

Principles and Practices of Financial Management (PPFM)

For Liberty Life

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1. Introduction

1.1 Background

Liberty Life is one of the largest insurers in South Africa and has sold a large variety of business since its inception in 1957. In addition, it has acquired a number of legacy books including Prudential, Manufacturer's Life, Sun Life and, most recently, Investec Employee Benefits comprising the business formally administered by Fedsure Life and Norwich Life.

1.2 Principles and Practices of Financial Management (PPFM)

This document sets out the Principles and Practices of Financial Management (PPFM) of Liberty Life in accordance with the Financial Services Board (FSB) directive 147.

The purpose of this PPFM is to document how Liberty Life will manage its discretionary participation products (DPP). In managing such business, insurers rely on their ability to use discretion, particularly in relation to the investment strategy adopted and the smoothing and bonus policies used. This document:

- explains the nature and extent of the discretion available;
- shows 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 this document explains the management of the DPP business; it does not give advice as to the benefits of a discretionary participation product.

Liberty Life is committed to providing open and honest communication and we believe that the PPFM will assist with that aim. Liberty Life's DPP's 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;
- providing certain guarantees, which usually increase over the lifetime of the policy (for example the payment of vesting bonuses at maturity, retirement or death); and
- for many policies, declaring a terminal / final / non-vested bonus which does not form part of the guaranteed amount but which may be added to the value of the contract.

Discretionary participation products include products known as with profits policies, smoothed bonus contracts, reversionary bonus contracts and with-profit annuities.

1.4 Principles

The Principles:

- are enduring statements of the overarching standards that Liberty Life adopts in managing discretionary participation products; and
- describe the business model used for managing the discretionary aspects of Liberty Life's discretionary participation policies 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.

1.5 Practices

The Practices:

- describe Liberty life's current approach to managing discretionary participation products and how we intend responding to changes in the business and economic environment in the short term; and
- 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 Liberty Life.

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.

1.6 Communication of the PPFM

This PPFM is available on the Liberty Life website. In addition, policyholders will receive a summarised version of the PPFM with their bonus statement following the implementation of the PPFM. The PPFM will also be available on request to interested third parties.

1.7 Monitoring compliance with the FSB Directive

It is the responsibility of the Liberty Life Board of Directors (Board) to ensure that the company manages DPP in line with the principles and practices set out in this document. The Board has delegated this responsibility to the Liberty Group Audit and Actuarial Committee (GAAC) who will report to the Board annually on this compliance.

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

1.8 Changes to the PPFM

Any changes to the PPFM must be approved by the Liberty Life Board. The Group Audit and Actuarial Committee (GAAC) may propose changes to the PPFM to the Board. The Board may seek the advice of the GAAC or the Liberty Statutory Actuary in considering such changes.

1.9 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 Bonus Committee
- The Liberty Life Group Audit and Actuarial Committee
- The Liberty Life Board

1.10 Classes of business

The main types of DPP business administered by Liberty Life are:

- **Conventional reversionary bonus business:** Where contracts commence with an initial sum assured, to which reversionary bonuses are added each year and a terminal bonus is payable at claim stage.

- **Smoothed bonus business:** Where premiums less charges are invested in an account for the policyholder and each year bonus additions are made to the account.
- **With profit annuities:** Where the amount of annuity increases each year, the increase calculated with reference to the bonus declaration.

The following classes of business are covered by the PPFM:

TYPE	Class	VESTING MODE	DECLARATION MODE
Conventional Reversionary Bonus Business	Manufacturers Life (MLI) Conventional	Fully vested	Annually in arrear
	Sun Life Conventional	Fully vested	Annually in arrear
	Liberty Conventional	Fully vested	Annually in arrear
	Prudential Conventional	Partially Vested	Annually in arrear
Smoothed Bonus Business			
	Individual		
	Individual Balanced Bonus	Partially vested	Annually in arrears
	Liberty Whole Life	Fully vested	Annually in arrear
	Liberty Progressive Bonus	Full Vested	Monthly in advance
	Corporate		
	Corporate Balanced Bonus	Partially vested	Annually in arrears
	Corporate Advance Bonus	Fully vested	Quarterly in advance
	Fedsure Guaranteed	Fully vested	Annually in arrear
	Fedsure Omega Plus	Fully vested	Monthly in advance
	Norwich Guaranteed	Partially vested	Annually in arrear
	Norwich Omega	Fully vested	Annually in arrears
Norwich Iris	Fully vested	Annually in arrears	
Norwich Unique	Fully vested	Annually in advance	
Norwich Omega Plus	Fully vested	Monthly in advance	
With-Profits Annuities	Growth Pensions	Fully vested	Annually in advance

