Principles and Practices of Financial Management (PPFM) for Liberty Group Limited reversionary bonus, smoothed bonus and with-profit annuity products

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1 INTRODUCTION

1.1 Background

Liberty Group Limited (Liberty) is one of the largest insurers in South Africa and has sold a wide variety of business since its inception in 1957. Liberty also has acquired a number of legacy books including Prudential, Manufacturers Life, Sun Life and Investec Employee Benefits comprising the business formerly administered by Fedsure Life and Norwich Life. In 2013 the businesses of Capital Alliance Life, Liberty Growth and Liberty Active were also transferred to Liberty.

1.2 Purpose of Principles and Practices of Financial Management

In the management of Liberty's *discretionary participation products*[1], Liberty must use its discretion in managing investments and allocating bonuses. In accordance with Directive 147.A.i.(LT) issued by the Financial Services Board (FSB), Liberty must define and make publicly available the Principles and Practices of Financial Management (PPFM) that Liberty applies in the management of its *discretionary participation products*.

Liberty has published the following documents covering the PPFM on its website (www.liberty.co.za):

- PPFM for Liberty reversionary bonus, smoothed bonus and with-profit annuity products
- PPFM for flexible annuity business
- PPFM for Stable Growth Fund

These PPFMs may be updated from time to time and policyholders are encouraged to check the Liberty website for any such changes.

The purpose of each PPFM is to document how Liberty will manage its *discretionary participation products*. In managing business with discretionary participation features, insurers rely on their ability to use discretion, particularly regarding the investment strategy adopted and the bonus smoothing policies used.

The purpose of Liberty's PPFMs is to:

- Explain the nature and extent of the discretion available; and
- Show how competing or conflicting interests or expectations of different groups of policyholders, of different generations of policyholders and between 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 *discretionary participation products* business and not to give advice as to the benefits of a *discretionary participation product*.

[1] *Items in italics are defined in the Glossary (section 7).*

Liberty is committed to providing open and honest communication and believes that the PPFM will assist with that aim. Liberty's *discretionary participation products* are managed in accordance with these principles and practices.

1.3 Principles

The principles are enduring statements of the overarching standards that Liberty adopts in managing *discretionary participation products* and are not expected to change often. They are the standards used to maintain the long-term solvency of the fund for current and future policyholders.

The principles also describe the business model used:

- when discretion is applied in the management of *discretionary participation products;* and
- in responding to longer-term changes in the business and economic environment.

Liberty does not expect to change the principles often and will give at least three months advance written notice to *discretionary participation product* policyholders of any changes to the principles, unless the regulator grants Liberty exemption from this requirement.

1.4 Practices

The practices describe Liberty's current approach to managing *discretionary participation products* and how Liberty intends responding to changes in the business and economic environment in the shorter term.

They are intended to contain sufficient detail for a knowledgeable observer to understand the material risks and rewards when taking out a *discretionary participation product* with Liberty.

Liberty expects to change the practices as the circumstances in Liberty's business environment change. Liberty will advise *discretionary participation product* 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 is available on the Liberty website. Policyholders will also receive a summarised version 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 Compliance

The Liberty Board of Directors (the board) is responsible for the governance of *discretionary participation products*, and has tasked the Liberty Group Actuarial Committee (GAC) to monitor compliance with the PPFM on its behalf.

The PPFM may change as the economic or business environment changes. The GAC will review, approve and note for challenge to the board any change to a principle or a practice, after consultation with the *statutory actuary*.

The GAC will present an annual report to the board on its work. The board will report on compliance with the PPFM in the annual statutory return.

2 OVERRIDING PRINCIPLES OF FINANCIAL MANAGEMENT

2.1 Principles regarding legal and contractual obligations

Liberty is committed to meeting all Liberty's contractual obligations, as well as legal and regulatory requirements. In the event of a conflict arising between the PPFM and the policy conditions, then the policy conditions will prevail.

Policies with values that are impacted by the amendment of Part 5 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.

