

# **Principles and Practices of Financial Management (PPFM)**

**For Capital Alliance Life**

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# 1. Introduction

## 1.1. Background

Capital Alliance Life is an insurer whose business model involved acquiring existing books of business, and running these off efficiently, using their own administration platform. The Capital Alliance book comprises the business of AA Life, Stangen, Fedsure and Norwich. In 2005, Capital Alliance was acquired by Liberty Life and now forms part of the Liberty Life Group.

## 1.2. Principles and Practices of Financial Management (PPFM)

This document sets out the Principles and Practices of Financial Management (PPFM) of Capital Alliance Life (CAL), in accordance with the Financial Services Board (FSB) directive 147. As CAL is a wholly owned subsidiary of Liberty Group Ltd certain references are made in this document to the Liberty Group Ltd.

The purpose of the PPFM is to document how CAL will manage its discretionary participation products (DPP). In managing business with discretionary participation features, insurers rely on their ability to use discretion, particularly in relation to the investment strategy adopted, and the bonus smoothing policies used. The purpose of CAL's PPFM is therefore to:

- explain the nature and extent of the discretion available;
- show how competing or conflicting interests or expectations of different groups and generations of policyholders, and policyholders and shareholders are managed so that policyholders and shareholders are treated fairly.

Users of the PPFM should note that the purpose of this document is to explain the management of the DPP business, and not to give advice as to the benefits of a discretionary participation product.

Capital Alliance Life is committed to providing open and honest communication and we believe that the PPFM will assist with that aim. The DPP of CAL are managed in accordance with these Principles and Practices.

Within each section of the PPFM, the Principles are shown first, followed by the corresponding Practices.

## 1.3. Definition of Discretionary Participation Products (DPP)

Discretionary participation products (DPP) have certain features that normally include some or all of the features below:

- using premiums to invest in a pooled fund made up of a range of assets, a significant proportion of which are usually in the form of equities;

- 'smoothing' the allocations to policies (bonuses) to cushion policyholders from short-term fluctuations in asset prices or other possible experience variations;
- for some products, sharing in certain of the profits or losses of the insurer, including those arising from mortality and expense risks;
- certain guarantees, which usually increase over the lifetime of the policy (for example the payment of vesting bonuses at maturity, retirement or death); and
- in many policies, a terminal / final / non-vested bonus is declared, which does not form part of the guaranteed amount but which may be added to the value of the contract.

Discretionary participation products may also be known as with-profits products, and normally include smoothed bonus contracts, reversionary bonus contracts and with-profit annuities.

#### **1.4. Principles**

The Principles are enduring statements of the overarching standards that we adopt in managing discretionary participation products.

They describe the business model used by the insurer for managing the discretionary aspects of its discretionary participation policies (in terms of its policy conditions) and in responding to longer-term changes in the business and economic environment.

We do not expect to change the principles often, and, except with the permission of the regulator we will give at least three months advance written notice to discretionary participation policyholders of any changes to the Principles.

#### **1.4. Practices**

The Practices describe our current approach to managing discretionary participation products and how we intend responding to changes in the business and economic environment in the shorter-term.

They are intended to contain sufficient detail to enable an understanding by a knowledgeable observer of the material risks and rewards from affecting a discretionary participation policy with CAL.

We expect to change the Practices as the circumstances in our business environment change. We will advise discretionary participation policyholders of any change in the Practices, within a reasonable period of the change becoming effective, for example in conjunction with an annual bonus statement or an annual member benefit statement in the case of retirement funding business.

### **1.5. Communication of the PPFM**

The PPFM will be available on the Liberty Life website. In addition, policyholders will receive a summarised version of the PPFM following the implementation of the PPFM, as well as an explanation as to what it entails. The PPFM will also be available on request to interested third parties.

### **1.6. Monitoring compliance with the FSB Directive**

It is the responsibility of the CAL Board of Directors (Board) to ensure that the company manages the DPP in line with the principles and practices set out in the document. The Board has delegated this responsibility to the CAL Internal Review Committee (IRC) which will report to the Board annually on this compliance. Compliance with the PPFM will also be communicated to the Liberty Group Audit and Actuarial Committee (GAAC), which reports to the Liberty Group Board.

The Board will produce an annual “Compliance with PPFM report” that will be made available on the Liberty Life website.

### **1.7. Changes to the PPFM**

Any changes to the PPFM must be approved by the CAL Board. The Internal Review Committee (IRC) may propose changes to the PPFM to the Board, and the Board may seek the advice of the IRC or CAL Actuarial Committee in considering such changes.

### **1.8. Approval of Bonus declarations**

Bonus rates are recommended by the statutory actuary, following the principles and practices laid down below. The bonus rates are then discussed and approved in the following forums:

- Liberty Group Bonus Committee
- The CAL Actuarial Committee
- The CAL Internal Review Committee
- The CAL Board

### **1.9. Classes of business**

CAL’s portfolio consists of legacy business from companies that were taken over by CAL over time. The main types of DPP business are:

- **Smoothed bonus business:** Where premiums less charges are invested in an account for the policyholder, and each year bonus additions (or possibly reductions) are made to the account.

- **Conventional reversionary bonus business:** Where the contract commences with an initial sum assured, to which are added reversionary bonuses each year, and a terminal bonus at claim stage.
- **With profit annuities:** Where the amount of annuity increases each year by a bonus declaration.

