Principles and Practices of Financial Management

Sun Life Assurance Company of Canada (U.K.) Limited
Confederation Life With-Profits Fund

Sun Life Financial of Canada

Contents

1. Introduction

Principles and Practices of Financial Management (PPFM)

The PPFM sets out how a firm manages its with-profits business. The PPFM is intended to secure an appropriate degree of protection for plan-holders, as part of a firm's obligation to treat its customers fairly, which the Financial Conduct Authority (FCA) requires to be made publicly available.

The Board of Directors of a firm carrying on with-profits business has to produce a report each year for with-profits plan-holders stating whether, throughout the financial year to which it relates, the firm believes it has complied with the PPFM.

The with-profits principles within the PPFM must:

- be enduring statements of the overarching standards the firm adopts in managing with-profits funds; and
- describe the business model used by the firm in meeting its duties to with-profits plan-holders and in responding to longer-term changes in the business and economic environment.

The with-profits principles are not expected to change often. If they are changed, plan-holders must be informed at least three months in advance, unless the FCA has granted a waiver of this requirement.

The with-profits practices within the PPFM must:

- describe the firm's approach to managing with-profits funds and to responding to changes in the business and economic environment in the shorter term; and
- contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits plan with the firm.

Subject to the with-profits principles, a firm's with-profits practices are expected to change as the firm's circumstances and the business environment change, with some alteration every few years. Plan-holders must be informed of any such change within a reasonable time period, although this notice may be given in arrears. Sun Life Assurance Company of Canada (U.K.) Limited intends normally to inform its with-profits plan-holders of any such change by including the required information in their annual statements.

A firm carrying on with-profits business is required to appoint a With-Profits Actuary to advise on key aspects involving the use of discretion as this relates to the fair treatment of with-profits plan-holders. Sun Life Assurance Company of Canada (U.K.) Limited has in addition established a With-Profits Committee, which is an advisory committee to the Board, to monitor amongst other things compliance with the PPFM. The Committee's purpose is to bring independent judgement to the assessment of compliance with the PPFM and to how competing or conflicting rights and interests of plan-holders and shareholders have been addressed.

A briefer version of the PPFM (the 'Consumer Guide') is also available. It explains in clear and non-technical language how Sun Life Assurance Company of Canada (U.K.) Limited manages its with-profits business. If there is any inconsistency between the Consumer Guide and this PPFM, then the version detailed in this document will apply.

Background to the Confederation Life With-Profits Fund

Sun Life Assurance Company of Canada is incorporated in Canada. On 22 March 2000, the Company was demutualised. The demutualisation involved eligible with-profits plan-holders being issued with shares in the new controlling company in exchange for relinquishing their existing ownership rights.

In connection with the demutualisation, the U.K. business of Sun Life Assurance Company of Canada was reorganised. In the U.K., Sun Life Assurance Company of Canada had written its with-profits business, through its U.K. branch. Also included in the U.K. branch was the Confederation Life Fund, a separate sub-fund within the long-term business fund.

The Confederation Life Fund was established when the closed block of mainly with-profits business in the U.K. branch of Confederation Life was transferred to the U.K. branch of Sun Life Assurance Company of Canada under the terms of a Scheme under Schedule 2C of the Insurance Companies Act 1982, which was approved by the High Court on 12 December 1994 ('The Scheme').

On demutualisation, all the business of the U.K. branch of Sun

Life Assurance Company of Canada was transferred to Sun Life Assurance Company of Canada (U.K.) Limited ('The Company'), an existing insurance subsidiary of Sun Life Assurance Company of Canada. This transfer was in accordance with the requirements of a further Scheme under Schedule 2C of the Insurance Companies Act 1982, which was approved in the High Court on 21 September 1999.

Under the terms of this further Scheme, on 22 March 2000 the Company established three separate sub-funds within its long-term business fund. These are the With-Profits Sub-Fund, the Non-Profit Sub-Fund and the Confederation Life Sub-Fund (which is referred to in this PPFM as the Confederation Life With-Profits Fund). The Company also maintains a shareholder fund. This further Scheme provided that the Confederation Life Fund would continue to be managed on a day-to-day basis in accordance with the terms of The Scheme, subject to the requirement to adhere to the provisions established by the further Scheme.