2.2 Principles regarding the general management of *discretionary participation products*

Liberty applies the following key principles to its *discretionary participation products*:

- Each class of *discretionary participation products* has a separate *asset share* that is used to support the benefits of the policyholders in that class.
- Where the contract allows for a maturity benefit, the benefit payment equals the vested plus the non-vested benefit.
- Policyholders share in the investment return of their respective *asset share* as well as the differences in value between the *asset share* and the value of the benefits paid. Policyholders may also share in other profits and losses, for example, those arising from mortality benefits, surrenders and expenses.

2.3 Principles regarding bonuses

The underlying bonus philosophy is that the *asset share* of a class of *discretionary participating policyholders* will be allocated to the benefit of those policyholders over time, subject to the charges accruing to shareholders.

The long-term solvency of the relevant class will be considered when bonus declaration decisions are made.

The company's bonus distribution policy further aims to:

- Give each *discretionary participation product* 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 ensuring that *discretionary participation product* policyholders in each *bonus series* receive a fair share of the *surplus* distributed by way of bonus additions to their policies.

- Retain flexibility in Liberty's investment policy and protect the ongoing solvency of the fund. For most classes of *discretionary participation products* Liberty aims to keep a substantial proportion of pay-out values in non-vested form (i.e. payable as a *final bonus*) and determine *regular bonus* rates accordingly. This gives Liberty the flexibility to invest in volatile assets which should outperform other asset classes in the longer term.

- 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.
- Ensure that 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 policyholders within a *bonus series*.
- *Set final bonus* rates so that in normal investment conditions pay-out values change only gradually over time, i.e. Liberty provides smoothed benefits.

The business will be managed by taking into account policyholders' reasonable benefit expectations, which have arisen from original contractual entitlements, past practice by Liberty, industry practice, as well as representations made to policyholders.

Where the *funding level* is less than 100%, this is recovered over time by awarding lower bonus declarations than implied by the actual investment returns. If the *funding level* falls below 92,5% 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 three years, as per Standards of Actuarial Practice 104 (SAP104) of the Actuarial Society of South Africa (ASSA).

Bonus rates are recommended by the *statutory actuary* following the principles and practices laid down below. The GAC will review, approve and note for challenge to the board the declared bonus rates.

Bonuses are a combination of *vested* and *non-vested bonuses*.

2.4 Principles regarding investment strategy

Policyholder and shareholder assets are segregated.

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

- The nature and term of the *discretionary participation product* liabilities and the management of cash flows.
- The current and expected future levels 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 different asset classes.
- Reasonable benefit expectations of policyholders.
- Appropriate protection of 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 by 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 per 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 *discretionary participation product* policies and different generations of *discretionary participation product* policyholders.

2.5 Principles regarding guarantees

Certain contracts have investment guarantees in that the maturity value is set according to a contractually determined guaranteed minimum growth rate. In addition, a *discretionary participation product* has an implicit guarantee that the value of the policy cannot fall below the vested benefit which is essentially a capital guarantee. For all contracts, the management fee 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.

2.6 Principles regarding surrender values and other early termination benefits

Liberty endeavours to pay out surrender values that do not have an adverse effect on continuing policies. When the *funding level* is less than 100%, *market value adjusters* will normally be applied to the *book value* to reduce the amount paid to policyholders who choose to surrender their policies early.

2.7 Principles regarding charges

For certain classes of business, Liberty shareholders are entitled to a fixed percentage of the bonuses declared to policyholders. The most common sharing arrangement is for shareholders to be allocated one-ninth of the policyholder's entitlement. If, for example, the policyholder bonus is 9%, then the shareholder entitlement is one-ninth or 1%, together making a total bonus of 10%. For certain other classes, Liberty shareholders are entitled to a proportion of the investment returns earned on the assets. For other classes, shareholders are entitled to the remainder of *surplus* after policyholder bonuses have been declared. The profit-sharing basis forms part of the policy conditions.

