Nedgroup Life Assurance Company Limited principles and practices of financial management

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1 Introduction

Background

Nedgroup Life Assurance Company Limited (Nedgroup Life) ('we') is a wholly owned subsidiary of Nedbank, operating since 1977 and offering a comprehensive range of life insurance and savings products.

Our Universal product range, which includes a smoothed-bonus portfolio, is no longer open to new business. Products covered in the smoothed-bonus portfolio are summarised in Annexure 2.

This document sets out the principles and practices governing the smoothed-bonus portfolio. Approval and ultimate responsibility rest with the board, who relies on input from our Market Conduct Committee and our Statutory Actuary. The Market Conduct Committee is a subcommittee of the board and ensures that clients are treated fairly.

Purpose of the principles and practices of financial management

At Nedgroup Life we use our discretion for both the investment strategy and the declaration of bonuses, and this document sets out how we apply this in practice.

For the purpose of this document, principles refer to the long-term standards we use to manage the smoothed-bonus portfolio, and will therefore seldom change.

Practices refer to short-term actions we take, based on the current environment, to achieve these principles. Any changes to our principles or practices must be approved by the board and the Statutory Actuary, and communicated to the Financial Services Board (FSB) and all policyholders within three months from approval.

2 Policyholder and shareholder funds

Background

The assets backing the smoothed-bonus portfolio are part of policyholder funds.

The regulatory capital we require to manage this portfolio is part of shareholder funds.

Principle

Policyholder and shareholder funds must be clearly demarcated and managed separately. Investment returns must accrue where they are earned.

Practice

Assets for each of these funds are managed separately by different portfolio managers with specific investment mandates.

Any short-term funding mismatch as a result of the funding of monthly surrenders or withdrawals will be cleared within a month through the management of the funds.

3 Smoothed-bonus management

Background

Surpluses arise from the differences between the actual investment return earned on the underlying assets and the bonuses added to policyholder investment accounts. The surplus is reduced with approved management charges, investment fees, capital charges and taxes.

The accumulated surpluses are paid into the Bonus Smoothing Account (BSA) and the costs of investment guarantees are debited to the BSA.

While the intention is to maintain a positive BSA balance, there are times when it can become negative. A negative BSA balance means that more was declared as bonuses to policyholders than what was earned to that date, net of approved management charges, investment fees, capital charges and tax(as a consequence of the smoothing process). When this happens, the shortfall will be recovered in future bonus declarations (i.e. future bonuses will be less than the net return earned). This is in line with best practice methodology for smoothed-bonus funds.

Principle

Underlying assets must be invested to provide a real return over the policy's lifetime. The intention is to maintain a long-term BSA balance of no more than 5% of the unit account, and distribute the balance in the form of bonuses.

Negative bonuses will never be declared. The actual bonus may at times be lower than the interim bonus and/or investment returns for the year.

Practice

As actual investment performance may be volatile, we aim to smooth bonus rates from one period to the next. To achieve this the BSA may fluctuate around the benchmark from time to time.

4 Smoothed-bonus declarations

Background

Bonuses are declared once a year. If we have to pay bonuses in the period between normal bonus declarations, we will use an interim bonus rate. Please note that once the actual bonus is declared, the interim bonus will fall away.

Actual bonus declarations will reflect the long-term investment performance of the underlying assets, and will therefore smooth out the volatility of the actual performance. In years when above-average investment returns are earned, the bonus declared may be lower than the net investment return earned, and vice versa when below-average investment returns are earned.

There are two types of bonuses, namely vested (guaranteed) and non-vested (not guaranteed) bonuses. Once declared, vested bonuses form part of the guaranteed benefits of the smoothed-bonus policies and cannot be removed for normal contractual claims. Non-vested bonuses (also known as final bonuses, claim bonuses or capital bonuses, depending on the product) are not guaranteed and may be removed wholly or in part to ensure the solvency of the policyholder fund.

Declaring part of a bonus in non-vested form enables us to give policyholders the benefit of higher exposure to more volatile growth assets (such as equities and property), which may earn higher returns in the long term.

