Principles of Financial Management for Sanlam Corporate Provider Pension Products

Sanlam

Sanlam Corporate: Investments

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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) and Sanlam Developing Markets (SDM) are part of the Retail cluster. Sanlam Corporate (SC) is part of the Institutional 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 Provider Pension business, Sanlam Life must use discretion in implementing pension increases. Directive 147.A.i (LT), issued by the Financial Services Conduct Authority (FSCA), 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*[1]. However, Sanlam decided to publish the Principles of Financial Management (PFM) also for Provider Pension business in the interest of transparency. It should be noted, however, that a PFM is neither a comprehensive explanation of the management of the Provider Pension 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 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

1 Items in italics are defined in the Glossary

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 the SC Provider Pension

Overview of the Provider Pension

Provider Pensions guarantee to pay out the initial level of pensions plus any increases implemented over the remaining lifespan of pensioners. Provider Pension splits the assets into a guaranteed sub-portfolio to completely match the current level of pensions and a growth sub-portfolio to finance pension increases.

Principles and Practices

The **Principles** define the overarching standards that have been adopted to manage Sanlam Life's Provider Pension 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 Provider Pension products; and
- in response to longer-term changes in the business and economic environment.

This PFM only covers the principles and not the practices.

Compliance

The Sanlam Life Insurance Limited Board ("Sanlam Life Board") is responsible for the governance of Provider Pension products written by Sanlam Life, and it has tasked the Sanlam Customer Interest Committee to monitor compliance with the PFM 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.

Principles of Financial Management

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. These requirements apply if there is any inconsistency between them and the PPFM.

Principles regarding the general management of Provider Pension business

Sanlam Life applies the following key principles to its Provider Pension business.

a) Each product has two investment sub-portfolios:

- Guaranteed sub-portfolio:

  Sufficient assets are placed in a guaranteed sub-portfolio to finance the current level of pension payment for each pensioner. Thereafter, the return on the assets in the guaranteed sub-portfolio does not affect subsequent pension increases. Sanlam shareholders finance any shortfall which may occur and benefit from any surplus. See par. 2.2.d for details on the treatment of a shortfall or a surplus due to mortality experience.

- Growth sub-portfolio:

  The remainder of the assets is placed in a growth sub-portfolio and is used to finance pension increases.

b) Pension increases occur annually on the increase date. Sanlam calculates the pension increase that is expected to be sustainable over the future lifespan of the remaining pensioners. The amount required to secure a one-off increase for the current year, which is based on the new business rates, is transferred from the growth sub-portfolio to the guaranteed sub-portfolio.

c) Growth sub-portfolio:

   Each pension fund has separate assets that are used to finance the pension increase for that fund 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 charges, applicable taxes taken from the portfolio and transfers to the guaranteed sub-portfolio.

   For smaller funds and individual policyholders, the assets of the growth sub-portfolio are grouped together based on the similar, sustainable long-term pension increases.

   Sanlam Life may leverage the assets in the growth 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.

d) Mortality risk:

   For Provider Pensions, the guaranteed sub-portfolio operates in the same way as a non-participating annuity and the growth sub-portfolio as a *linked policy*. This means that for Provider Pensions, the mortality risk on the guaranteed sub-portfolio is underwritten by Sanlam.

   For Provider Pensions, the mortality risk on the growth sub-portfolio is carried by all the pensioners in the same fund.

e) Investment risk:

   Investment risk on the guaranteed sub-portfolio is carried by Sanlam while on the growth sub-portfolio it is carried by all the pensioners in the fund.

f) 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 Provider Pension product:

- pricing and reserving for benefits;
- investment policy;
- policyholder expectations, in particular with regard to future pension increases, through marketing material, policy contracts and other communications that are accurate and easy to understand; and
- benefits payable in case of *terminations*.

Principles regarding investment strategy

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

b) Guaranteed sub-portfolio: Assets are managed to match the expected cash flows of the current pension payments.

c) Guaranteed sub-portfolio: Credit risk is limited 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.

d) Growth sub-portfolio: There are different growth sub-portfolios to choose from. The requirements for the investment management of each portfolio are set out in investment guidelines, with a view to managing risk through:

- 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 certain types of assets, such as assets that cannot be easily liquidated and unlisted equities;
- compliance with regulatory constraints; and
- benchmarks for the performance measurement of each asset class and limits on deviations from these benchmarks to help manage returns on portfolios.

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

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, 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.

Principles regarding terminations benefits

On termination, the cash value of the growth sub-portfolio equals the market value of the units cancelled in the growth sub-portfolio, provided that the appropriate notice period has been given and there is no penalty or exit fee on termination indicated in the *actuarial basis.*

On termination, the cash value of the guaranteed sub-portfolio is calculated on a basis similar to that used for non-participating annuities as described in the *actuarial basis.*

Principles regarding charges

a) Growth sub-portfolio: Charges, as applicable, will be recovered from policyholders' funds for, inter alia:

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

b) Growth sub-portfolio: 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.

c) Growth sub-portfolio: No explicit profit charges are taken, but profit will arise from the difference between charges taken and expenses incurred or risk benefits paid.

d) Guaranteed sub-portfolio: The current guaranteed pension (and subsequent increases purchased) payable is after all charges have been taken into account.

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

f) Rand-based charges are increased to allow for inflation, as specified in the *actuarial basis*.

g) 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.

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.

Governance

A sound governance structure is needed to manage Provider Pension business. The Board is ultimately responsible for the governance of Provider Pension 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.

Further Information

Sanlam Corporate specialises in the provision of risk, investment and administration services to institutions and retirement funds as well as medical aid solutions. 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.zaor contact:

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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 as well as medical aid solutions.

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.

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.

Exchange traded funds

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

Hedge funds

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.

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.

Net Premiums

The premium less charges recovered from the premium.

Strategic investments

Sanlam Life’s investments in subsidiaries and associated companies.

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.

Terminations

Removing funds under Sanlam Life’s management from Sanlam Life’s portfolios or products. This applies only to a pension fund in bulk and not to individuals or part of a pension fund.