2.8 Principles regarding new business and portfolio mergers

The Liberty *discretionary participation products* covered by this document are closed to new business, with the exception of Corporate Advance Bonus, Liberty Progressive Bonus and CAL ELM smoothed bonus.

Since the majority of the funds are closed to new business, they will over time become smaller and eventually will not be economically viable to manage as separate entities. At this point Liberty will consider merging these funds with larger ones. This should not materially affect policyholder expectations and Liberty aims to ensure a continuation of the policyholder

expectations, because generally when a fund contracts it becomes necessary to invest in less volatile assets which generally means lower long-term expected returns.

A merger of funds may require changes to the way that profits are shared between policyholders and shareholders, which may result in adjustments to the *funding level* to allow for the impact of such changes. These adjustments will be determined in a manner that aims to ensure that policyholder expectations are not materially disadvantaged.

2.9 Principles regarding financial assistance

It is a statutory requirement to provide financial assistance to portfolios with a *funding level* of less than 100% if the deficit in the portfolio is not expected to be eliminated within the next three years. The board may also decide to provide assistance in circumstances where it is deemed to be in shareholders' interests. Support will normally be provided in the form of interest-free loans that may be recovered from the portfolio when they are deemed to no longer be required.

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3 CONVENTIONAL REVERSIONARY BONUS BUSINESS

3.1 Types of business

The following classes of reversionary business are covered:

Class	Vesting mode	Declaration mode
Manufacturers Life (MLI) Conventional	Fully vested	Annually in arrear
Sun Life Conventional	Fully vested	Annually in arrear
Liberty Conventional (dividend declaring policies)	Fully vested	Annually in arrear
Liberty Conventional (non-dividend declaring policies)	Partially vested	Annually in arrear
Prudential Conventional Reversionary Bonus	Partially vested	Annually in arrear
Norwich Conventional Reversionary Bonus	Partially vested	Annually in advance
Fedsure Conventional Reversionary Bonus	Partially vested	Annually in arrear
CAL (Stangen, AA Life, Traduna, ACA) Conventional Reversionary Bonus	Partially vested	Annually in arrear
Liberty Active Conventional Reversionary Bonus	Partially vested	Annually in arrear
Rentmeester Conventional Reversionary Bonus	Fully vested	Annually in arrear

3.2 Practices regarding bonuses

3.2.1 Declaration dates

The declaration dates coincide with the financial year-end of Liberty, namely 31 December.

3.2.2 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 3.2.6) will apply. For other classes, bonus rates are declared in advance of the coming year, and then no interim bonus rate will apply. The table in section 3.1 indicates which classes of business declare bonus rates in advance and which declare bonus rates in arrears.

3.2.3 Regular bonus variation

- Liberty declares separate rates of *regular bonus* in respect of each *bonus series* within each of the classes of business mentioned in section 3.1. The *regular bonus* is also known as the *reversionary bonus*.
- Bonus rates vary depending on the original premium rate for the contract as well as 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 the existing (declared) *regular bonus*.
- Bonus rates may also differ depending on 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, i.e. no further tax is deducted from the bonus rates.

Liberty calculates a 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 the investment. *Asset share* calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders.

3.2.4 Amendment of regular bonus rates

Reversionary bonus rates are normally reviewed annually, but may be reviewed more frequently at the discretion of Liberty's *statutory actuary* (and subject to the approval process detailed in 2.3) in the event of exceptional investment conditions arising.

3.2.5 Maximum change to regular bonus rates

In normal investment conditions Liberty expect changes to *regular bonus* rates to be gradual over time and changes to *regular bonus* rates, which are expressed as a percentage, are not expected to exceed one percentage point over any year. However, the Liberty *statutory actuary* (following the approval process detailed in 2.3) 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.