1. 11 Technical Terms

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

2. Bonus Philosophy

2.1 Overriding Principles

- 2.1.1 The overriding principles will take precedence over any other principles.
- 2.1.2 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, the policy conditions will prevail.
- 2.1.3 Any decisions regarding the distribution of surplus will first consider the long-term solvency of the relevant fund.
- 2.1.4 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 Liberty Life, industry practice and representations made to policyholders.
- 2.1.5 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.

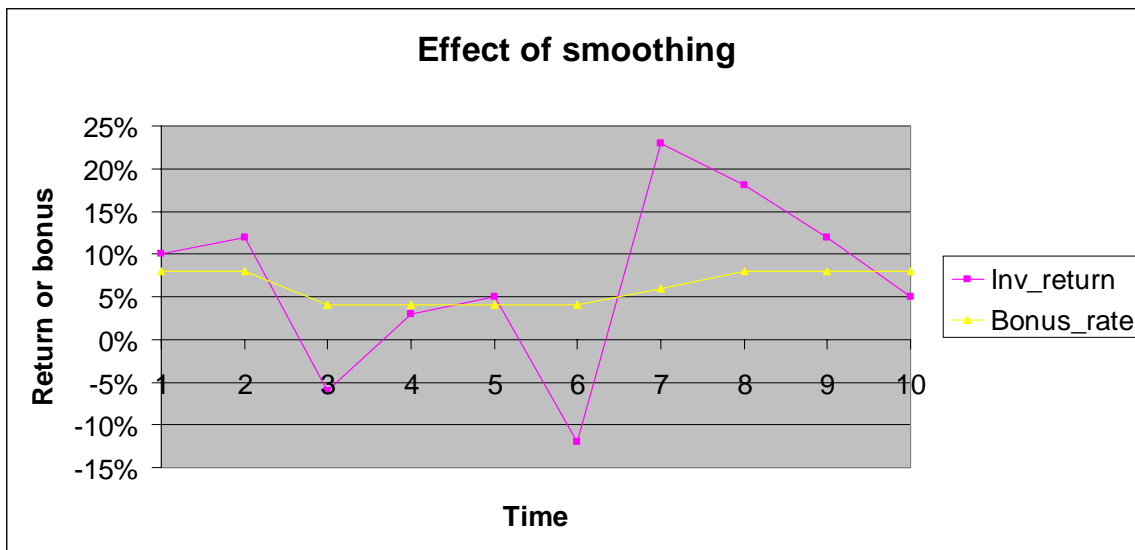
2.2 Objectives

- 2.2.1 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 the 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 would with a market-related policy, but rather shares in surplus as a part of a pool where surplus is shared amongst members. 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 Liberty Life flexibility to invest in assets which may be more risky in the short term, but should outperform other asset classes in the longer term.

- To set pay-out values by reference to the asset share of the respective class of business, except where guaranteed minimum benefits increase the total amount payable.
- To declare one bonus rate to all policyholders within each bonus class. There is no cross-subsidy between various bonus classes. However cross-subsidy can occur between different generations of policyholder within a bonus class.
- To set final bonus rates so that in normal investment conditions pay-out values change only gradually over time i.e. we provide smoothed benefits.
- To declare bonuses such that smoothing profits and losses should balance out over time, so that in the long run DPP policyholders in each sub-fund, or within a product group with a specific smoothing account, neither gain nor lose as a result of our smoothing policy. The accumulative cost of smoothing and guarantees is monitored. The short-term cost of smoothing is constrained only by the impact that smoothing costs have on the risk level of the fund and hence the security of continuing policyholders.



2.2.2 The main factors affecting the determination of the bonus rates are

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

2.3 Distribution of Surplus

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

- A **regular bonus** (also known as an annual or reversionary bonus), a part of which vests, 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) added to policies when a claim is paid in a specified period or the contract matures, but is not guaranteed.

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

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 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 policy, so that significant differences in investment mix, guarantees and charges, tax, premium rates, and profit sharing philosophy are recognized.