The following classes of business are covered by the PPFM:

TYPE	CLASS	DECLARATION MODE
<b>Conventional (reversionary bonus) business</b>	Norwich Conventional	Annually in advance
	Fedsure Conventional	Annually in arrear
	Stangen (CAL) Conventional	Annually in arrear
	AA Life Conventional	Annually in arrear
	Traduna Conventional	Annually in arrear
	ACA Conventional	Annually in arrear
<b>Smoothed Bonus Business</b>		
Individual	Norwich Smoothed Bonus	Annually in advance
	Norwich Future Select	Annually in advance
	Fedsure Deposit Administration	Annually in arrear
	Fedsure Fully Vesting	Monthly in advance
	CAL Smoothed bonus	Annually in arrear
	Corporate	CAL Guaranteed fund
<b>With-profits annuities</b>	IEB With Profits Annuities	Annually in advance

### 1.10. Technical Terms

A glossary of the technical terms used in this document is provided in Section 11.



## **2. Bonus Philosophy**

### **2.1. Determining values of discretionary profits policies**

Discretionary participation policies receive their share of the distributable surplus by way of bonuses which are declared, generally annually, out of available surplus in the following form:

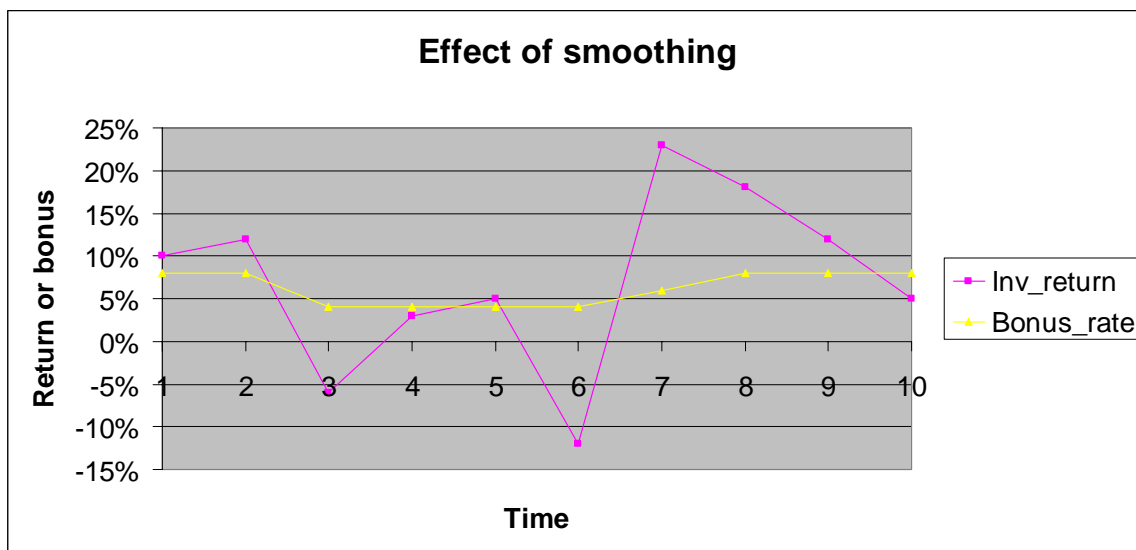
- A **regular bonus** (also known as an annual or reversionary bonus), only a part of which vests, may be added during the lifetime of a policy, so gradually increasing the guaranteed benefit payable in the event of a claim, and;
- A **final** bonus (known as a terminal or additional bonus) which may be added to policies when a claim is paid in a specified period or the contract matures, but is not guaranteed. The final bonus may also comprise a claim bonus in addition to a terminal bonus.

The determination of distributable surplus varies by business type and is described in the relevant sections below.

### **2.2. Overriding Principles**

- 2.2.1. The overriding principles will take precedence over any other principles.
- 2.2.2. We will meet all our contractual obligations, legal and regulatory requirements. In the event of a conflict arising between the PPFM and the policy conditions, then the policy conditions will prevail.
- 2.2.3. Any decisions regarding the distribution of surplus will first consider the long-term solvency of the relevant fund.
- 2.2.4. The business will be managed having regards to policyholder reasonable benefit expectations, which have arisen from original contractual entitlements as well as past practice by CAL, industry practice and representations made to policyholders.
- 2.2.5. Subject to the above, we aim to achieve fairness of treatment between different types and groups of discretionary participation policyholders, and between them and shareholders. In particular:
  - We aim to provide payout values on death or maturity that are fair between different policy types and different generations of policyholder.
  - We aim to provide payout values on surrender, transfer or retirement that are also fair between those policyholders leaving and those remaining in the fund.
- 2.2.6. The main objectives of the company's bonus distribution policy are:

- To give each DPP policyholder a fair and equitable return on the premiums paid reflecting the return on the underlying investments over the time the policyholder has held the policy, smoothing the peaks and troughs of investment performance, and to ensure that DPP policyholders in each bonus series receive a fair share of the surplus distributed from that sub-fund by way of bonus additions to their policies.
- It is important for policyholders to understand that the policy does not earn the exact return on the underlying investments as it is earned as it would with a market-related policy, but rather shares in surplus over time as part of a pool of policyholders. This is the essential principle of smoothing.
- To retain flexibility in our investment policy and to protect the ongoing solvency of the fund, for most types of DPP we aim to keep a substantial proportion of pay-out values in non-guaranteed form (i.e. payable as a final bonus) and determine regular bonus rates accordingly. This gives CAL flexibility to invest in assets which may be more risky in the short term, but should outperform other asset classes in the longer term.
- We set pay-out values by reference to the asset share of the respective class of business, except where guaranteed minimum benefits increase the benefit amount payable.
- All policyholders within a certain bonus series receive the same bonus rate applicable to that bonus series. There is cross-subsidy between various bonus series, and cross-subsidies occur between different generations of policyholder within a bonus series.
- Final bonus rates are set so that in normal investment conditions pay-out values change only gradually over time i.e. we provide smoothed benefits.
- The intention is that in the long run DPP policyholders in each business class neither gain nor lose as a result of our smoothing policy. The accumulative cost of smoothing is monitored.