3.2.6 Interim bonus rates

For classes of business where bonuses are declared in arrears, bonus rates are normally declared retrospectively at the end of a financial year once the *surplus* arising is known. When bonus rates have been declared for the past year, the *statutory actuary* (following the approval process detailed in 2.3) 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 Liberty's expectation at the time it is set of the *regular bonus* rate to be declared at the next bonus declaration date. The interim *reversionary bonus* rate will be similar to the long-term sustainable expected rate.

Interim bonus rates are not guaranteed.

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

3.2.7 Amendment of interim bonus rates

In normal investment conditions Liberty does 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* (subject to the approval process detailed in 2.3).

3.2.8 Final bonuses

Asset share calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders.

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 changes in the market value of assets in the fund may not be reflected in claim payments in full.

The *final bonus* for *conventional reversionary bonus policies* is defined as a *terminal bonus* and is usually based on a percentage of the sum assured and the *accrued bonus*. 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 and the 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* among generations of policyholders.

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 to recognise the shorter duration that the policyholder has elected (to be fair to remaining policyholders), and the fact that bonuses are declared with the expectation of being paid on maturity or death.

A suitable level of *terminal bonus* is determined by comparing the *asset share* with the *book value* of the corresponding group of policies.

3.3 Practices regarding surrenders

A *market value adjuster* (MVA) may be applied on surrender. It serves to protect the fund against adverse selection when, for example, policyholders may take advantage of poor market conditions to benefit from *book value* exceeding *asset share*.

MVA scales are reviewed frequently and may be changed at any time at the discretion of the *statutory actuary*. Changes are more likely in times of volatile asset movement.

3.4 Practices regarding charges

The profit-sharing between policyholders and shareholders is summarised in the table below:

	Policyholders	Shareholders
Prudential Conventional	All other profits and losses	10% of total bonuses declared
Manufacturers Life (MLI) Conventional	All other profits and losses	10% of total bonuses declared
Sun Life Conventional	All other profits and losses	10% of total bonuses declared
Liberty Conventional	All other profits and losses	20% of total bonuses declared
Norwich Conventional Reversionary Bonus	All other profits and losses	Investment charges and expense profits and losses
Fedsure Conventional Reversionary Bonus	All other profits and losses	Investment charges plus maturity, surrender, and expense profits and losses
CAL (Stangen, AA Life, Traduna, ACA) Conventional Reversionary Bonus	All other profits and losses	Investment charges plus surrender and expense profits and losses
Liberty Active Conventional	All other profits and losses	10% of total bonuses declared
Rentmeester Conventional	Net investment returns	All other profits and losses

4 SMOOTHED BONUS BUSINESS

4.1 Types of business

The following classes of smoothed bonus business are covered:

Class	Vesting mode	Declaration mode
Individual Balanced Bonus	Partially vested	Annually in arrear
Liberty Whole Life	Fully vested	Annually in arrear
Liberty Progressive Bonus	Fully vested	Monthly in advance
Calibre Progressive Bonus	Fully vested	Monthly in advance
Norwich Smoothed Bonus	Partially vested	Annually in advance
Norwich Future Select	Partially vested	Annually in advance
Fedsure Deposit Administration	Partially vested	Annually in arrear
Fedsure Fully Vesting	Fully vested	Monthly in advance
CAL Smoothed Bonus	Partially vested	Annually in arrear
CAL Entry Level Market Smoothed Bonus	Partially vested	Annually in arrear
Liberty Active Smoothed	Partially vested	Annually in arrear
Liberty Active Groguard	Partially vested	Annually in arrear
Rentmeester Smoothed Bonus	Partially vested	Annually in arrear
Corporate Balanced Bonus	Partially vested	Annually in arrear
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 arrear
Norwich Unique	Fully vested	Annually in advance
Norwich Omega Plus	Fully vested	Monthly in advance
CAL Guaranteed Fund	Partially vested	Annually in arrear

4.2 Practices regarding bonuses

4.2.1 Declaration dates

The declaration dates coincide with the financial year-end of Liberty, namely 31 December.