3.2 Regular Bonus Practices

3.2.1. Bonus variation

- We declare separate rates of regular bonus in respect of each of the categories of policies mentioned in section 1.10. 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.
- 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 depending on which tax fund the policy is held in as required by the Long term Insurance Act, so that the bonus rates reflect the effect of taxation in the respective underlying tax funds.

3.2.2. We calculate a level of regular (reversionary) bonus rate which is likely to be sustainable 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 policy, 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 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 Liberty Life 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.

3.2.4. Reversionary bonus policies normally have regular bonuses added in one of 3 possible ways:

- 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. Once regular bonus additions are made they become part of the guaranteed benefits of the policy and cannot be removed.
- 3.2.6. **Amendment of regular bonus rates:** Reversionary bonus rates are normally reviewed annually, but may be reviewed more frequently at the discretion of Liberty Life's Statutory Actuary (and subject to the review process discussed in 1.9) in the event of exceptional investment conditions arising.
- 3.2.7. **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 Liberty Life Statutory Actuary (following the process described in 1.9) retains the discretion as to whether or not to declare a regular bonus each year, and consequently there is no limit on the amount by which regular bonus rates can change, particularly in the event of volatile investment conditions.
- 3.2.9. **Interim bonus rates:** Final bonus rates are declared retrospectively at the end of each financial year once surpluses arising are known. The statutory actuary will also 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 his expectation at that time of the long-term sustainable expected rate.
- Interim bonus rates are not guaranteed and can change retrospectively.
- 3.2.10. **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.
- 3.2.11. **Declaration dates:** The declaration dates coincide with the financial year-end of Liberty Life, namely 31 December.
- 3.2.12. **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 3.2.9. 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. The table in section

1.10 sets out which classes of business declare bonus rates in advance and which declare bonus rates in arrear.

3.3. Final Bonus Principles

- Final bonus rates are set with the aim of distributing the balance of distributable surplus earned over the lifetime of the fund, to the extent that such surpluses have not previously been distributed by way of regular or other bonus additions. The aim is to distribute the total asset share to policyholders over the life of the fund.

- 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

- 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.
- 3.4.5. In general, the same final bonus scale applies to maturity and death payments. Surrender claims will 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 matures.
- 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 actuarial reserve is called the bonus stabilization 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 Liberty

Life has reserved for or declared bonuses in excess of those which 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 an ideal targeted level of BSR. The long-term target level is 0% meaning 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.

4. Smoothed bonus business

4.1 Regular bonus principles

- We aim 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 is more smoothing and less volatility in the bonus declarations. These policies are generally backed by a more conservative asset mix, allowing a more stable bonus policy to be followed.

4.2. Regular bonus practices

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

- Investible premiums (Premiums 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 these policy conditions. However, this will only be done if deemed justifiable by the statutory actuary and not to simply increase shareholder profits.

4.2.2 Each class of business has its own fund of assets. The size of the fund is calculated using the same items as used in calculating the policyholder fund account, but accumulated at the investment return earned on the assets and deducting the profits transferred to shareholders.

4.2.3 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 (BSR). This is calculated as the value of the fund of assets less the sum of the policyholder fund accounts. If the company has allocated bonuses in excess of actual surplus earned then the BSR may be negative.

4.2.4 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.

4.2.5 In times of good 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 (i.e. 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, 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 Liberty 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 falls below -7,5% then this must be disclosed in the report of the Statutory Actuary and published in Liberty's Report and Accounts. The Statutory Actuary must explain how this deficit can be recovered within 3 years in accordance with Professional Guidance Note 104 (PGN104) of the Actuarial Society of South Africa (ASSA).

4.2.7. At present the Liberty smoothed bonus BSR's are managed as follows:-

- For each class of business, we have established a target BSR as a percentage of the fund account at the end of each calendar year and a smoothing term.
- The aim is to set bonus declarations so that the actual BSR equals the target at the end of the smoothing term.
- The target BSR and the smoothing term have been set taking into account the size of each class, the term of the policies and the speed at which the funds are increasing or contracting.
- The current targeted BSR and smoothing terms are as follows:

Product	Targetted BSR	Smoothing term
Individual Balanced Bonus	5%	2.5 years
Liberty Whole Life	11%	3 years
Corporate Balanced bonus	5%	2 years
Fedsure Guaranteed	5%	2 years
Norwich Guaranteed	5%	2 years
Norwich Omega	5%	2 years

- If the BSR exceeds 20% at the end of any year, the excess over 20% may be declared as an additional bonus.
- If the BSR falls to between 0% and -15%, the deficit will be recouped through lower bonus declarations over the following three years.