Surplus arising in the Confederation Life With-Profits Fund accrues exclusively for the benefit of the plan-holders in that fund. No transfers of surplus can be made from the Confederation Life With-Profits Fund to the shareholder fund.

The Scheme and changes to this PPFM

The Directors are obliged at all times to manage the with-profits business of the Company in accordance with the terms of The Scheme. Accordingly, changes may not be made to the principles or practices set out in this PPFM if they would result in the PPFM being inconsistent with the terms of The Scheme, unless The Scheme is also modified to correct that inconsistency. However, The Scheme may normally only be modified or added to with the approval of the High Court and the consent of the Prudential Regulatory Authority (PRA) and/or FCA (although in the event of certain changes in legislation which cause The Scheme to operate in a materially different manner from that originally envisaged, The Scheme may be modified with the approval of the PRA and FCA, but without the need for High Court approval, in order to limit the effect of such a change on the operation of The Scheme).

It is possible that either market practice or FCA requirements in respect of the PPFM, at some stage in the future, may conflict with the provisions set out in the terms of The Scheme. In such circumstances, the PPFM would not be changed to comply with such market practice or requirements unless and until the terms of The Scheme were changed in the manner described above.

If there is any inconsistency between the PPFM and the terms of The Scheme, the terms of The Scheme will apply.

The business covered by this PPFM

This PPFM covers the business written in the Confederation Life With-Profits Fund. The business written is mainly conventional with-profits business (endowment and whole-life). There is also a very small amount of permanent health insurance and annuity business. There is no unitised with-profits business. The rest of this document considers only the endowment and whole-life business.

2. Amount payable under a with-profits plan

a. Methods used to guide determination of amount payable

Principles

In operating the Confederation Life With-Profits Fund, the aim is to distribute all surplus to plan-holders over the lifetime of the plans in a manner that is fair to all plan-holders. This process will be managed as the plans become claims and the fund declines.

The total amount payable is determined on this premise by carrying out regular projections of all asset and liability cashflows through to the expiry of the plan. Investigations are carried out annually to determine the suitability of payout levels and to make adjustments where necessary in order to meet the objectives of fairness as set out above.

Practices

The Confederation Life With-Profits Fund is managed by carrying out regular projections of all asset and liability cashflows through to the expiry of the fund. Using this approach, bonus rates can be selected and adjusted from year to year to achieve the aim of distributing the available assets to the remaining plan-holders over the lifetime of the plans. These investigations are carried out using assumptions that represent a best estimate assessment of the future with market consistent assumptions for future investment returns.

The liability cashflows explicitly take into account the value of future benefits, including future projected bonuses, plus future expenses, and the value of future premiums payable is deducted.

The amount payable on surrender is calculated with the objective of achieving a fair balance between amounts payable to plan-holders terminating early and those remaining in-force, having regard to the need to maintain a safety margin for future contingencies. Some plans have guaranteed surrender values, which therefore represent the minimum amount payable on surrender.

b. Annual bonuses

Principles

Reversionary bonuses are added annually to all with-profits plans. Special non-recurring reversionary bonuses may also be granted from time to time. Once added, reversionary bonuses form guaranteed additions to the benefits payable on maturity or death. The amount payable on surrender also takes account of reversionary bonuses already added to the plan. Recurring reversionary bonus rates are relatively stable from year to year and are not expected to change significantly except under adverse conditions.

Reversionary bonus rates are determined having regard to the advice of the With-Profits Actuary, taking into account the practices prior to The Scheme, the objectives of fairness to plan-holders and the financial condition of the fund from time to time.

A reversionary bonus scale is used where the amount of bonus is expressed as a flat amount per £1000 of sum assured plus an additional amount varying by duration and plan period. The recurring reversionary bonus scale is different for the three different series of contracts issued since 1975.

Plans written prior to 1975 originally shared in profits through the payment of annual dividends according to the North American contribution method. Under this method the dividend was related to the investment, mortality and expense experience during the previous year. Depending on the plan terms, the dividend could be used to purchase further plan benefits known as a paid-up addition, or paid in the form of cash which could be applied in various ways. However, during 2003 the North American contribution method was replaced by the standard U.K. reversionary bonus approach for these plans. Existing paid-up additions were converted to reversionary bonuses of the same amount. In order that reversionary bonuses matched the dividends produced by the North American contribution method, it was necessary to adopt a number of separate reversionary bonus scales for these plans.