4.2.2 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 4.2.8) will apply. For other classes, bonus rates are declared in advance of the coming year, and then no interim bonus rate will apply. Refer to the table in section 4.1 to see which classes of business declare bonus rates in advance and which declare bonus rates in arrears.

4.2.3 Smoothed bonus regular bonus

Asset share calculations are used as a guide to determine bonus rates and the amounts distributable to policyholders.

At present Liberty's *funding level*s for the classes of business shown in the table below are managed as follows:

- For each class of business an optimal long-term target *funding level* and a *smoothing* term has been established.

- The aim is to set the bonus declarations so that the actual *funding level* equals the target at the end of the *smoothing* term.
- The target *funding level* and the *smoothing* term have been set taking into account the size of each class, the term of the policies, the speed at which the funds are increasing or contracting and the level of any guarantees.
- The target *funding levels* will be reviewed as the funds wind down to zero to ensure that the full value of the fund accrues to policyholders in accordance with principle 2.3.

The current targeted *funding level* and *smoothing* terms are as follows:

Product	Targeted funding level	Smoothing term
Individual Balanced Bonus	105%	2.5 years
Liberty Whole Life	111%	3 years
Norwich Smoothed Bonus	103%	3 years
Norwich Future Select	103%	3 years
Fedsure Deposit Administration	103%	3 years
Fedsure Fully Vesting	103%	3 years
CAL Smoothed Bonus	103%	3 years
Entry Level Market Smoothed Bonus	103%	3 years
Liberty Active	103%	3 years
Liberty Active Groguard	103%	3 years
Rentmeester Smoothed Bonus	103%	3 years
Corporate Balanced Bonus	105%	2 years
Fedsure Guaranteed	105%	2 years
Norwich Guaranteed	105%	2 years
CAL Guaranteed Fund	103%	3 years
Norwich Omega	105%	2 years

- If the *funding level* before declaration exceeds 120%, the excess over 120% may be distributed to policyholders in the year in which it arises as an additional bonus.
- If the *funding level* before declaration falls below 100% then lower policyholder bonuses will be declared over the next three years in order to recoup part or all of the deficit.
- If the *funding level* before declaration falls below 85%, then the previously declared *non-vested bonus* may be removed (where applicable) until the funding level is restored to 85%. If this is insufficient to restore the *funding level* to 85% then shareholder funds, typically in the form of a loan, will be utilised to make up the difference.

4.2.4 Features applicable to specific classes of business

- Corporate Advance Bonus: The assets backing these portfolios comprise equities, together with derivatives on those equities designed so that the value of the assets should 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 *funding level* remains between 95% and 105%.

- Liberty Progressive Bonus and Calibre Progressive Bonus: The assets backing these portfolios are invested in an absolute return strategy including protected equity that aims to provide a return in excess of CPI with the limitation of aiming to preserve capital over a rolling three year term. The aim is to declare bonuses such that the *funding level* remains between 95% and 105%.
- 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.
- CAL Guaranteed Fund: Any *funding level* in excess of 120% will be distributed to policyholders in the year in which it arises as an additional bonus.

4.2.5 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 Liberty 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 policyholders' reasonable benefit expectations. In the event that there is a cost involved in applying the underpin, this will be met by the shareholders.

Additional limits have been placed on the Fedsure and Norwich fund management charges. These may not exceed the charges in force as at May 2001, i.e. 3,75% per annum.

4.2.6 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 *vested bonuses*, and the balance of the bonus rate is the capital or *non-vested bonuses.*

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 balance representing 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 Liberty to manage 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 to manage 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 change in the *funding level*.

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

4.2.7 Removal of non-vested bonus or injection of shareholder funds

In the event of *non-vested bonuses* being removed, as described above, these may be restored following sustained good investment conditions, so removal may not be permanent. Should *non-vested bonuses* be removed, the *asset share* will remain unchanged, but the *funding level* will improve due to the removal of the *non-vested bonus*.

