Principles and Practices of Financial Management

Sanlam Developing Markets Limited's Individual Smooth Bonus Products

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Principles and Practices of Financial Management For Sanlam Developing Markets Limited's Individual Smooth Bonus Products

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Section 1 Introduction

1.1 INTRODUCTION

Smooth bonus products insured by Sanlam Developing Markets Limited require discretion to be applied by the company to determine the bonus rate declared on these policies. The Financial Services Board of South Africa has issued directive 147 that requires all companies that offer products that allow for the discretionary allocation of returns, to document the principles and practices applied in determining those returns.

Sanlam Developing Markets Limited accepts the principle that policyholders have the right to full disclosure of issues that affect the value of their policy, and therefore provides these principles and practices of financial management in the interests of our policyholders and sound corporate governance.

Sanlam Developing Markets Limited has in the past offered two products that had the option to earn smooth bonus returns. These products are endowment policies and retirement annuities and have elsewhere been described as participating in a "Quasi-linked" portfolio.

This document is not intended to be a complete description of the financial management of these products. If in any instance this document contradicts the policy wording, the policy wording would take precedence. These principles and practices have been approved by the Sanlam Developing Markets Limited board and apply from 31 December 2007.

1.2 PRINCIPLES AND PRACTICES

Principles describe the standards which are applied in general to the smooth bonus products in order to balance the need to meet the reasonable expectations of policyholders with the need to maintain the long term solvency of the portfolio while achieving equity between cohorts of policyholders. This must be achieved in an environment of uncertain future economic circumstances.

Practices offer in more detail the specific features of these products and the actions applied to manage these products. These features and management actions are consistent with the principles set out in this document.

The principles provide a benchmark to ensure that the development of future products and management actions do not breach these principles.

1.3 GOVERNANCE AND COMPLIANCE

The Sanlam Developing Markets Limited board is responsible for the performance of the smooth bonus portfolios relative to their obligations. The governance structure put in place by the board comprises:

- The board's Finance, Actuarial and Risk Committee which receive reports from the internal audit, manager, the risk manager and the compliance officer.
- The statutory actuary
- The actuarial committee
- The management committee of the Sanlam Developing Markets Limited operation
- The external auditors and their actuaries.

The Sanlam Developing Markets Limited board is responsible for this document and the governance of the smooth bonus products. The actuarial committee and statutory actuary apply the principles and practices in making recommendations to the board.

The compliance officer is tasked by the board's Finance, Actuarial and Risk Committee to monitor compliance with these principles and practices.

Section 2 General Principles

The principles set out in this section apply to both types of smooth bonus products – the endowment policies and the retirement annuities.

2.1 LEGAL AND CONTRACTUAL REQUIREMENTS

Smooth bonus products are managed to comply with relevant legislation and to meet contractual requirements. Contractual requirements arise from the policy contract issued to the policyholder.

Operation of the smooth bonus products will comply with the product specification agreed to with the statutory actuary of Sanlam Developing Markets Limited.

Requirements may arise from time to time from regulators and industry bodies that will be complied with.

2.2 MANAGEMENT

Each product has its own asset portfolio to back the benefits promised by the policy contract. The assets are increased by allocated premiums invested and positive investment returns earned on the portfolio of assets. The assets are reduced by charges, fees, taxes, benefit payments and any negative investment returns. Each policyholder will have a notional share of the product asset portfolio.

Each policy will have a book value which is determined by accumulating the allocated premiums invested at the bonus rates declared at regular intervals. The book value of any policy is increased by premiums allocated and bonuses declared. The book value is reduced by benefits paid out. In specific circumstances the book value may be reduced by either a market value adjustment or by the removal of previously declared non-vested or interim bonuses.

The allocated premiums used for accumulating the notional asset share and book value of each policy, are determined from the product specification and any unallocated premiums are a charge by Sanlam Developing Markets Limited for the administration and servicing of the policy.

The total benefit payable to policyholders is the sum of the book value of each policy. The difference between the total asset value and the total book value is called the bonus stabilisation reserve.