A summary of past bonuses is shown in Annexure 3.

Principle

The main objective of our bonus declaration policy for the smoothed-bonus portfolio is to distribute the BSA balance fairly over the lifetime of all policies.

Bonuses must be declared in such a way that:

- the BSA balance remains within acceptable limits under prevailing and prospective economic and market conditions after bonus declarations;
- an appropriate proportion of the unit account is held in a non-vested form; and

- the returns policyholders receive are competitive in comparison with other closed funds (subject to the above).

The board will remove non-vested balances wholly or in part on the recommendation of the Statutory Actuary if the negative BSA balance reaches unacceptable levels. When non-vested bonuses are removed they will be added to the BSA and therefore remain part of policyholder funds.

Practice

The board declares vesting and non-vesting bonuses for any year within three months of the relevant year-end on recommendation of the Statutory Actuary. An interim bonus rate is set at the beginning of each year, and remains valid for that year unless conditions warrant a revised rate to be declared.

The expected average BSA for smoothed bonus business in the long-run is between 0% and 5%, while in the short-term it could vary between –5% and 15%.

To qualify for a declared bonus, policies must have a positive balance in the relevant smoothed-bonus fund on the date the bonus is credited to policies.

When setting the vested bonus rate, we will consider the following:

- The extent to which the performance is made up of realised returns versus unrealised returns.
- The level of vested bonuses in the smoothed-bonus portfolio.
- The economic outlook.
- The asset mix and potential impact a fall in asset values will have on the smoothed-bonus portfolio.

The target level of non-vested bonuses is 10% to 30% of the smoothed-bonus portfolio.

The following aspects are taken into account when setting interim-bonus rates:

- For claims, the interim bonus should (as far as possible) provide a reasonable return when compared with expected returns earned in the fund for the period between the last bonus declaration date and the claim date. Interim-bonus rates are reviewed quarterly and may be changed at any time between bonus declaration dates in light of actual investment returns earned.
- To ensure that all policyholders are treated fairly, interim-bonus rates are set carefully to minimise the possibility that declared bonuses are lower than interim bonuses.
- Bonuses may also be adjusted to provide for a change in investment strategy, for example to build up or reduce the BSA balance as the funds adjust their risk profile.

5 Terminations and changes

Background

Policy contracts usually specify how the benefits payable on normal contractual events such as maturity or death are determined. However, some contracts – and particularly older contracts – do not specify how benefits payable will be determined if policyholders terminate their contract, nor do they specify how benefits will change when a contract is changed. We therefore usually have discretion in determining termination values and benefits when a contract is changed.

Principle

We aim to offer termination, paid-up and change values that provide reasonable value to affected policyholders without prejudicing those policyholders who continue to meet their contractual obligations, subject to any regulatory or legal constraints.

Practice

- **Terminations**
  Termination values are determined at our discretion in accordance with section 52 of the Long-term Insurance Act and part 5 of the Regulations under the Long-term Insurance Act. Termination values take into account the recovery of unamortised initial expenses (where relevant), and are reduced when asset values are depressed [through a market value adjustment (MVA)]. These regulations regarding maximum allowable deductions are taken into account where applicable.

  MVAs are applied on early termination of smoothed-bonus policies if the BSA has a negative balance and they are set taking into account the value of the underlying assets in which the fund is invested. It is necessary to apply an MVA to ensure that the security of return to continuing policyholders is not adversely affected by paying termination values significantly in excess of the value of the underlying assets. The MVA applying to terminations will vary as the value of the underlying assets changes. If termination values are adjusted downwards because of depressed asset values, the consequent reduction in termination values paid out will be credited to the BSA.

Special considerations for specific products

Adaptability policies

For these policies the amount paid on surrender is based on the total policyholder accounts, including vested and non-vested bonuses, where applicable, less:
- an MVA (when applicable);
- the value of the unrecouped initial expense account (an internal account that represents commission and other initial expenses less policy charges earmarked for covering these initial expenses, accumulated with interest); and
- a disinvestment charge on a sliding scale that decreases linearly from 5% to 0% of the difference between the fund value (after the application of the MVA) and the value of the unrecouped initial expense account over the term of contract.