If shareholder funds are utilised to restore the funding level of the portfolio, then these funds would be repaid to shareholders as soon as investment conditions improve. Shareholder funds would be repaid without interest before policyholder bonuses are reinstated as they provided the support needed to ensure the *funding level* did not drop below the absolute required minimum.

N*on-vested bonuses* may be removed from Norwich business provided that a similar level of *non-vested bonus* is removed from the Fedsure business and that the underpin condition still holds. However, if the Norwich *funding level* falls below 100% due to the application of the underpin condition (described in 4.2.5 above), it is not permissible to remove previously declared *non-vested bonuses* in order to restore the funding position.

4.2.8 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* (following the approval process detailed in 2.3) 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 Liberty's 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.

4.2.9 Smoothed bonus business final bonus

A *final bonus* is not usually paid to *smoothed bonus policyholders*, however, for closed books with a *funding level* substantially above the target *funding level*, a *terminal bonus* may be paid at claim stage as the number of policyholders in the portfolio declines. This would be at the recommendation of the *statutory actuary* and subject to the approval process described in section 2.3.

4.3 Practices regarding surrenders

A *market value adjuster* may be applied on surrender. 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.

An MVA will normally apply when the underlying *asset share* of the policy is less than the policy *fund account* value. However, an 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*.

MVA scales are reviewed frequently and may be changed at any time at the discretion of the *statutory actuary*. Changes are more likely in times of volatile asset movement.

4.4 Practices regarding charges

The profit-sharing between policyholders and shareholders is summarised in the table below:

	Policyholders	Shareholders
Individual Balanced Bonus	All other profits and losses	10% of income bonuses declared
Liberty Whole Life	All other profits and losses	10% of total bonuses declared
Liberty Progressive Bonus	All other profits and losses	Investment charges
Calibre Progressive Bonus	All other profits and losses	Investment charges
Norwich Smoothed Bonus	All other profits and losses	Investment charges plus expense profits and losses
Norwich Future Select	All other profits and losses	Investment charges plus expense profits and losses
Fedsure Deposit Administration	All other profits and losses	Investment charges plus surrender, maturity, mortality and expense profits and losses
Fedsure Fully Vesting	All other profits and losses	Investment charges plus surrender, maturity, mortality and expense profits and losses
CAL Smoothed Bonus	All other profits and losses	Investment charges plus surrender, maturity and expense profits and losses
Emerging Consumer Market Smoothed Bonus	All other profits and losses	Investment charges plus surrender, maturity and expense profits and losses
Liberty Active Smoothed	All other profits and losses	10% of total bonuses declared
Liberty Active Groguard	All other profits and losses	10% of total bonuses declared
Rentmeester Smoothed Bonus	Net investment returns	All other profits and losses
Corporate Balanced Bonus	All other profits and losses	10% of total bonuses declared
Corporate Advance Bonus	All other profits and losses	Investment charges
Fedsure Guaranteed	All other profits and losses	Investment charges
Fedsure Omega Plus	All other profits and losses	Investment charges
Norwich Guaranteed	All other profits and losses	Investment charges
Norwich Omega	All other profits and losses	Investment charges
Norwich Unique	All other profits and losses	Investment charges
Norwich Omega Plus	All other profits and losses	Investment charges
CAL Guaranteed fund	All other profits and losses	Investment charges

5 WITH-PROFIT ANNUITIES

5.1 Types of business

The following classes of with-profit annuities are covered:

Class	Vesting mode	Declaration mode
Growth pensions	Fully vested	Annually in advance
IEB with-profit annuities	Fully vested	Annually in advance

5.2 Nature of with-profit annuities

The nature of the with-profit annuity is completely different to the *smoothed bonus* or *conventional reversionary bonus* type of contract where a bonus addition enhances the benefit to be payable on claim. However, 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.

5.3 Practices regarding bonuses

5.3.1 Declaration dates

The declaration is performed once a year and applies to annuity increases that are effective from 1 April in the year of declaration to 31 March the following year.

