declared annually in advance according to the bonus philosophy approved by the Sanlam Life Board. The Sanlam Life Board receives an annual bonus report and must approve any changes to the philosophy.

b) Bonuses are declared net of charges and tax in the policyholders' fund (if applicable).

c) The starting point is to set bonuses equal to the expected long-term rate of return on the assets underlying the fund and then to adjust these bonuses with actual experience to date (as reflected by the *funding level*). The difference between the actual *funding level* and 100% is normally added to the bonus over a rolling 4-year period. The following exceptions apply:

- Net surpluses that arise due to reductions in the expected long-term rate of return may be spread over the full future lifetime of the portfolio.
- The bonus is subject to a minimum of the *purchase rate*.

d) Bonuses are declared annually in advance based on the position of the fund at 31 December.

Investment practices

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

b) The investment guideline limits the maximum exposure to *volatile assets* having due regard to the nature of the product and the income benefit payments guaranteed.

c) Credit risk is limited to investment grade debt instruments, although there will not necessarily be exposure to the lowest grade. 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 South African Reserve Bank (SARB).

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 maximum exposure to *volatile assets* from say 10% to 20%.

Practices regarding charges

a) If applicable, tax and any other statutory charges are levied.

b) The fund charges (including any investment management performance charges) are contained in the actuarial basis.

c) Any changes to charges are subject to:

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

d) The *statutory actuary* should be satisfied that any change to charges is reasonable based on actual past and expected future experience.

Practices regarding movements out of the fund

Four calendar months' written notice is required for all *terminations*. The lower of *book value* (less the allowance for future charges) and market value is paid out, unless it is considered not to be in the interests of remaining policyholders to pay out *book value* immediately. Payment is then made over a period which must not exceed 3 years.

Further Information

Sanlam Corporate specialises in the provision of risk, investment and administration services to institutions and retirement funds. Focused on meeting the unique needs of its diverse clients, Sanlam Corporate assists companies to create and deliver customised employee benefits solutions, including the collection of premiums and communication to fund members. For more information, please visit www.sanlam.co.za or contact:

Karen Wentzel
Head: Annuities
Sanlam Corporate
Tel: 021 950 2974
Email: karen.wentzel@sanlam.co.za

Archie Bezuidenhout
Annuities Support
Sanlam Corporate
Tel: 021 950 2972
Email: archie.bezuidenhout@sanlam.co.za

Sanlam Corporate (SC) is an operating division of Sanlam Life Insurance Ltd, which specialises in the provision of risk, investment and fund administration services to institutions and retirement funds.

Sanlam Life Insurance Ltd is an authorised financial services provider.

Registration Number 1998/021121/06

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

Book value is calculated on a prospective basis, on the valuation date, as the discounted value of expected future income benefit payments (including an allowance for future charges). Both the expected future increases and discount rate used in this calculation are based on the expected long-term rate of return on the assets underlying the product. The current income used to determine expected future income benefit payments depends on the policyholders' initial income and the past declared bonuses up to the valuation date. Declared bonuses are net of charges and tax recovered in the fund (if applicable).

Business risks

The risk of losses due to the actual experience being different from the assumptions made when pricing a product. *Business risks* also include the risk of losses incurred in respect of other products.

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 an asset is sold by a seller for delivery 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.

Partial terminations

Removing part of the funds under Sanlam Life's management from Sanlam Life's portfolios or products. This is only allowed by means of an approved transfer to another pension fund or another insurer.

Private equity investments

Private equity is a broad term that commonly refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market.

Purchase rate

The interest rate used when calculating the initial income benefit payment for a participating annuity at new business stage.

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 subsidiaries and associated companies.

Terminations

Removing funds under Sanlam Life's management from Sanlam Life portfolios or products. This is only allowed by means of an approved transfer to another pension fund or another insurer.

Under funded

When the liabilities are more than the assets in the portfolio, i.e. when the portfolio is less than 100% funded.

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.

Sanlam

Wealthsmiths™