The bonus stabilisation reserve is the amount of money available to enhance future bonuses even though the actual returns then may be lower than required or negative. This means that policyholders do not experience the returns on the portfolio of assets directly on their policy. The variable (positive or negative) returns experienced on the underlying portfolio can be spread out over time.

If the bonus stabilisation reserve is negative, then the solvency position of the portfolio is restored by applying the following, generally in this order:

- Declaring bonuses lower than the actual returns earned
- Removing non-vested or interim bonuses
- Applying a market value adjustment on early termination of the policy

Bonus rates declared for policyholders are only dependent on the investment returns on the specific portfolio backing the product the policyholder has bought. Policyholders do not share in profits or losses arising from investment returns on other portfolios or from experience of mortality, expenses, lapses etc. being different from that expected.

2.3 INVESTMENT STRATEGY

The Sanlam Developing Markets Limited board delegates the responsibility for the investment strategy of the Sanlam Developing Markets Limited investment portfolios to the investment committee. The strategy adopted for portfolios backing smooth bonuses will take into account recommendations from the actuarial committee and the statutory actuary.

The investment strategy will aim to balance the need to achieve competitive, market related returns without excessive volatility and the need to meet guaranteed benefits.

The policyholder portfolios are managed separately from shareholders portfolios as the expectations, time horizons and tolerance for risk are different. The policyholder portfolio is managed according to an investment guideline document which sets out amongst other things:

- The objective of the portfolio and a benchmark portfolio against which its performance will be measured
- The limitations placed on the exposure to various asset classes
- The limitations on the use of specialised investments, such as derivatives, hedge funds and options
- The limitations on the exposure to any one counterparty
- The minimum level of security with regards to credit risk for any investment
- The fees payable to the asset manager
- The regulatory constraints that the portfolio management must comply with.

The investment committee receives quarterly feedback on the performance of the portfolios and a monthly compliance report advising them of any breaches of the investment guidelines.

The portfolio may not speculate in derivatives and the use of derivatives is limited to:

- managing the risk of the portfolio, especially while rebalancing the portfolio
- taking advantage of pricing anomalies between the derivatives market and the spot market

2.4 BONUSES

The bonus philosophy and the bonus rates declared are approved by the board on recommendation by the statutory actuary.

The bonuses declared over time are intended to be consistent with the investment returns earned on the underlying portfolio net of taxes, charges and fees. The bonus declaration must balance the conflicting objectives of smoothing the investment returns over time and achieving equity between different policyholders participating in the portfolio over different time periods.

The statutory actuary will apply discretion in recommending a bonus declaration to the board. In making this recommendation, the statutory actuary will consider among other things:

- the long term expected return on the underlying portfolio
- the outlook for future economic circumstances
- the release or recovery of the bonus stabilisation reserve over a suitable time period
- the charges, fees and tax applied to the portfolio.

Discretion is also applied in determining how much of the bonus can be declared as a vested bonus which is guaranteed. Non-vested bonuses are not guaranteed and can be removed should the funding position of the portfolio justify this.

Special once-off bonuses can be declared where the bonus stabilisation reserve is considered large and that by releasing it over time will result in inequity between policyholders.

The bonus rate is declared net of all charges, fees and taxes.

2.5 CHARGES

Charges are recovered from the investment returns earned and on the capital invested in the underlying portfolio. The charges cover the cost of:

- administration
- asset management
- taxes
- regulatory charges

These charges are taken into account when declaring the bonus.

There is no specific charge for profit and profit for the shareholders of Sanlam Developing Markets Limited arises from the difference between the charges levied and the cost.

2.6 EARLY TERMINATION

The payment of benefits on early termination of policies either as a result of a surrender or transfer to another fund should not materially affect the value of the benefits to policyholders that remain in the portfolio. During periods when the bonus stabilisation reserve is negative, Sanlam Developing Markets Limited may apply a market level adjustment for that period to ensure that book value paid is not unreasonably higher than the market value, resulting in a strain on the funding level of the portfolio.

The principles of the regulations (Part 5) of the Long Term Insurance Act are applied in determining early termination values.