2.2.6. The main factors affecting bonus distribution are

- The outlook for future investment performance
- The current level of the bonus stabilization reserve (BSR)
- Policyholder reasonable benefit expectations (PRE)

### **3. Conventional business**

#### **3.1. Regular Bonus Principles**

- We aim to set regular bonus rates that provide a progressive build-up of guaranteed benefits over the lifetime of the policy with an overarching aim of retaining sufficient surplus to provide an appropriate margin for determination of the final bonus. Regular bonus rates will be smoothed to limit the changes in these rates from year to year.
- We set regular bonus rates at levels which are likely to be sustainable in the long term, taking into account the terms on which the policies were written and expected future investment returns.
- Different bonus rates may apply to different classes of business and bonus series within these classes, so that significant differences in investment mix, guarantees and charges, tax, premium rates, and profit sharing philosophy may be recognized.
- Once regular bonus additions are made, they become part of the guaranteed benefits of the policy and cannot be removed at the discretion of CAL.

#### **3.2. Regular Bonus Practices for Conventional bonuses**

##### 3.2.1. Bonus variation

- We declare separate rates of regular bonus in respect of each of the classes of business mentioned above in section 1.9. For conventional bonus policies, the regular bonus is also known as the reversionary bonus.
- Bonus rates vary depending on the original premium rate for the contract, and the inherent loading in the premium rate for bonus. The higher the bonus loading in the premium, the higher the expected bonus rate declaration.
- Different levels of regular bonus may apply to the basic benefit and to existing (declared) regular bonus for the same benefit.
- Bonus rates may also differ dependent upon which tax fund the policy is held in as required by Section 29A of the Income Tax Act, so that the bonus rates reflect the tax basis of the respective underlying tax funds. Bonus rates declared are after tax ie no further tax is deducted from the bonus rates.

- 3.2.2. We calculate a level of regular (reversionary) bonus rate which is likely to be sustainable in the future and is likely to give scope for final bonus additions in the future which reflect the market conditions over the period of investment. Asset share calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders. Asset share methodology is described in section 7.
- 3.2.3. It is useful in understanding the mechanics of a reversionary bonus contract, to understand the impact that a certain level of bonus may have on a policyholder's benefits:
- When a reversionary bonus policy is first taken out, the policyholder has a basic sum assured payable on maturity or death.
  - When the company declares new bonus rates, there is an addition to the basic sum assured as well as to the reversionary bonus that has been declared to date.
  - What may seem as a low bonus rate when compared with actual investment returns on an investment portfolio over the applicable period, is in fact more significant than it appears because the bonus relates to the underlying sum assured and accrued bonus rather than the premiums paid.
  - For example, consider a policy where the policyholder pays a premium of R1000 per annum for 10 years, and the initial sum assured is R10000. If CAL declares a bonus of 3% after one year, the accrued reversionary bonus is determined as 3% of R10000 = R300, which in fact translates as a 30% return on the premium paid to date. (R300 bonus earned on a premium paid of R1000). Note that this bonus is not immediately payable to the policyholder, but forms part of the benefit payable when a claim is made.
  - The mechanics of the bonus structure are illustrated in the table below. For example, looking at year 1, the bonus addition is 3% of the sum assured, namely R300. In year 2, the bonus addition is again 3% of the sum assured plus 4% of the past accrued bonus, namely R12, and hence the total bonus addition is R312.

Time	Premium paid	Initial sum assured	Accrued bonus	Bonus rate on sum assured	Bonus rate on bonus	Bonus addition amount	Accrued benefits
1	1,000	10,000	-	3%	4%	300	10,300
2	1,000	10,000	300	3%	4%	312	10,612
3	1,000	10,000	612	3%	4%	324	10,936
4	1,000	10,000	936	3%	4%	337	11,274
5	1,000	10,000	1,274	3%	4%	351	11,625
6	1,000	10,000	1,625	3%	4%	365	11,990
7	1,000	10,000	1,990	3%	4%	380	12,369
8	1,000	10,000	2,369	3%	4%	395	12,764
9	1,000	10,000	2,764	3%	4%	411	13,175
10	1,000	10,000	3,175	3%	4%	427	13,602

For this example policy, the annual return to the policyholder is 5,5%pa. If the bonus on sum assured was changed to 5%pa and the bonus on bonus to 5,5%pa then the annual return to the policyholder is 8,9%pa.

3.2.4. Reversionary bonus contracts normally add bonuses in one of 3 possible ways, namely:

- Simple bonus where bonus additions apply to the original sum assured only.
- Compound bonus where bonus additions apply to the original sum assured plus accrued bonus at the same bonus rate.
- Super-compound bonus where bonus additions apply at one rate to the original sum assured, and at another (usually higher) rate to the accrued bonus. This is the most common approach adopted, and the above example is an illustration of this approach.

3.2.5. **Amendment of regular bonus rates:** Reversionary bonus rates are normally reviewed annually, but may be reviewed at the discretion of CAL's statutory actuary (and subject to the review process discussed in 1.8) in the event of exceptional investment conditions arising.

3.2.6. **Maximum change to regular bonus rates:** in normal investment conditions we expect changes to regular bonus rates to be gradual over time and changes are not expected to exceed 1 percentage point over any year. However, the CAL statutory actuary (following the process described in 1.8) retains the discretion as to whether or not to declare a regular bonus each year, and consequently there is no real limit on the amount by which regular bonus rates can change, particularly in the event of volatile investment conditions.

3.2.8. **Interim bonus rates:** For classes of business where bonus is declared in arrear, bonus rates are normally declared retrospectively at the end of a financial year once surpluses arising are known. When bonus rates have been declared for the past year, the statutory actuary will declare an interim bonus rate which will apply to claims in the year ahead, so that policyholders who claim benefits in that year will receive credit for being in the fund for at least part of that year. The rate of

interim reversionary bonus normally represents our expectation at the time it is set of the regular bonus rate to be declared at the last bonus declaration date. The interim reversionary bonus rate will be similar to the long-term sustainable expected rate.