All other universal policies

For these policies the amount paid on surrender is based on the total policyholder accounts, including vested and non-vested bonuses, where applicable, less:
- an MVA (when applicable);
- the value of the unrecouped initial expense account (an internal account that represents commission and other initial expenses less policy charges earmarked for covering these initial expenses, accumulated with interest); and
- a disinvestment charge on a sliding scale that decreases linearly from 2% to 0% of the difference between the fund value (after the application of the MVA) and the value of the unrecouped initial expense account over the term of the contract.

Changes

Change values are determined at our discretion in accordance with section 52 of the Long-term Insurance Act and part 5 of the Regulations under the Long-term Insurance Act.

Unit account values after changes (including making a policy paidup and increasing or reducing the sum assured or premiums payable under the policy) are calculated:
- to be supportable by the asset share of the policy on the change date on the basis of expected future experience;
- to take into account the recovery of unamortised initial expense, where relevant; and
- to allow for an alteration fee;

and, as far as possible, to be consistent with:
- projected maturity values at later durations; and

- current termination values (ie resulting in termination values immediately before and after the change being similar).

These regulations regarding maximum allowable deductions are taken into account, where applicable.

Special consideration for specific products

All Universal policies

A reduction in the contractual premium payable (including making a policy paidup) will result in a reduction in policy benefits. This reduction in benefits is calculated to recover charges in respect of commission and other initial expenses that will no longer be received due to the reduction in the contractual premium. MVAs are also taken into account, where applicable.

6 Investment policy

Background

Asset allocation between different asset classes (ie equities, bonds, property, cash, as well as local and international assets) has a significant effect on investment return earned and therefore on benefits paid in respect of the smoothed-bonus portfolio.

Principle

The investment policy in respect of the smoothed-bonus portfolio is aimed at maximising net long-term investment returns for policyholders in accordance with the risk/return profile that policyholders have selected, subject to:

- the nature of the liabilities (including guarantees, policy terms and matching requirements);
- prevailing regulatory requirements (including limitations on the concentration of assets in a particular share/bond);
- a diversified portfolio of assets (within an asset class as well as between asset classes, where applicable; and
- the availability of suitable assets.

Practice

- **Asset allocation and mandates**
  The underlying assets in our smoothed-bonus portfolio are invested in accordance with a mandate, which provides a targeted real return and asset allocation limits. The mandate allows asset managers some flexibility in the long-term asset allocation, based on their view of the markets and where they expect to earn higher returns.

  The asset allocations of the smoothed-bonus portfolio are influenced by the level of guarantees provided and the desired risk profile. This portfolio generally comprises a mix of local assets in a range of asset classes, such as listed equities, interest-bearing assets (eg bonds), direct property and alternative assets (such as private equity). Asset-liability modelling techniques are used to set the investment mandates, which aim to balance the reasonable expectations of policyholders with the capital considerations arising out of the guarantees provided. In addition to representing sound financial management, this also satisfies section 31(2) of the Long-term Insurance Act regarding asset-liability matching. Mandate managers represent the interests of policyholders in setting and reviewing investment mandates in consultation with the asset manager.

  Although these mandates are not expected to change often, we may change them if the regulatory, economic or investment environment changes, or the standards of capital management (internal or external) change.

The current investment objectives and mandates of the funds that make up the smoothed-bonus portfolio, as well as the range within which the asset allocation of these funds can change, are provided in Annexure 5.

- **Portfolio management**
  Portfolio managers responsible for policyholder funds have been clearly instructed that all investment decisions taken with respect to policyholder funds must be in the best interest of policyholders over the long term, within the constraints of the specified investment mandates.

  All potential conflicts of interest arising from proposals that policyholder funds invest in a company or fund in which shareholders have an interest, must be disclosed to the Statutory Actuary, who will report it to the board's Risk, Audit and Compliance Committee. If material, approval is also required. Such transactions are conducted at arm's length, and only when it has been clearly demonstrated that such investments are in the interest of policyholders.