Practices

Reversionary bonus is declared as a percentage of sum assured (which differs by plan series and by whether the plan is premium paying or not), plus a percentage of attaching bonus (which differs by plan series).

Normal practice is for a review of bonus rates to be performed once a year by carrying out projections of all asset and liability cashflows through to the expiry of the plan. Using this approach, bonus rates can be selected and adjusted from year to year to achieve the aim of distributing the available assets to the remaining plan-holders over the lifetime of the plans.

These investigations are carried out using assumptions that represent a realistic assessment of the future. Reversionary bonuses are declared annually for each year commencing on 1 January, and are added to a plan on its plan anniversary in that year. Interim bonuses are not paid.

c. Final bonus

Principles

Reversionary bonus additions are supplemented by a final or terminal bonus, which is added to the amount payable on death or maturity. The purpose of the final bonus is to supplement the benefits payable on termination in order to better achieve the objective of fair allocation of surplus to plan-holders. The amount payable on surrender may also be enhanced to allow for a proportion of the prevailing rate of final bonus applicable to deaths or maturities. Unlike reversionary bonuses, final bonuses only apply for plans terminating at that time and the rate of final bonus may vary up or down for plans terminating on different dates. Terminal bonuses are normally reviewed annually, but may be reviewed more frequently in exceptional circumstances. The rates of terminal bonus may be nil.

Practices

Subject to the following constraint, terminal bonus rates can be increased or reduced in line with changes in financial conditions and the experience of the fund, subject always to the requirement to allocate surplus fairly to plan-holders. Terminal bonus rates are normally reviewed at the same time as annual bonus rates, but may be reviewed more frequently in exceptional circumstances, for example, in the event of the default of one or more of the corporate bonds in which the fund is partly invested. Terminal bonuses on one particular series of plans issued between 1 May 1982 and 30 June 1988, (known as the UK82 series) are expected to be maintained at or above their pre-2004 level, except under adverse conditions.

d. Smoothing

Principles

Due to the prospective manner in which the fund is managed and the passive investment strategy adopted, there is no need for any explicit smoothing. There is a sufficient degree of matching between assets and liabilities that leads to a smooth return.

The Company does, however, reserve the right in exceptional circumstances to make changes to the basis for determining surrender values other than solely to reflect changes in underlying asset values, in order to maintain the financial condition of the fund and to maintain equity between those plan-holders who continue their plans and those who surrender them.

Practices

A feature of the approach taken to determine the total amount payable is that the effect of emerging experience, and any differences between this experience and assumptions used from time to time, will be spread over the remaining lifetime of the plan. When combined with the current investment practice set out under ‘Investment Strategy’, the overall effect is that future changes in bonus rates are more likely to be driven by reductions in numbers of plan-holders remaining in the fund than by changes in external financial conditions. Should, however, there ever be a large and sudden change in long-term interest rates (in either direction), then this may require a more sudden change in bonus rates.

3. Investment strategy

Principles

The investment strategy of the Confederation Life With-Profits Fund takes into account the aim of paying satisfactory bonuses to with-profits plan-holders, whilst at the same time protecting the financial condition of the fund. It is also necessary to take into account the fact that the fund is currently closed to new business, as well as the expected pattern of maturities and expected claims by death or surrender.

The investment strategy of the Confederation Life With-Profits Fund is to provide a stable investment return while meeting the emerging cashflow requirements of the underlying liabilities.

The only assets within the fund that would not normally be traded are loans to which with-profits plan-holders are entitled under the terms of their plans. It is not expected that the investment returns on these loans will have any significant effect on the overall investment return of the fund.

Derivative instruments may be used to manage risk exposures by hedging portfolio risk to benchmarks or by taking positions that offset existing or anticipated risks. Maximum limits exist for exposure to derivatives and to corporate bonds issued by any one counterparty. The limits for derivatives involve both the market value of the derivative and the potential exposure.

Practices

The Board is responsible for the investment strategy of the Confederation Life With-Profits Fund, taking account of the principles outlined above. Investment strategy proposals are reviewed by the With-Profits Committee and the Investment Management Committee, a committee established by the Company's management, prior to being considered by the Board for approval.

The investment strategy is based upon a regular investigation which compares emerging liability cashflow requirements with the cashflows generated from the respective assets backing these liabilities to arrive at the overall cashflow requirements. This is then used to determine the investment guidelines.