Interim bonus rates are not guaranteed and can change retrospectively.

For classes of business where bonuses are declared in advance, an interim bonus rate does not apply.

- 3.2.9. **Amendment of interim bonus rates:** in normal investment conditions we do not expect to review interim bonus rates over the year in which such bonus rates apply, but in the event of volatile investment conditions, these rates may be revised at the discretion of the statutory actuary.
- 3.2.10. **Declaration dates:** The declaration dates coincide with the financial year-end of CAL, namely 31 December.
- 3.2.11. **Declaration in advance or arrear:** For certain bonus classes, bonus rates are declared at the end of a year, with the bonus rate then applied to the preceding year. For these cases, an interim bonus rate (as discussed in section 3.2.8. above) will apply. For other classes, bonus rates are declared in advance of the coming year, and here no interim bonus rate will then apply. Refer also to the table 1.8 to see which classes of business declare bonus rates in advance and which declare bonus rates in arrear.

### **3.3. Final Bonus Principles for Conventional Business**

- Final bonus rates are set with the aim of distributing the balance of distributable surplus earned over the lifetime of the policy, to the extent that such surpluses have not previously been distributed by way of regular bonus additions. Thus we aim to distribute the total asset share to policyholders over the life of the policy.
- We aim to smooth fluctuations in payouts arising from varying investment returns or other factors. Smoothing reduces the effect of fluctuations, by ensuring that payouts change less frequently than asset values, by limiting the size of changes from one year to the next and by shaping the scales of bonus rates. Smoothing may apply differently between different types of policy and between different types of payout, such as maturities and surrenders. We intend smoothing to remain neutral between generations of policyholder over time.

### **3.4. Final bonus Practices for Conventional Business**

- 3.4.1. Asset share calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders. Asset share methodology is described in section 7.

- 3.4.2. The amounts payable on maturity in any particular year, or to any particular policyholder may be more or less than the asset share due to the effects of smoothing, guarantees and grouping of policies. Thus the full extent of changes in the market value of assets in the fund is not immediately reflected in claim payments.
- 3.4.3. The final bonus for conventional bonus policies is known as a terminal bonus, and is usually based on a percentage of the accrued bonus plus sum assured. The percentage applied is normally related to the period that the policy has been in-force. For example, if the bonus class has a terminal bonus rate of 1% for each year in force, then a policy which matures after 20 years in-force will get a terminal bonus of 20% of the basic sum assured plus accrued declared bonus. For certain classes of policy, a claim bonus may be payable in addition to the terminal bonus. The claim bonus is usually determined as a percentage of the total benefit payable including terminal bonus, and is designed to assist in the equitable distribution of surplus amongst generations of policyholders.
- 3.4.5. In general, the same final bonus scale applies to maturity and death payments. Surrender claims would typically have an adjustment to compensate for early termination of the contract, bearing in mind that the bonus was intended to be paid in full perhaps many years hence when the contract matured.
- 3.4.6. A suitable level of terminal bonus is determined by comparing the asset share with the actuarial reserve of the corresponding group of policies. The difference between the asset share and the reserve is called the bonus stabilisation reserve (BSR). The BSR is effectively the surplus not yet distributed to policyholders or allowed for in the actuarial reserve, and forms part of the policyholder liabilities in respect of the conventional bonus contracts. If CAL has reserved for or declared bonuses in excess of what the asset share can support, then the BSR may be negative.
- 3.4.7. The intention is therefore to set reversionary bonus rates and terminal bonus rates that result in a long-term targeted level of BSR. The long-term target level of BSR is 0% which means that the BSR will be zero and the actuarial reserve will equal the asset share. In the event of a negative BSR, bonus rates will be reduced over the next three years to recover the shortfall. Similarly, in the event of a positive BSR, bonus rates will be increased over the next three years to declare out the excess.

## **4. Smoothed bonus business**

### **4.1. Regular bonus principles for smoothed bonus business**

- The broad philosophy of smoothed bonus business is to distribute the total asset share to maturing policyholders in a smoothed manner over time.
- Surplus is distributed via a regular bonus where bonus declarations are smoothed over time, but with less smoothing applied than in the determination of the regular bonus rate under a conventional policy.
- For policies that are fully vesting, there would typically be more smoothing and less volatility in the bonus declarations. These policies are generally backed by a more conservative asset mix which hence allows a more stable bonus policy to be followed.

### **4.2. Regular bonus practices for smoothed bonus business**

4.2.1. Asset share calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders. Asset share methodology is described in section 7.

4.2.2. The policyholder fund account is the value of the policyholder's investment, including bonus declared to date. It is determined as follows, in line with policy conditions:

- Investible premium (Premium less policy fee multiplied by allocation percentage)
- Less charges for risk benefits and expenses
- Plus Bonus rate addition.

Charges are set as part of the policy conditions and may be reviewed in line with policy conditions. However, this will only be done if deemed justifiable by the statutory actuary, and not to simply increase shareholder profits.

4.2.3. The broad philosophy of smoothed bonus business is to distribute the total asset share to maturing policyholders in a smoothed manner over time. The amounts payable on maturity in any particular year, or to any particular policyholder may be more or less than the underlying asset share due to the effects of smoothing, guarantees and grouping of policies. Thus the full extent of changes in the market value of assets in the fund is not immediately reflected in claim payments.

4.2.4. The surplus not yet distributed to policyholders forms part of the policyholder liabilities in respect of the smoothed bonus contracts, and is called a bonus stabilization reserve or bonus smoothing reserve (BSR). If the company has allocated bonuses in excess of actual surplus earned, then the BSR may be negative. The BSR for smoothed bonus contracts is defined to be the difference between the asset share held and the fund account representing policyholder entitlements.