7 Business risks

Background

The main risk to which smoothed-bonus policyholders are exposed is investment risk (including credit risk and investment guarantees). Smoothed bonus policyholders are not directly exposed to any other business risks (eg mortality, expense and persistency risks). These other business risks are borne by shareholders. However, we may vary mortality and expense charges if justified and in accordance with policyholder documentation, as well as on the recommendation of the Statutory Actuary.

We may take action in adverse investment conditions to ensure the ongoing viability of smoothed-bonus funds.

Principle

In adverse investment conditions we will adjust the benefits payable to policyholders so that the benefits paid to departing policyholders do not unfairly affect the benefits of remaining policyholders.

Practice

Business risk is managed through the asset allocation process, credit risk guidelines and restrictions on the use of derivatives. Smoothing investment returns cushions smoothed-bonus policyholders against the risk of adverse fluctuations in investment returns in the short term. However, in the long term declared bonuses reflect the actual net investment returns earned by each smoothed-bonus fund.

In adverse conditions management actions (as approved by the board) will be taken to ensure the ongoing viability of the smoothed-bonus portfolio. The aim of these management actions is to restore the BSA balance to its long-term target range. Adverse conditions include adverse investment conditions, such as a significant fall in asset values. While we have internal guidelines (see Annexure 24), there are no absolute BSA threshold levels at which particular management actions are automatically taken to restore the BSA balance to its long-term target range, as this will depend on the specific circumstances at the time.

If the BSA balance becomes increasingly negative, the extent of management action will become more pronounced, and will include the following remedial steps, taking due consideration of the economic and investment environment at all times:

- Termination values will be reduced by the application of the MVA when the BSA has a negative balance.
- Interim bonuses may be reduced.
- Low or no bonuses may be declared.
- The non-vested portion of a policy (or part thereof) may be removed when the BSA has an unacceptably negative balance.

If, after the removal of non-vested balances, the board does not consider it possible to restore the level of the BSA to its long-term target range during the following three years, shareholder capital will be used to support

the portfolio for as long as necessary. If and when the BSA balance position improves, the capital provided will be returned to the shareholder funds together with any returns earned on that capital.

8 Charges

Background

Expense charges include management fees and investment fees or expenses. For some policies risk charges are levied in respect of the cost of death, disability, illness or other such benefits provided by the policy. These charges may be set or reviewed at the discretion of the board based on the recommendation of the Statutory Actuary.

The tax payable for the policyholder funds is based on a formula with three main components – the investment return earned, expenses incurred and transfers to shareholder funds. We must ensure that the correct tax is paid and we have discretion as to how this tax is recovered from policyholder funds.

Principle

We aim to:
- change rand-based expense charges in line with inflation where policy contracts permit;
- change expense and risk charges in line with actual past and expected future experience if it is different to prevailing charges where policy contracts permit;
- allocate tax to policyholders in line with the expected tax payable in respect of policyholder funds; and
- ensure that investment fees charged by asset portfolio managers are reasonable and in line with the market.

Practice

- **Expense and risk charges**
  Certain policy contracts permit expense and risk charges to be changed from time to time. This is subject to the Statutory Actuary being satisfied that these changes are reasonable in the light of actual past and expected future experience. Increasing profit margins for shareholders is not enough reason to increase charges.

  Expense charges expressed as a rand amount may be reviewed annually with reference to the rate of inflation.

- **Tax charges**
  Taxes on investment income and capital gains are deducted from taxable investment income and capital gains at the applicable policyholder fund tax rates.

  If tax procedures change or new taxes are imposed, a fair basis for the allocation of tax charges to policyholders will be derived based on input from the Statutory Actuary.

9 New business

Nedgroup Life has closed the smoothed-bonus portfolio to new business.

10 Policy reviews

Background

Smoothed-bonus policies were priced on a set of mortality, economic, lapse and expense assumptions. However, we reserve the right to change these assumptions, which may impact the level of the premiums we charge.

Principle

We may change the underlying charges or premium rates of smoothed-bonus policies if current premiums are insufficient to support the full policy benefits.