5.4 Regular bonuses

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

Liberty's with-profit annuity range is closed to new business. These annuities were priced allowing for a minimum guaranteed interest rate, supportable by the expected long-term investment returns and based on the client's required annuity increase target. Consequently, annuity increases are only awarded to the extent that the declared bonuses are in excess of the minimum guaranteed interest rate.

In the event of the declared bonus being less than the minimum guaranteed interest rate, it is not possible to reduce the annuity amount payable by declaring a negative bonus rate. This represents a significant risk to Liberty in managing this business.

Bonuses on with-profit annuity business are declared via a *regular bonus. Final bonuses* are not applicable to with-profit annuities given that these contracts do not provide maturity or death benefits.

The with-profit annuity product was designed so that the underlying asset mix achieves the following:

- It provides a reasonable match for the minimum guaranteed annuities in payment, which generally requires investment in bond type instruments; and

- It provides a reasonable probability of exceeding the minimum guaranteed interest rate, in order to allow for the targeted pension increases to be achieved. This generally requires investment in equity type investments.

Given that each *regular bonus* is fully vesting, the guaranteed portion of the liability increases as a proportion of the total liability as the book matures. The investment policy is therefore adjusted accordingly over time, i.e. the proportion of bond type instruments will increase over time in order to increase the extent to which the guaranteed minimum annuities in payment are backed by appropriate matching assets.

5.5 Practices regarding charges

The profit-sharing between policyholders and shareholders is summarised in the table below:

Name	Policyholders	Shareholders
Growth Pensions - Single Manager	All other profits and losses	Investment charges plus mortality profits and losses
Growth Pensions - Multi Manager	All other profits and losses	Investment charges
IEB With-profit Annuities	All other profits and losses	Investment charges

6 INVESTMENT PRACTICES

6.1 General

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

6.2 Current investment strategy

Currently, the fund underlying the *discretionary participation products* business is invested in a mix of listed equities, property, fixed interest investments and cash. The strategic asset mix and tactical asset allocation ranges around the strategic asset mix have regard to the following factors:

- Statements regarding the mix of assets set out in marketing literature and other documents available to policyholders.
- Fund solvency position.
- The requirement to hold specified assets to support guarantees.
- Expected returns and risks from each asset class, including the views of Liberty and the asset managers.
- Expected correlations between the performance of various asset classes, enabling Liberty to reduce risk by diversifying holdings.

For each asset class, performance targets, benchmarks and asset allocation ranges are set. The current mandates for the main asset classes are:

6.2.1 Equities

Liberty invests a substantial portion of Liberty's *discretionary participation product* funds in equities. These investments benefit from any growth in companies' profits and Liberty expects them to benefit from economic growth generally. Equities have traditionally outperformed other classes of investments over time. Equity values are volatile and hence significant rises and falls in the market value of these equities may be experienced. Furthermore, individual holdings are subject to risk of failure of that individual company. In order to reduce these risks, Liberty invests in a broad range of equities, by sector and stock selection. Liberty also holds equities in offshore countries. This diversifies Liberty's risk and gives Liberty exposure to foreign markets and currencies.

6.2.2 Properties

Property investments benefit from growth in rentals and property values, and hence, like equities, Liberty expects 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.

6.2.3 Fixed Interest

These form a significant part of the investment of the funds. Fixed interest investments typically have lower returns than 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. Government bonds are particularly suitable for backing the guaranteed portion of with-profit liabilities. Government bonds are also highly liquid and have low dealing costs. Liberty also invests in corporate bonds, which generally have a higher yield than comparable government bonds, although there is then a higher risk of default.

6.2.4 Cash

The cash holding is generally low; its main purpose is to ensure liquidity and availability of funds for operational reasons. Liberty's definition of 'cash' has a maximum duration of 180 days and invests in a diversified range of fixed and floating rate interest instruments.

6.2.5 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.

6.2.6 Treasury shares

The funds do not invest in Liberty shares.

6.2.7 Collective investment schemes

The *discretionary participation product* funds do not invest in collective investment schemes owned by Liberty.