- 4.2.5. In times of exceptional investment returns, part of the return will be held back, and a lower bonus declared than actually earned. In times of poor investment returns, a higher bonus may be declared than implied by the low returns, provided there is sufficient undistributed surplus available (ie a positive BSR exists). If returns in a period are negative, then it may still be possible to allocate a positive bonus rate to policyholders, if a positive BSR exists. However, in times of sustained, exceptionally poor investment performance, and depending on the level of the BSR it may be necessary for the company to remove non-vested bonus, and this essentially constitutes a negative bonus declaration. However, it should be noted that CAL cannot declare a negative bonus rate.
- 4.2.6. Any negative BSR is recovered over time by awarding lower bonus declarations than implied by the actual investment returns. If the BSR as a percentage of the policyholder fund account falls below negative 7,5% then this must be disclosed in the report of the Statutory Actuary, and the Statutory Actuary must explain how this deficit can be recovered within 3 years, as per Professional Guidance Note 104 (PGN104) of the Actuarial Society of South Africa (ASSA).
- 4.2.7. At present the CAL Smoothed BSR's are managed as follows:
- The optimal long-term target funding level is 103% of the fund account; thus the BSR would be 3% of the policyholder fund account.
  - The BSR may be positive up to 20% of the policyholder fund account. This excess will be distributed back to policyholders over a three year period.
  - If the BSR (funding level) exceeds 20%, the excess over 20% will be distributed to policyholders in the year in which it arises. Thus the maximum level to which the fund will withhold excess returns from a particular generation of policyholder is 20%.
  - If the BSR falls to between 0% and negative 15%, then the deficit will be recouped through lower policyholder bonus declarations over the next three years.
  - If the BSR falls to below negative 15%, then the previously declared non-vested bonus will be removed until the negative BSR is at most negative 15%.
  - If the removal of non-vested bonus is not sufficient to restore the funding level to negative 15%, then shareholder funds will be utilised to make up the difference.
- 4.2.8. **Income and Capital bonus:** When a smoothed bonus rate is declared, part of the bonus rate is the vested or income bonus rate, which means it forms part of the guaranteed policyholder benefits, and the balance of the bonus rate is the capital or non-vested bonus, which means that it does not form part of the guaranteed policyholder benefits, and hence can be removed from the policyholder at the discretion of CAL. The non-vested portion does however form part of the benefit payment at claim stage.

The philosophy for determining the split between the vested and non-vested portion is

- the vested component should correlate closely with the component of the investment return in the year made up of interest, dividend and rental

income net of tax and charges. The non-vested component would then be the capital gains portion of the investment return net of an allowance for capital gains tax. The rationale for this is that the capital gain could be lost over time and hence should not be part of the guaranteed benefit until the policy is paid out.

- A high proportion of vested to non-vested bonus means a high level of guarantees for CAL to manage (as the vested bonus is effectively part of the guaranteed benefit) and this restricts the investment policy resulting in a more conservative asset mix and hence potentially lower bonus rates in the long-term.
- A low proportion of vested to non-vested bonus means a low level of guarantees for CAL to manage (as the vested bonus is effectively part of the guaranteed benefit) and more investment freedom and hence potentially higher bonus rates in the long-term.

For example, ignoring tax and charges, given an investment return of 10% for the year, comprised of:

Interest income:	2%
Dividend income:	1%
Capital gains:	7%

Then the vested bonus component would be set at 3%, and the non-vested component would be 7% plus or minus any transfer from the BSR.

Some of the classes of smoothed bonus business are fully vesting, where the full bonus rate declared vests fully on declaration and immediately becomes part of the policyholder's guaranteed benefit. With these classes of business, bonus declaration is naturally more cautious because the company no longer has discretion to remove non-vested bonus rates.

#### **4.2.9. Fedsure Norwich merger agreement**

Fedsure acquired the Norwich book of business as at May 2001 and in terms of the merger agreement, Norwich bonus rate declarations may not be less than the corresponding Fedsure declarations, on a cumulative basis since the merger took place. This does place an additional obligation on the part of CAL in that bonus rates which may not be affordable have to be maintained. This obligation will then be met out of shareholders' assets.

In applying the underpin condition the Fedsure policyholders' bonuses may not be unreasonably held back in order to satisfy the condition. In effect the Fedsure bonus rates must be set independently of the underpin condition, in line with PRE. In the event that there is a cost involved in applying the underpin this will be met by the CAL shareholders.

#### **4.2.10. Removal of non-vested bonus or injection of shareholder funds**

In the event of non-vested bonus being removed, as described above, these may be restored following sustained good investment conditions, so removal may not be permanent. If non-vested bonuses are removed, the asset share will remain

unchanged and hence the BSR will increase by the amount of non-vested bonus removed.

If shareholder funds are utilized to restore the funding level of the portfolio, then these funds, with a return would be repaid to shareholders as soon as investment conditions allow. Shareholder funds would be repaid before policyholder bonuses are reinstated as they provided the support needed to ensure the funding level did not drop below the absolute required minimum.

However, if the Norwich BSR becomes negative due to the application of the underpin condition described in 4.2.9 above, it is not permissible to remove previously declared non-vested bonuses in order to restore the funding position. However, non-vested bonuses may be removed from Norwich business provided that a similar level of non-vested bonus is removed from the Fedsure business, and such that the underpin condition still holds.

#### **4.2.11. Market Value Adjusters (MVA):**

4.2.11.1 A market-value adjuster may be applied on surrender, but not on death or maturity. It serves to protect the fund against adverse selection when, for example, policyholders may take advantage of poor market conditions to benefit from higher smoothed bonus fund accounts. It therefore serves to protect the remaining policyholders in the fund.

4.2.11.2 A MVA will normally apply when the underlying asset share of the policy is less than the policy fund account value. However, a MVA may also be applied when there is a risk of large withdrawals from the fund, to protect the remaining policyholders.