Practice

If the economy, investment and claims experience is worse than expected, we will, on the advice of the Statutory Actuary, review the adequacy of the premiums and communicate changes to policyholders. If the policyholder chooses to not pay the adjusted premium, policy benefits will be adjusted accordingly.

We will not change premiums during any premium guarantee periods of the policy.

Annexure 1: Definitions

Term	Definition
Actuarial liabilities	The amount required to provide for policyholder benefits, including the costs of maintaining the policies, determined on the statutory valuation method, as prescribed in the Long-term Insurance Act and associated regulations and notices applied in South Africa.
Asset share	The theoretical amount that would be accumulated in respect of a policy if investment performance and other applicable surpluses were allocated to a policy on an individual basis.
Bonus Smoothing Acc (BSA)	An account that reflects the difference between the value of the assets in the underlying portfolio and the amounts accumulated in the policies (i.e. net amounts invested plus bonuses). It represents the difference between surpluses earned and bonuses declared.
Book value	The total value of the policy, based on bonuses declared for a policy, net of charges and tax. In general terms, for a linked policy the book value and the market value would be the same, whereas for a smoothed-bonus policy, the book value would differ from the market value, with the difference allocated to the Bonus Smoothing Account.
Change	A contractual change to a policy, such as a premium increase, a term extension or a part surrender initiated by a policyholder. Any changes must be agreed by the insurer and will result in an addendum to the policy document.
Credit risk	The risk of loss as a result of default by counterparties or a reduction in asset values because of the credit impairment of a counterparty.
Interim-bonus rate	The rate used to determine an investment return when processing a claim between annual bonus declarations. The interim-bonus rate tends to be set at a conservative level, and may be changed at any time.
Investment risk	The risk that policy benefits are adversely impacted when low or negative investment returns are earned.
Market value	The total asset value attributable to a policy, based on the actual investment return earned in respect of the policy, net of charges and tax. In general terms, for a linked policy the book value and the market value would be the same, whereas for a smoothed-bonus policy the book value would differ from the market value, with the difference allocated in the Bonus Smoothing Account.
Market-value adjustment	An adjustment made to the book value of a smoothed-bonus policy if a policyholder surrenders the policy while the Bonus Smoothing Account for the class of business has a negative balance to ensure that the surrender value is equal to the market value of the policy. This adjustment is credited to the Bonus Smoothing Account and serves to protect the remaining policyholders.
Mortality risk	The risk that policy benefits are impacted by more or fewer deaths than allowed for in the pricing of the contract.
Nedgroup Life	Nedgroup Life Assurance Company (South Africa) Ltd.
Paidup policy	A policy in respect of which the policyholder stops paying the contractual premiums, in which event the benefits of the policy are adjusted.

Policyholder funds	Assets held to back actuarial liabilities
Practice	This refers to our shorter-term actions aimed at achieving our principles based on the current environment.
Principle	This refers to the long-term standards we use to manage the Smoothed Bonus portfolio. By nature, this should seldom change.
Reserve	A provision established for meeting future claims.
Regulatory capital	The amount of assets the Regulator (the Financial Services Board) requires us to hold for statutory solvency purposes.
Shareholder funds	Assets that represent the interest or equity of shareholders (assets in excess of policyholder funds).
Surrender	When a policyholder decides to cancel a policy before maturity and take the proceeds in cash.
Termination	This is another term for a surrender. Policyholders withdraw all or part of their money before a normal contractual claim occurs.
Unit account	Accumulated premiums less charges plus bonuses credited to policyholders at a point in time.

Annexure 2: Products included in the smoothed-bonus portfolio

Products included in the smoothed-bonus portfolio:

- Pure endowment
- Endowment with life cover
- Adaptability
- Whole-life maximum cover
- Whole-life maximum investment
- Joint life
- Retirement annuity

Annexure 3: Past bonus declarations

Bonus declaration periods for the smoothed-bonus products

The bonus declaration periods for the smoothed-bonus products are given below.

