

Sanlam Life Insurance Limited
Principles of Financial Management (PFM) for Sanlam Life Linked and Market-Related 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 linked and market-related business long-term insurers must use their discretion particularly in relation to the management of investments. 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 business*¹. However, Sanlam Life decided to publish the Principles of Financial Management (PFM) also for linked and market-related business in the interest of transparency. It should be noted, however, that the PFM is neither a comprehensive explanation of the management of the linked and market-related business nor of every matter that may affect a particular policy contract.

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

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
- PPFM for Sanlam Life linked and market-related products
- PPFM 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*.

This document comprises the PFM for all Sanlam Life linked and market-related products, covering both SPF and SEB products.

1.3 Overview of linked and market-related products

A *linked policy* is a policy where the amount of the policy benefits is not guaranteed by Sanlam Life. The policy benefits are determined by the value of the underlying assets. The underlying assets are specified in the policy contract and are **actually held** by (or on behalf of) Sanlam Life for the policy.

A *market-related policy* is a policy, which is not a *linked policy*, where the amount of the policy benefits is not guaranteed by the Sanlam Life. The policy benefits are determined by the value of the underlying assets. **The policy also has a minimum performance guarantee** and the underlying assets are specified in the policy contract, but are **not necessarily held** by (or on behalf of) Sanlam Life for the policy.

1.4 Principles and Practices

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

- when discretion is applied in the management of linked and market-related business; and
- in response to longer-term changes in the business and economic environment.

This PFM only covers the principles and not the practices.

1.5 **Compliance**

The Sanlam Life Insurance Limited Board (“Sanlam Life Board”) is responsible for the governance of linked and market-related products written by Sanlam Life, and it has tasked the Sanlam Customer Interest Committee to monitor compliance with the PPFM on its behalf.

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

Section 2 – Overriding principles of financial management

The overriding principles in this section cover all linked and market-related products of Sanlam Life.

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 linked and market-related business

Sanlam Life applies the following key principles to its linked and market-related business.

- a) Each product has 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 benefit payments, *terminations*, charges and applicable taxes, which are deducted from the portfolio. The value of the underlying assets of a particular product is also called the market value of that product.

For the linked and market-related business, policyholders share in the investment return of their respective underlying portfolios. Policyholders do not share in experience profits and losses, for example those arising expenses. This means that policyholders are exposed to the investment risk (including credit risk), but not to other *business risks*. The 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 linked and market-related business:
- pricing and reserving for benefits;
 - investment policy;
 - policyholder expectations through marketing material, policy contracts and other communications that are accurate and easy to understand;
 - conditions for early withdrawal benefits, **for SPF products**; and
 - conditions for movements into and out of a fund to protect the interests of all policyholders, **for SEB products**.

2.3 Principles regarding investment strategy

- a) For linked policies the aim is to ensure alignment between underlying assets specified in the policy contract and assets actually held by (or on behalf of) Sanlam Life for the policy.
- b) For market-related policies the aim is to find the optimum balance between attractive investment returns and stable investment returns, given any minimum performance guarantee that must be met.
- c) Policyholders' funds are managed separately from shareholders' funds.
- d) The requirements for the investment management of each portfolio are set out in investment guidelines. For *market-related policies* the risk is managed 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) 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, *regulated funds*, 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*.
- g) *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.

2.4 Principles regarding *surrender* values and *terminations* benefits

For SPF products: *Surrender* value or *partial surrender* value equals the market value of the units cancelled less policy charges as indicated in the *actuarial basis*. *Switches* between investment funds are possible, but are subject to policy charges as indicated in the *actuarial basis*.

For SEB products: On termination or *partial termination*, a cash value equal to the market value of the units cancelled will be paid, provided that the appropriate notice period has been given and that there is no penalty or exit fee on termination indicated in the *actuarial basis*. Member *switches* between funds are possible at market value provided the required notice period has been given and subject to policy charges as indicated in the *actuarial basis*.

2.5 Principles regarding charges

- Charges, as applicable, will be recovered from policyholders' funds for, inter alia:
 - administration and marketing;
 - tax (if applicable);
 - other regulatory charges;
 - risk benefits (**for SPF products only**); and
 - investment activities and other guarantees.
- 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 the need for fair compensation to shareholders for risks assumed.
- No explicit profit charges are taken, but profit will arise from the difference between charges taken and costs incurred or risk benefits paid.
- The charges are specified in the *actuarial basis* that applies to a specific policy.
- Rand-based charges are increased to allow for inflation, as specified in the *actuarial basis*.
- Charges are used to, inter alia, 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 to charges are fair in relation to charges in the market and must inform the Financial Services Board of such changes.

2.6 Principles regarding new business and portfolio mergers

- a) The Sanlam Life Board manages the types and volumes of new business as part of its management of the overall risk, profitability and ongoing solvency of Sanlam Life.
- b) The Sanlam Life Board may close portfolios to new business if new business is no longer considered to be viable. Alternatively, adjustments may be made to the terms on which new business is accepted. The administration processes involved in the closing of portfolios to new business will then determine whether portfolios are closed or terms adjusted for new policyholders.
- c) 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 from the diminishing portfolio to the larger portfolio. This will only be done if equity is achieved between the portfolios being combined.

2.7 Governance

A sound governance structure is needed to manage linked and market-related business, which forms a substantial proportion of Sanlam Life's liabilities. The Sanlam Life Board is ultimately responsible for the governance of linked and market-related 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.

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.

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.

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.

Hedging – *Hedging* is a strategy designed to reduce exposure to market risk, for example a fall in equity prices.

Linked policy - A *linked policy* is a policy where the amount of the policy benefits is not guaranteed by the Sanlam Life. The policy benefits are determined by the value of the underlying assets. The underlying assets are specified in the policy contract and are actually held by (or on behalf of) Sanlam Life for the policy.

Market-related policy - A *market-related policy* is a policy, which is not a *Linked policy*, where the amount of the policy benefits is not guaranteed by the Sanlam Life. The policy benefits are determined by the value of the underlying assets. But the policy also has a minimum performance guarantee. The underlying assets are specified in the policy contract, but are not necessarily held by (or on behalf of) Sanlam Life for the policy.

Net Premiums – The premium less charges recovered from the premium.

Partial surrender - When part of a policy is surrendered on request of the policyholder before the policy's maturity date.

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.

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

Switches – Movement of funds between different Sanlam Life portfolios or products.

Terminations – Removing funds under Sanlam Life's management from Sanlam Life's portfolios or products.

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