For example, given a fund value of R100, and an asset share of R80, a 20% market-value adjuster may be applied to the fund value so that the surrender value paid, corresponding to a unit reserve of R100, is R80, consistent with the asset share.

Management of MVA – implementation and target levels: MVA scales are reviewed frequently and may be changed at any time at the discretion of the Statutory Actuary. Changes are more likely at times of volatile asset movement.

4.3. **Interim bonus rates:** Bonus rates are normally declared retrospectively at the end of a financial year once surpluses arising are known. When bonus rates have been declared for the past year, the statutory actuary will declare an interim bonus rate which will apply to claims in the year ahead, so that policyholders who claim benefits in that year will receive credit for being in the fund for at least part of that year. The rate of interim bonus normally represents our expectation at the time it is set of the bonus rate that could be declared at the next bonus declaration date.

Interim bonus rates are not guaranteed and can change retrospectively.

#### 4.4. **Smoothed bonus business final bonus**

A final bonus is not usually paid to smoothed bonus policyholders; however, for closed books with a large positive BSR, a terminal bonus may be paid at claim stage as the number of policyholders in the portfolio runs down. This would be at the recommendation of the Statutory Actuary and subject to the approval process described in section 1.8.

#### 4.5. **Terminations**

In the event a contract is terminated early, an adjustment will normally be applied to the fund account to reflect the early termination of the contract. In addition, an MVA may be applied, as discussed in section 4.2.11 above.

## **5. With profit annuities**

5.1. The nature of the with-profit annuity is completely different to the smoothed bonus or conventional bonus type of contract where a bonus addition enhances the benefit to be payable on claim. With a with-profit annuity, the bonus addition results in an enhancement to the annual or monthly amount payable (annuity), and such enhancement applies until the annuity contract ceases, usually following the death of the annuitant.

### **5.2. Principles**

Surplus is distributed via a regular bonus where surplus is smoothed over time, but with more caution than is applied to a smoothed bonus contract owing to the long-term risk to CAL of granting an increase in the annuity, which results in a guaranteed increase in the annuity for the remainder of the annuity payment period, reflecting the more onerous nature of the guarantee provided.

### **5.3. Practices**

5.3.1. The bonus addition is fully vesting once granted which means that the accrued bonus cannot be reduced.

5.3.2. With profit annuities are priced allowing for a minimum guaranteed annuity increase rate, supportable by the expected long-term investment returns. Consequently, bonuses are only declared to the extent that returns earned are in excess of the minimum guaranteed interest rate.

5.3.3. In the event of poor investment returns where investment returns are less than the minimum guaranteed increase rate, it is not possible to reduce the annuity amount payable by declaring a negative bonus rate. This represents a significant risk to CAL in managing this business.

5.3.4. Bonuses on with profit annuity business are declared via a regular bonus and a final bonus would not be appropriate owing to the nature of the contract.

## **6. Amendment of Part 5 of the Long Term Insurance Act**

Policies whose values are impacted by the above amendment to the Long Term Insurance Act (the Statement of Intent agreed between the National Treasury and the Life Office Association), will benefit by any enhanced value as per the Statement of Intent, over and above the normal bonus additions.

## **7. Asset Share Calculations**

- 7.1. The asset share is the retrospective buildup of the asset pool belonging to a group of discretionary participation policies. It is the accumulation of all items of income and outgo that are relevant to each policy type. The asset share can be seen as the total value of benefits at a point in time that will be granted to a pool of policyholders over time.
- 7.2. Asset shares have been calculated at the asset portfolio level (essentially at a line of business level) and not at an individual (per policy) level.
- 7.3. Items of income allowed for in the asset share calculation include:
- Premiums paid
  - Investment returns net of tax and management fees
  - Miscellaneous profits if applicable
- 7.4. Items of outgo allowed for in the asset share build up includes:
- Mortality, disability, surrender and maturity claims paid
  - Expenses and commission (covered by management fees on certain contract types)
  - Charges for guarantees
  - Shareholders' profit transfers
  - Miscellaneous losses
- 7.5. Guarantees: Certain contracts have investment guarantees in that the maturity value is determined having regards to a contractually determined guaranteed minimum growth rate. In addition, a smoothed bonus contract has an implicit guarantee that the value of the policy cannot fall below the value of premiums allocated less charges deducted plus vested bonuses which is essentially a capital guarantee. For all contracts, the management fee charged covers the cost of any guarantees. Thus the cost of the guarantee is met out of charges made and if charges are insufficient, then the balance of the cost of the guarantee is met out of shareholder funds.
- 7.6. **Profit sharing between policyholders and shareholders**
- 7.6.1. For certain classes of business, CAL shareholders are entitled to a fixed percentage of the bonuses declared to policyholders. The most common sharing arrangement is for shareholders to be allocated 1/9th of the policyholders' entitlement. This is known as the 90/10 rule, and for example if the policyholder bonus is 9%, then the shareholder entitlement is 1/9<sup>th</sup>, or 1%, together making a total bonus of 10%. For other classes, shareholders are entitled to the residue of surplus after policyholder bonuses have been declared. The profit sharing basis forms part of the policy conditions.
- 7.6.2. For certain classes of business, the asset share also includes profits and losses arising from death and morbidity claims. This is indicated in the table below.

7.6.3. For certain classes of business, the asset share also includes profits and losses arising from policy surrenders and maturities.