Product	Bonus declaration period	Period ending
Universal Smoothed Bonus portfolio	Annual in arrear	31 December

Bonuses declared in previous years are shown in the table below:

Year	Total bonus
Dec 2002	4%
Dec 2003	3%
Dec 2004	9%
Dec 2005	15%
Dec 2006	15%
Dec 2007	9%
Dec 2008	3%
Dec 2009	6%
Dec 2010	5%
Dec 2011	5%
Dec 2012	7%
Dec 2013	10%
Dec 2014	4,5%
Dec 2015	5,5%
Dec 2016	3,5%

Annexure 4: Management Action Policy

Smoothed-bonus Management Action Policy

Under extremely adverse investment conditions that will result in a negative smoothed-bonus stabilisation reserve (BSR), Nedgroup Life will follow a course of action based on, but not restricted to, the guidelines set out below to restore the BSR.

Level of BSR	**Action taken**
-5% >= BSR > -10%	Implement a 5% MVA on all surrender benefits payable and on portfolio switches in respect of policies invested in the Smoothed Bonus Business Fund.
-10% >= BSR > -15%	Implement a 10% MVA on all surrender benefits payable and on portfolio switches in respect of policies invested in the Smoothed Bonus Business Fund.
-15% >= BSR > -20%	Implement a 15% MVA on all surrender benefits payable and on portfolio switches in respect of policies invested in the Smoothed Bonus Business Fund.
-20% >= BSR	Implement at least a 20% MVA on all surrender benefits payable and on portfolio switches in respect of policies invested in the Smoothed Bonus Business Fund. The extent of the MVA will depend on the level of the BSR at the time.

In addition, consideration will be given to reducing interim bonuses. Future bonus declarations on smoothed bonus policies may also be set at levels lower than the achieved fund performance. Lastly, consideration will be given to remove a portion of accumulated non-vested bonuses if asset values decline as described above and do not recover within a few months. The portion of non-vested bonuses removed will be set to broadly reflect the market fall.

Annexure 5: Investment mandate

Investment objectives and mandates for the smoothed-bonus portfolio

The Nedgroup Life smoothed-bonus portfolio is invested to provide stable real returns for policyholders, ie returns that will exceed inflation by at least 3,5% on a rolling three-year average (net of investment management fees deducted by asset managers), while also providing a good level of capital protection. This mandate has been given to suitable asset managers. Asset allocations (summarised below) are wide to give asset managers the flexibility to achieve their mandate.

- Equity weighting of 20% to 40%.
- Bond weighting (including index-linked bonds) of 30% to 60%.
- Cash and money market weighting of 10% to 30%.

Bonds and cash will be subject to a minimum credit rating as advised by NedGroup Life's investment committee.

Some limited direct property exposure of up to 10% may be permitted as part of bond exposure, as long as the portfolio remains sufficiently liquid.

Foreign exposure of up to 25% is permitted, but is subject to regulatory limits.

Annexure 6: Charges

Charges applying to the smoothed-bonus portfolio

The following charges apply to the smoothed-bonus portfolio:

Investment management fees (deducted at source by asset manager)

The following two charges cover our maintenance expenses and costs, as well as
the cost of providing:

10% of after-tax returns[1]
1,5% of assets[1]

Bid offer spread: 5% of allocated premium
Policy fee: product specific – ranges from R60 to R90 a year
Allocation percentages: product specific – ranges from 0% to 30% of the premium
Risk charges are based on the cost of providing risk cover (difference between the sum assured and the unit account at a point in time multiplied by the relevant risk rate).

How charges are deducted

The policy fee, allocation percentage and risk charges are deducted explicitly, separately from the bonuses declared. These charges may be deducted monthly from premiums paid before they are invested and/or from policy fund values. These charges, which may be expressed as a rand amount and/or as a proportion of the premium paid and/or as a proportion of the fund value, are specified in the relevant policy contracts under special considerations.

Other charges such as profit charges, management fees and investment fees or expenses are deducted from the return earned by the smoothed-bonus funds before bonuses are declared, and are therefore indirectly reflected in the bonuses. These charges are not disclosed in the relevant contracts.

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