The results of current investigations indicate that a suitable asset mix for the fund is one of predominantly government fixed interest securities and corporate bonds with a small exposure to mortgages and other assets, in particular plan loans.

The investigations show that the assets held should be realisable at market value within reasonable timeframes. They currently do not indicate a need to be able to realise the assets immediately. The investment guidelines stipulate that the minimum credit quality for corporate bonds purchased by the fund is 'BBB' investment grade, while the average credit quality for such bonds should be at least equal to 'A' grade. Constraints are also imposed on the maximum proportion of fixed interest assets that may be comprised from below investment grade holdings.

The Investment Management Committee reviews the investment policy and the financial condition of the fund annually. In exceptional investment conditions it will do so more frequently. It comprises experienced senior managers who are qualified to review investment policy, evaluate the various classes of asset and understand their effect on the financial condition of the fund and plan-holders' future benefits.

The investment policy of the Confederation Life With-Profits Fund is subject to the investment risk management policies of the Company and associated operating guidelines. These provide a framework of processes, controls and reporting requirements with respect to each class of asset. These investment risk management policies are reviewed by the Risk Committee, a committee of the Board.

The invested assets of the fund are managed by Sun Life Global Investments (Canada) Inc. under the terms of an investment management agreement. This management agreement includes general investment policy guidelines with respect to each class of asset and also specific guidelines relating to the fund. These guidelines are reviewed and approved by the Investment Management Committee and changed from time to time.

Investment in derivatives to manage risk exposures is permitted by the investment guidelines, subject, for each type of derivative, to a number of detailed conditions regarding their use. In practice, any such investments would be discussed in advance with the Investment Management Committee, the With-Profits Committee, and the Risk Committee. Investment in investment instruments in lines of business that have not previously used derivatives would require the approval of the Board.

The Company routinely monitors its overall exposure to all counterparties and sets limits on its exposure to any one counterparty according to the PRA Rules.

4. Charges and expenses

Principles

The Scheme (as defined in the Introduction) sets out a maximum level of expense charges which may be levied against the Confederation Life Fund. The maximum level of charges is as follows:

- 170% of renewal commissions actually payable;
- £30 per plan per annum as at 30 June 1994, increasing at the rate of increase in the Retail Prices Index thereafter;
- 25% of the claims payments on individual permanent health insurance plans; and
- 0.20% per annum of the fund.

In addition, under the terms of The Scheme the Company may from time to time levy against the Confederation Life With-Profits Fund any special levies and compensation payments due to plan-holders in relation to the marketing or administration of the business, as agreed by the With-Profits Actuary.

Practices

The Company currently does not expect to charge expenses to the Confederation Life With-Profits Fund at a level other than the maximum set out in The Scheme.

Under The Scheme, regulatory levies may be charged to the Confederation Life With-Profits Fund on a fair apportionment basis, as determined by the With-Profits Actuary.

The Board, on the advice of the With-Profits Actuary, may also decide it to be appropriate that mis-selling liabilities in respect of with-profits business, and other exceptional costs, should be charged to the Confederation Life With-Profits Fund. In practice, such costs would be met in the first place either from assets attributable to the shareholder or from the Inherited Estate. These would only be charged to the remaining assets of the Confederation Life With-Profits Fund if, in the opinion of the Board of Directors and with the advice of the With-Profits Actuary, it would not prove possible to meet such costs from either of the above (or other) sources. It is not permitted to charge any regulatory fines to the Confederation Life With-Profits Fund.

5. Management of the Inherited Estate

Principles

When the Confederation Life With-Profits Fund was established, sufficient assets were allocated to the fund in order to meet the reasonable expectations of plan-holders in normal circumstances.

The excess of the value of the assets over the realistic value of the liabilities of the fund is described as the Inherited Estate. The purpose of the Inherited Estate is to provide general working capital for the fund, and to support the reasonable expectations of plan-holders, if required in adverse circumstances. It can be used, if necessary, to meet the cost of guaranteed benefits under plans.

It is intended over the long term to maintain the level of the Inherited Estate at an appropriate percentage of the aggregate realistic value of the liabilities of the fund, having regard to the financial condition of the fund and the relatively low level of risk to which the fund is subject. This leads to the distribution of the Inherited Estate to with-profits plan-holders in a fair manner over time.