2.7 NEW BUSINESS

Neither the current endowment nor the retirement annuity products offer the option to participate in a smooth bonus portfolio. The investment portfolios are therefore closed to new business but continue to receive allocated premiums from policies sold in the past.

Sanlam Developing Markets Limited may review this in future should a suitable opportunity arise and in doing so will consider any impact on existing policyholders.

2.8 FINANCIAL SUPPORT

In the event that the policies are underfunded, the following actions are possible and are in general applied in the order presented:

- Lower bonus than would be declared if the funding position was satisfactory.
- Removal of interim and non-vested bonuses.
- Applying a market level adjustment on policies terminating earlier than expected.
- Sanlam Developing Markets Limited’s shareholders provide financial support.

The support by Sanlam Developing Markets Limited will normally be in the form of an interest free loan to the policyholder portfolio, which is repayable if and when the funding position of the portfolio is restored to an acceptable level.

If the funding level falls below 92.5% it must be published in the group's financial statements.

Section 3 Practices for Smooth Bonus Retirement Annuity Policies

3.1 INVESTMENT STRATEGY

The investment strategy is determined by Sanlam Developing Markets Limited's investment committee. The investment committee will review the portfolio from time to time with regards to:

- the investment strategy considered suitable
- the appointment of the asset manager
- the limitations imposed on the asset manager
- the performance of the portfolio relative to expectations; and
- regulatory requirements.

Sanlam Investment Management is the current asset manager and the current investment strategy of the retirement annuity portfolio aims to achieve:

- A long term (5 years +) real return that is competitive in the market
- Moderate to high risk that recognises that the proceeds of a retirement annuity are to supplement retirement income
- Limited liquidity due to the expected long term nature of the underlying policy contracts
- Compliance with Regulation 28 of the Pensions Fund Act
- Appropriate diversification of investments between asset classes and within each asset class.

3.2 BONUSES

Bonuses declared by the board may comprise of:

- A vested bonus
- A non-vested bonus
- An interim bonus
- A special once off non-vested bonus.

The total bonus rate in any period is set on the basis of the long term expected return on the underlying portfolio net of charges, fees and taxes. The allocation of the bonus between vested and non-vested bonus is at the discretion of the statutory actuary and takes into consideration:

- the long term inflation expectation
- the nature of the returns earned
- the charges, fees and taxes

If after the bonuses referred to above have been declared the bonus stabilisation reserve is considered excessive, then a special once-off non-vesting bonus may be declared additionally.

If the bonus stabilisation reserve is positive, the excess cumulative return held back is generally released over a 5 year period to supplement the non-vested bonus in the current year. The vested and non-vested bonus will be reduced if the bonus stabilisation reserve is negative.

Bonuses are declared annually and apply from 1 January each year and notification of the declaration will be made to policyholders. Bonuses are declared net of tax and all charges.

3.3 CHARGES

Charges are levied by Sanlam Developing Markets Limited on the portfolio of assets and fees may be incurred in the use of service providers. Neither these charges nor the fees are guaranteed and may be altered by Sanlam Developing Markets Limited, giving the appropriate notice to the policyholder.

The fees currently levied against the portfolio to cover the cost of the asset management services are:

- 0.15% per annum of the value of local assets
- 0.75% per annum of the value of foreign assets
- a sliding scale depending on performance up to a maximum of 0.45% per annum.

In addition VAT is paid on these fees.

The following charges are currently levied to cover Sanlam Developing Markets Limited's expenses when providing the investment portfolio and the administration of the smooth bonus option:

- 10% of the return earned each year
- 1.5% per annum of the value of the portfolio

VAT does not apply to these charges.

No tax is currently charged against this portfolio, however, if any tax or a regulatory levy is imposed in future these would be charged to the portfolio.

3.4 EARLY TERMINATION

The book value of the policy is paid out on early termination, prior to the original maturity date. Penalties are applied to the benefit proceeds as specified in the policy document. In addition, if the asset value of the portfolio is less than the total book value a market level adjustment may be applied to all policies terminating at that time.

All early termination values take into account the regulations in the Long Term Insurance Act relating to minimum values in the event of premiums ceasing prior to the original maturity date of the policy.