7.6.4. The profit sharing is summarised in the table below:

	<b>POLICYHOLDERS</b>	<b>SHAREHOLDERS</b>
<b>Conventional business</b>		
Fedsure conventional	Net investment returns	All other profits
Norwich conventional business	Net investment returns plus surrender and maturity profits	All other profits including mortality and expense profits
<b>Smoothed bonus business</b>		
Fedsure deposit administration	Net investment returns	All other profits
Fedsure fully vested smoothed bonus	Net investment returns	All other profits
Norwich smoothed bonus	Net investment returns plus surrender and maturity profits	All other profits including mortality and expense profits
Capital Alliance smoothed bonus business	90% if gross return is less than 16%, 75% on portion of return in excess of 16%pa.	10% if gross return is less than 16%, 25% on portion of return in excess of 16%pa.
<b>With profit annuities</b>	All profits	Nil

7.6.5. Expenses are allocated to the asset share on a per policy basis, as per the company expense investigation.

## **8. Investment strategy**

### **8.1. Principles**

The investment strategy aims to maximise long-term returns (after allowance for taxation) commensurate with acceptable levels of investment and solvency risk, having regards to:

- 8.1.1. The nature and term of the DPP liabilities and the management of cashflows.
- 8.1.2. The current and expected future level of contractual guarantees.
- 8.1.3. Regulatory solvency requirements and future possible scenarios.
- 8.1.4. Advice from the fund manager.
- 8.1.5. The short-term and long-term anticipated returns from different asset classes.
- 8.1.6. The expected volatility of various different asset classes.
- 8.1.7. Policyholder reasonable benefit expectations
- 8.1.8. Protecting appropriately the relative interests of all groups of policyholders.

The fund assets will be invested in an appropriate and broad range of suitable investments to reduce the risk of volatile investment performance.

Investment returns are measured against asset manager benchmarks which are set taking into consideration the levels of risk inherent in each asset class and stock.

Maximum and minimum exposures to and performance benchmarks for different asset classes will be set from time to time in accordance with investment portfolio objectives. Maximum exposures to any one counterparty are specified.

Investments may be made in derivatives or similar instruments if they are appropriate to the objectives of the investment portfolio.

The investment strategy of the portfolio takes into account the nature and term of the liabilities, by considering appropriate assets for different classes of with-profits policy and different generations of with-profits policyholders.

Policyholder and shareholder assets are segregated.

### **8.2. Practices**

8.2.1. An investment management agreement exists between CAL and the asset manager which sets out investment strategy and guidelines.

8.2.2. Certain classes of business invest in the same asset portfolio, namely:

- All Conventional business
- Norwich smoothed bonus and Fedsure Deposit Administration
- Fully vested smoothed bonus
- CAL smoothed bonus

- 8.2.3. The CAL Investment Committee oversees the relationship between CAL and the asset manager, sets the strategic direction and reviews performance against benchmarks. It is also tasked with approving major, special or strategic investment decisions. The investment committee meets quarterly.
- 8.2.4. The Investment committee is also responsible for determining the asset allocation strategy, setting risk appetite and reviewing both competitor activity and economic outlook alongside expected returns on different asset classes.
- 8.2.5. **Current investment strategy:** Currently, the fund underlying the smoothed bonus book is invested in a mix of listed equities, property, fixed interest investments and cash. The typical mandated mix is around 60% in equities, 10% in property, 20% in fixed interest and 10% in cash. For each asset class, performance targets, benchmarks and asset allocation ranges are set. These proportions and maximum variations have regard to the following factors:
- Statements regarding the mix of assets set out in marketing literature and other documents available to policyholders.
  - Company solvency position.
  - The requirement to hold fixed assets to support guarantees.
  - Expected returns and risks from each asset class, including the views of the company and the asset managers
  - Expected correlations between the performance of various asset classes, enabling us to reduce risk by diversifying holdings.

The current mandates for the main asset classes are:

- 8.2.5.1. **Equities:** We invest a substantial portion of our DPP fund in equities through an absolute return portfolio (ABR). This portfolio is actively managed and seeks to limit the downside risk of equity investment by picking value stocks. These investments benefit from any growth in companies' profits and we expect them to benefit from economic growth generally. Equities have traditionally outperformed other classes of investments over time. Equity values are volatile and hence large rises and falls in the market value of these equities may be experienced. In addition, individual holdings are subject to risk of failure of that individual company. In order to reduce these risks, we invest in a broad range of equities, by sector and stock selection. We also hold equities in offshore countries. This diversifies our risk and gives us exposure to foreign markets and currencies.
- 8.2.5.2. **Properties:** Property investments benefit from growth in rentals and property values, and hence, like equities, we expect them to benefit from economic growth generally. Property investments have historically outperformed cash and fixed interest, but have been less volatile than equities in the long-term, and hence also provide a diversification from equities.
- 8.2.5.3. **Fixed Interest:** These form a significant part of the investment of the funds. Fixed interest investments typically have lower returns than on equities and property in the long-term, but are generally less volatile especially when held to maturity. There is generally a much lower risk of default on government bonds compared with corporate equity. These assets are particularly suitable

for backing the guaranteed portion of with-profits liabilities. Government stock is also highly liquid and has low dealing costs. We also invest in corporate bonds which generally have a higher yield than comparable government bonds, although there is then a risk of default.

- 8.2.5.4. **Cash:** The cash holding is generally low; its main purpose is to ensure liquidity and availability of funds for operational reasons. Cash has a maximum duration of 180 days and invests in a diversified range of fixed interest instruments. The benchmark is the Stefi Composite.
- 8.2.5.5. **Derivatives:** Derivatives are used to hedge the financial exposures of policyholders and shareholders, and are only permissible for efficient portfolio management and reduction in investment risk. Derivatives are not permitted for speculative purposes.
- 8.2.5.6. **Negative rand reserves:** The funds do not invest in negative rand reserves.
- 8.2.5.7. **Treasury shares:** The funds do not invest in treasury shares.
- 8.2.5.8. **Collective investment schemes:** The DPP funds do not invest in collective investment schemes owned by Capital Alliance Life.
- 8.2.4. Although mandates indicate the bulk of investments in equities, we may make a short term asset allocation change to take advantage of specific market conditions or opportunities.
- 8.2.5. The fund invests predominantly in quoted investments in order to maintain the liquidity quality of the fund.
- 8.2.6. The funds do not invest in any strategic assets of CAL.