Under the terms of The Scheme, when the number of plans in the Confederation Life With-Profits Fund falls below 5,000, subject to the approval of the PRA and FCA, it need not be maintained as a separate fund. If this approach is taken then all of the remaining surplus in the Confederation Life Fund will be allocated to the existing plans in the form of a guaranteed bonus rate and the plans will become non-profit. If the Company has continued to maintain a separate Confederation Life With-Profits Fund, it must be wound up in this way once the number of plans falls below 500.

Practices

The Inherited Estate is being paid out on a gradual basis to terminating plans, with the aim of ensuring that the remaining balance in the Inherited Estate represents a small and reasonably constant proportion of realistic liabilities for in-force plans, after making prudent provision for the cost of guarantees.

The investment strategy for the Inherited Estate is the same as for the rest of the Confederation Life With-Profits Fund. It is intended that the Confederation Life With-Profits Fund will be managed without recourse to other funds in the Company.

The number of plans in the Confederation Life With-Profits Fund fell below 5,000 in 2009. The Company is investigating the conversion of the Confederation Life With-Profits Fund to non-profit status, in line with The Scheme.

6. Volumes of new business and arrangements on cessation of writing new business

Principles

The Confederation Life Fund is currently closed to new business.

Practices

No new business has been written since June 1990.

Investment management services are provided through an agreement with Sun Life Global Investments (Canada) Inc. Ongoing plan servicing is provided through an agreement with Diligenta Limited. The Diligenta agreement is for a 10-year term ending in 2018, with provision for it to continue after that date. The Company will review these agreements each year, and may consider alternative options for the provision of these services in the future.

7. Business risk

Principles

The Company has an overall risk management framework that is consistent with the worldwide policy of Sun Life Assurance Company of Canada. This risk management framework is reviewed annually and ratified by the Board. Risk management is considered across all the Company's operations including the Confederation Life Fund.

The Company aims to manage the exposure of the Confederation Life With-Profits Fund itself to business risk, bearing in mind plan-holder expectations, the levels of guaranteed benefits under the plans, and the need to protect the financial condition of the fund. There is currently no intention to take on any new business risks within the Confederation Life With-Profits Fund. The main business risks to which the Confederation Life With-Profits Fund is currently exposed are essentially those inherent in maintaining the existing with-profits plans as they run off over time. Any costs arising as a result of these business risks would be met as described under Practices below.

Practices

The Company identifies and manages those risks considered most relevant over its planning horizon. These risks are identified and reported to the Board, along with specific mitigating actions identified. As a result of the Company's risk management principles, as described above, any business risks known to exist within the Confederation Life With-Profits Fund are regularly monitored. Experience has shown the fund to be stable in this regard. The fund is not directly exposed to any risks associated with the taking on of any new business, or through investment in subsidiary companies.

Underpinning this risk approach are business area risk registers. These are at a more detailed level, and are reviewed on a quarterly basis. Where the operational responsibility for the risk now sits within an outsourced partner, reviews actively involve that outsourcer. Risk strategies and policies within outsource partners are monitored to ensure that they match the standards set by the Company's policies. The business risks to which the Confederation With-Profits Life Fund is exposed include risks that are natural to with-profits plans. Some of these risks are intended to be borne by the Inherited Estate. These include the cost of meeting guarantees under plans.

Some other business risks that are natural to with-profits plans are taken into account in determining the amounts payable under the plans. These risks include investment risk, although the effect of this is managed to some extent by the investment strategy of the Confederation Life With-Profits Fund. Other such risks include the effect of mortality.

Because the Confederation Life With-Profits Fund is currently closed to new business, it could be exposed in future to the risk of being unable to continue to deliver effective investment management and ongoing plan servicing at a reasonable cost. These services have therefore been obtained through outsourcing agreements, which are regularly monitored.

8. Equity between the With-Profits Fund and shareholders

Principles

Under the terms of The Scheme, surplus arising in the Confederation Life With-Profits Fund accrues exclusively for the benefit of the plan-holders in the fund. No transfers of surplus can be made from the Confederation Life With-Profits Fund to the shareholder fund. There is no expectation of using the shareholder fund to support the Confederation Life With-Profits Fund. The tax attributed each year to the Confederation Life With-Profits Fund is the same as the tax that would be calculated if the fund were a separate mutual life insurance company.

Practices

In practice the Confederation Life With-Profits Fund is run in accordance with the Principles above.

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Life's brighter under the sun