- If the BSR falls below –15%, previously declared non-vested bonuses may be removed (where applicable) or shareholder funds will be utilized to restore the BSR to a minimum of –15%.

4.2.8. Features applicable to Specific Classes of Business

- 4.2.8.1. Liberty Progressive Bonus and Liberty Advance Bonus: The assets backing these portfolios comprise equities, together with derivatives on those equities designed so that the value of the assets will not fall over any bonus period. These derivatives also limit the maximum return that can be achieved over the bonus period. The aim is to declare bonuses such that the BSR remains between -5% and 5% of the fund value.
- 4.2.8.2. Norwich Unique: The bonus will be set equal to the bonus declared on the Norwich Guaranteed fund in order to comply with the terms of the Norwich Transfer agreement.
- 4.2.8.3. Norwich Omega: The bonus will be set equal to the bonus declared on the Fedsure Guaranteed fund in order to comply with the terms of the Norwich Transfer agreement.

4.2.9 Income and Capital bonus: The smoothed bonus rate is declared in two parts:

- The vested or income bonus rate, which forms part of the guaranteed policyholder benefits.
- The non-vested or capital bonus, which does not form part of the guaranteed policyholder benefits and hence can be removed from the policyholder at the discretion of Liberty Life. 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 income net of tax and charges, rental and dividend income. The non-vested component would then be the capital gains portion of the investment return. 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 Liberty Life to manage (as the vested bonus is 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 Liberty Life to manage, more investment freedom and hence potentially higher bonus rates in the long-term.

For example, 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.

4.2.10 **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 excellent 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 would be repaid to shareholders as soon as investment conditions allow.

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.

4.2.11.3 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 the Statutory Actuary's expectation at the time of the bonus rate to be declared at the next bonus declaration date. The interim bonus rate will be similar to the long-term sustainable expected rate.

Interim bonus rates are not guaranteed and can change retrospectively.

4.4. Final bonus rates

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 1.9.

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 4.2.11 above.

5. With profit annuities

5.1. The nature of the with-profit annuity is very different to the smoothed bonus or conventional bonus type of contract where a bonus addition enhances the benefit to be payable on claim. For a with-profit annuity, the bonus addition results in an enhancement to the annual or monthly income amount (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 so that the distribution of surplus is smoothed over time. Greater caution is applied in setting the bonus rate than for a smoothed bonus contract owing to the long-term risk to Liberty Life of granting an increase in the annuity, resulting in a guaranteed increase for the remainder of the annuity payment period.

5.3. Practices

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

5.3.2. With profit annuities are priced allowing for a targeted 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 targeted increase rate.

5.3.3. In the event that investment returns are less than the targeted increase rate, then it is not possible to reduce the annuity amount payable by declaring a negative bonus rate. This represents a significant risk to Liberty Life in managing this business.

5.3.4. Bonuses on with profit annuity business are declared via a regular bonus and a final bonus is not appropriate due 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 (past and future) at a point in time that will be granted to a pool of policyholders over time. [Does this explain it]
- 7.2. Asset shares are 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
- 7.4. Items of outgo allowed for in the asset share build up include:
- Mortality, disability and surrender claims paid
 - Expenses and commission
 - Charges for guarantees
 - Shareholders' profit transfers
- 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, which is essentially a capital guarantee. For all Liberty 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, Liberty Life 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 1/9th, 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.
- 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:

TYPE	Class	POLICYHOLDER	SHAREHOLDER
Conventional business	Manufacturers Life (MLI) Reversionary	All other profits	10% of bonuses declared
	Sun Life Reversionary	All other profits	10% of bonuses declared
	Liberty Reversionary Bonus	All other profits	20% of bonuses declared
	Prudential	All other profits	10% of bonuses declared
Smoothed Bonus Business			
Individual	Individual Balanced Bonus	All other profits	10% of bonuses
	Liberty Whole Life	All other profits	10% of bonuses declared
	Liberty progressive Bonus	100% of return	Nil
Corporate	Corporate Balanced Bonus	All other profits	10% of bonuses
	Corporate Advance Bonus	100% of return	Nil
	Fedsure Guaranteed	100% of return	Nil
	Fedsure Omega Plus	100% of return	Nil
	Norwich Guaranteed	100% of return	Nil
	Norwich Omega	100% of return	Nil
	Norwich Iris	100% of return	Nil
	Norwich Unique	100% of return	Nil
	Norwich Omega Plus	100% of return	Nil
With-profits annuities	Growth Pensions	100% of return	Nil

8.2.5 Expenses are allocated to the asset share on a per policy basis, as per Liberty Life's 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:

- The nature and term of the DPP liabilities and the management of cashflows.
- The current and expected future level of contractual guarantees.
- Regulatory solvency requirements and future possible scenarios.
- Advice from the fund manager.
- The short-term and long-term anticipated returns from different asset classes.
- The expected volatility of various different asset classes.
- Policyholder reasonable benefit expectations
- 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.