**9. New bonus classes**

The Capital Alliance Life with-profits funds are closed to new business. In the event that new with-profits business was to be written into CAL, then CAL would consider setting up a new smoothed bonus class for the new business.

**10. Small funds**

Since the funds are closed to new business, they will over time become smaller and eventually not worth managing as a separate entity. At this point we will consider merging these funds with larger ones. This should not affect policyholder expectations in any way, and in fact will ensure a continuation of the policyholder expectations, since otherwise as a fund contracts it becomes necessary to invest in less risky assets which generally means lower long-term returns.

## **11. Glossary**

### **Accrued bonus**

The bonus accrued as a result of the compound effect of bonus declared in the past.

### **Actuarial Reserve**

The value placed on the companies policyholder liabilities by the actuary. The reserve is the company's future obligation in respect of the policies on its book and is calculated using a set of assumptions together with actuarial formulae.

### **Asset share**

The asset share is the value of assets underlying a class of business, built up from past premiums and investment returns less charges. It is used as a guide when setting bonus rates.

### **Bonus Series**

A bonus series is a tranche of business sold within a class of business. For example the Fedsure Conventional bonus series may have a range of different bonus constructs and each of these will have their own bonus declarations and are know as a bonus series,

### **Bonus stabilization reserve (BSR)**

A liability held in respect of a class of business as part of the policyholder liabilities, being the undistributed surplus owed to that class of business but not yet allowed for in the actuarial reserve, or not yet added to the policyholder fund account. It represents surplus earned but not yet distributed.

### **Conventional Bonus Policy**

A DPP contract where bonuses are declared by means of regular reversionary bonuses and a final terminal bonus if applicable.

### **Discretionary participation products (DPP)**

Discretionary participation products (DPP) have certain features that normally include some or all of the features below:

- using premiums to invest in a pooled fund made up of a range of assets, a significant proportion of which are usually in the form of equities;
- 'smoothing' the allocations to policies (bonuses) to cushion policyholders from short-term fluctuations in asset prices or other possible experience variations;
- for some products, sharing in certain of the profits or losses of the insurer, including those arising from mortality and expense risks;

- certain guarantees, which usually increase over the lifetime of the policy (for example the payment of vesting bonuses at maturity, retirement or death); and
- in many policies, a terminal / final / non-vested bonus is declared, which does not form part of the guaranteed amount but which may be added to the value of the contract.

### **Final Bonus**

A bonus declared at claim stage and added to the final payout value.

### **Fund account**

The buildup of past premiums paid less charges plus bonuses declared for a smoothed bonus policyholder.

### **Market-related**

A type of policy where the policyholder participates directly and immediately in the value of an underlying investment ie the policy value depends directly on the performance of an investment portfolio.

### **Market value adjuster (MVA)**

An adjustment made to a surrender claim to reflect the underlying asset values, typically when market values have fallen following poor investment conditions.

### **Non-vested bonus**

The portion of bonus declared under a smoothed bonus contract which is not guaranteed on declaration and hence may be removed by the insurer if investment conditions dictate. It may also be known as the capital bonus.

### **Profit sharing philosophy**

The company's agreed sharing of profits between policyholders and shareholders, and between various classes and generations of policyholder.

### **Regular bonus**

A bonus declared typically each year while the policy is in-force.

### **Retrospective calculation**

This is a calculation determined by looking back at what actually happened, whereas prospective looks forward using certain assumptions.

## **Reversionary bonus**

The regular bonus declared on a conventional bonus policy. It is declared as a percentage of the sum assured and possibly as a percentage of the existing bonus to date. Reversionary bonus contracts normally add bonuses in one of 3 possible ways, namely:

- Simple bonus where bonus additions apply to the original sum assured only.
- Compound bonus where bonus additions apply to the original sum assured plus accrued bonus at the same bonus rate.
- Super-compound bonus where bonus additions apply at one rate to the original sum assured, and at another (usually higher) rate to the accrued bonus. This is the most common approach adopted.

## **Reversionary bonus policy**

A reversionary bonus policy is a DPP where bonuses are declared by means of regular reversionary bonuses and final terminal bonuses. The bonus is declared on the original sum assured of the policy and the accrued bonus to date.

## **Smoothed bonus policy**

A policy where a policyholder's premiums less charges are invested into a fund account and the policy value is enhanced by bonus declarations applied to the balance at a point in time. It thus works like a bank account with interest additions.

## **Smoothing**

The concept of smoothing is fundamental to a DPP contract. When investment returns are distributed via a bonus rate declaration to policyholders, the full investment return is not granted to the policyholder as and when it is earned, but rather over time. When investment returns are higher than expected, a lower bonus rate is usually declared, and the balance is preserved so that when returns are lower than expected a higher bonus rate may be declared.

## **Statutory Actuary**

The Statutory Actuary is the actuary appointed by a long-term insurance company in terms of section 20(1) of the Long Term Insurance Act 1998. This person should be a natural person who is permanently resident in the Republic, is a Fellow of the Actuarial Society of South Africa and has, as an actuary, appropriate practical experience relating to long-term insurance business. The appointment should be approved by the Registrar of long-term insurance. The duties of the statutory actuary are set out in the Act.

## **Surplus**

The surplus is the amount available for distribution to discretionary participation policyholders, that has not yet been reserved for or allocated to the policy fund account.

**Terminal bonus**

The final bonus declared on a conventional bonus policy. This is normally a percentage of the basic sum assured plus accrued reversionary bonus.

**Vested bonus**

The portion of bonus declared under a smoothed bonus contract which is guaranteed on declaration. It may also be known as the income bonus.