Section 4 Practices for Smooth Bonus Endowment Policies

4.1 INVESTMENT STRATEGY

The investment strategy is determined by Sanlam Developing Markets Limited's investment committee. The investment committee will review the portfolio from time to time with regard to:

- the investment strategy considered suitable
- the appointment of the asset manager
- the limitations imposed on the asset manager
- the performance of the portfolio relative to expectations; and
- regulatory requirements.

Sanlam Investment Management is the current asset manager and the current investment strategy of the endowmment portfolio aims to achieve:

- A gross return that exceeds inflation by 5% over a rolling 3 year period
- Stable returns over the short term (< 5 years)
- Moderate to low risk
- High degree of liquidity

To meet this objective an absolute return portfolio has been selected for which the benchmark is a gross return of inflation plus 5% over a three year period. The portfolio manager is incentivised to achieve more than this up to prudent limits.

4.2 BONUSES

Bonuses declared by the board may comprise of:

- A vested bonus
- A non-vested bonuses
- An interim bonus
- A special once-off non-vested bonus

The total bonus rate in any period is set on the basis of the long term expected return on the underlying portfolio net of charges, fees and taxes. The allocation of the bonus between vested and non-vested bonus is at the discretion of the statutory actuary and takes into consideration:

- the long term inflation expectation
- the nature of the returns earned
- the charges, fees and taxes

If after the bonuses referred to above have been declared the bonus stabilisation reserve is considered excessive, then a special once-off non-vesting bonus may be declared additionally.

If the bonus stabilisation reserve is positive the excess cumulative return held back is generally released over a 3 years period to supplement the non-vested bonus in the current year. The vested and non-vested bonus will be reduced if the bonus stabilisation reserve is negative.

Bonuses are declared annually and apply from 1 January each year and notification of the declaration will be made to policyholders. Bonuses are declared net of tax and all charges.

4.3 CHARGES

Charges are levied by Sanlam Developing Markets Limited on the portfolio of assets and fees may be incurred in the use of service providers. Neither these charges nor the fees are guaranteed and may be altered by Sanlam Developing Markets Limited, giving the appropriate notice to the policyholder.

The fees currently levied against the portfolio to cover the cost of the asset management services are:

- 0.15% per annum of the value of local assets
- 0.75% per annum of the value of foreign assets
- a sliding scale depending on performance up to a maximum of 0.45% per annum.

In addition, VAT is paid on these fees.

The following charges are currently levied to cover Sanlam Developing Markets Limited's expenses when providing the investment portfolio and the administration of the smooth bonus option:

- 10% of the return earned each year
- 1.5% per annum of the value of the portfolio

VAT does not apply to these charges.

Tax is currently charged against this portfolio at the required rate and subject to change depending on future legislation and regulations.

4.4 EARLY TERMINATION

The book value of the policy is paid out on early termination, prior to the original maturity date. Penalties are applied to the benefit proceeds as specified in the policy document. In addition, if the asset value of the portfolio is less than the total book value a market level adjustment may be applied to all policies terminating at that time.

All early termination values take into account the regulations in the Long Term Insurance Act relating to minimum values in the event of premiums ceasing prior to the original maturity date of the policy.

Section 5 Glossary

Benchmark portfolio: The portfolio against which performance is measured.

Book value: This is the guaranteed benefit amount to be paid and is calculated as the net contributions plus declared bonuses, less any outflows.

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

Guaranteed payments: Payments that include all vested bonuses.

Non-vested bonuses: Bonuses that can be removed under adverse circumstances.

Partial terminations: Removing a part of the funds under Sanlam Developing Markets Limited's management from Sanlam Developing Markets Limited's portfolios or products.

Smoothed Bonus products: Sanlam Developing Markets Limited's business that allows discretion to be used in the way bonuses are declared.

Terminations: Removing funds under Sanlam Developing Markets Limited's management from Sanlam Developing Markets Limited's portfolios or products.

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 cannot be taken away for normal benefit payments.

Volatile assets: The value of these assets may vary considerably over time and include asset classes such as equities and international investments.