8.2. Practices

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

8.2.2. Each class invests in its own portfolio.

8.2.3. The Liberty Asset Liability Matching Committee oversees the relationship between Liberty Life and the in-house asset manager, sets the strategic direction

and reviews performance against benchmarks. It is also tasked with approving major, special or strategic investment decisions. The committee meets monthly.

8.2.4. The Asset Liability Matching committee is also responsible for determining the asset allocation strategy and reviewing both competitor activity and economic outlook alongside expected returns on different asset classes.

8.2.5. For retirement annuity funds, the investment strategy is formulated by the trustees.

8.2.6 **Current Investment Strategy:** Currently, the assets underlying the DPP business are invested in a mix of listed equities, property, fixed interest investments and 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 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, to enable reduction of risk by diversifying holdings.

The current mandates for the main asset classes are as follows:

8.2.6.1. **Equities:** A substantial portion of the DPP funds are invested in equities. These investments benefit from any growth in companies' profits and from economic growth generally. Equities have traditionally outperformed other classes of investments. 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, a broad range of equities are invested in, by sector and stock. Equities in offshore countries are also held. This diversifies risk and gives exposure to foreign markets and currencies.

Equities are managed in accordance with the equity house view. The benchmark is the SWIX Index and the performance objective is to outperform the benchmark by 1% pa.

8.2.6.2. **Properties:** Property investments benefit from growth in rentals and property values, and hence, like equities, are expected to benefit from economic growth generally. Property investments have historically outperformed cash and fixed interest, but have been less volatile than equities and hence also provide a diversification from equities.

8.2.6.3. **Fixed Interest:** These investments have typically lower returns than equities and property 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 highly liquid and has low dealing costs. Investments are also made in corporate bonds which generally have a higher yield than comparable government bonds, although there is then a risk of default.

The Core Bond portfolio will be managed within a duration range of +/- 1,5% around the BEASSA All Bond Index and will invest in a diversified range of fixed interest investments. The target performance is 0,35% per annum above the index. The benchmark is the BEASSA All Bond Index.

8.2.6.4. **Cash:** The cash holding is generally low. Its main purpose is to ensure liquidity and availability of funds for operational reasons. Investments are made in a diversified range of fixed interest instruments that qualify for the investible universe. The benchmark is the Stefi Composite.

8.2.6.5. **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.

8.2.6.6. **Treasury shares:** The funds do not invest in treasury shares.

8.2.6.7. **Collective investment schemes:** The DPP funds do not invest in collective investment schemes own by Liberty Life.

8.2.7. Although mandates indicate the bulk of investments in equities, a short term asset allocation change may be made to take advantage of specific market conditions or opportunities.

8.2.8. The fund invests predominantly in quoted investments in order to maintain the liquidity quality of the fund.

8.2.9. The funds do not invest in any strategic assets of Liberty Life.

9. **New bonus classes**

The Liberty Life with-profits funds are closed to new business, with the exception of Corporate Advance Bonus and Liberty Progressive Bonus. In the event that new with-profits business were to be written by Liberty Life a new smoothed bonus class would be set up for that new business.

10. **Small funds**

The funds that are closed to new business will over time become smaller and eventually not economically viable to manage as separate entities. At that point we will consider merging these funds with larger ones. This will 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 compound effect of bonus declared in the past.

Actuarial Reserve

The value placed on the companies 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 stabilization reserve (BSR)

A liability held in respect of a class of business as part of the life fund, being the undistributed surplus owed to that class of business but not yet allowed for in the actuarial reserve, or 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 a regular reversionary bonus and a final terminal bonus.

Discretionary participation policies (DPP)

Discretionary participation policies (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 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 is also 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

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 bonus is declared by means of a regular reversionary bonus and a final terminal bonus. 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 are invested into a fund account (less charges) 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 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 is 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 is also known as the income bonus.