6.2.8 Other assets

The *discretionary participation product* funds may invest in such other assets as Liberty deems appropriate to meet the objectives of the funds.

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

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

The funds do not invest in any of Liberty's strategic assets.

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7 GLOSSARY

Accrued bonus

The total regular bonuses accrued as a result of the compound effect of bonuses declared in the past.

Asset share

The *asset share* is the *retrospective build-up* of the asset pool belonging to a group of *discretionary participation product* policies. It is the accumulation of all items of income and outgo that are relevant to each policy type.

Asset shares have been calculated at the asset portfolio level (essentially at a class of business level) and not at an individual (per policy) level.

Items of income allowed for include:

- Premiums paid
- Miscellaneous profits if applicable

Items allowed for which may be either positive or negative include:

- Investment returns

Items of outgo allowed for may include (see above):

- Applicable taxes
- Management fees (which include an implicit charge for guarantees)
- Mortality, disability, surrender and maturity claims or charges paid
- Expenses and commission (covered by management fees on certain contract types)
- Shareholders' profit transfers

- Miscellaneous losses

Book value

For reversionary bonus products, the *book value* is calculated on a prospective basis and equals the discounted value of the projected vested benefit plus the discounted value of the projected non-vested benefit plus an allowance for expenses less an allowance for expected future premiums. In this calculation, provision is made for future bonuses that are expected to be declared to ensure policyholders receive reasonable benefits compared to the assets underlying their policies. The vested benefit is calculated as the sum assured plus reversionary bonuses on the sum assured plus further reversionary bonuses on the accumulated reversionary bonuses. The non-vested benefit (if applicable) is the non-vested terminal bonus on the sum assured and non-vested bonuses on the reversionary bonuses. Declared bonuses are net of charges and tax.

For smoothed bonus products, the *book value* is equal to the *fund account*.

For with-profit annuity products, the *book value* is calculated on a prospective basis and equals the discounted value of expected future income benefit payments (including an allowance for future charges) plus an allowance for expenses.

Bonus series

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

Conventional reversionary bonus policy

A *conventional reversionary bonus policy* is a *discretionary participation product* where bonuses are declared by means of regular *reversionary bonuses* and a final *terminal bonus,* if applicable. The bonus is declared on the original sum assured of the policy and the *accrued bonus* to date, if applicable.

Discretionary participation products

Discretionary participation products 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 at claim stage.

Final bonus

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

Fund account

The *fund account* for a *smoothed bonus policyholder* is calculated on a retrospective basis by accumulating the net premiums with declared bonuses. The vested benefit is calculated as the net premiums plus vesting bonuses. The non-vested benefit is calculated as the difference between the net premium plus total bonuses and the vested benefit.

Funding level

The *funding level* is the ratio of *asset share* to *book value* of a *discretionary participation product* class.

Market-related

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

Market value adjuster

An adjustment made to a surrender claim on a *discretionary participation product* to reflect the underlying asset values, typically when market values have fallen due to poor investment conditions.

Non-vested bonus

The portion of bonus declared under a *discretionary participation product* which is not guaranteed on declaration and hence may be removed by the insurer to maintain solvency of the policyholder fund. *Non-vested bonuses* will only be removed or reduced based on a recommendation from the *statutory actuary* (following the approval process detailed in 2.3) when the *funding level* becomes unacceptably low.

Regular bonus

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

Retrospective build-up

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 reversionary 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 three 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.

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. Hence it works like a bank account with interest additions.

Smoothing

The concept of *smoothing* is fundamental to a *discretionary participation product* 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 bonus rate that is lower than the return is usually declared and the balance is reserved so that when returns are lower than expected a higher bonus rate than the return 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 South Africa, 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 in a class of *discretionary participation products* is the difference between the *asset share* and the *book value*. This may be negative.

Terminal bonus

The *final bonus* declared on a *conventional reversionary 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 *discretionary participation product* which is guaranteed on declaration and cannot be removed.