MOODY'S INVESTORS SERVICE

CREDIT OPINION
14 July 2022

Update

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RATINGS

**Sun Life Assurance Company of Canada**

| | |
|---|---|
| Domicile | TORONTO, Ontario, Canada |
| Long Term Rating | Aa3 |
| Type | Insurance Financial Strength - Dom Curr |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Sun Life Assurance Company of Canada

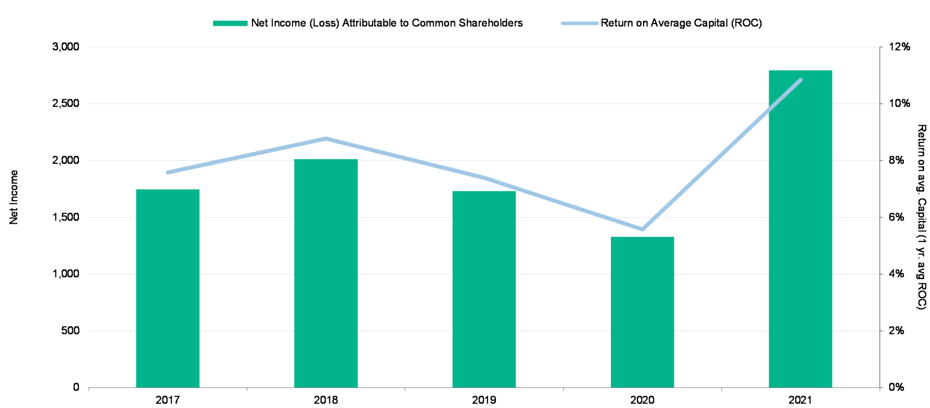
## Focused on growth opportunities in the US and Asia, while Canada remains an attractive market


## Summary

Sun Life Assurance Company of Canada (SLA), a wholly owned subsidiary of Sun Life Financial, Inc. (SLF, unrated), has established an exceptional market position in Canada, with SLA holding a top three market share position in virtually all its market segments. This provides the company with the pricing power to maintain attractive margins and supports its strong and predictable Canadian earnings. These credit strengths, combined with good product risk and diversification as well as solid capitalization, support SLA's Aa3 insurance financial strength rating. On June 1, 2022, SLF completed its acquisition of DentaQuest, the largest provider of Medicaid dental benefits in the US with a growing Medicare Advantage business, from CareQuest Institute for Oral Health and Centerbridge. This acquisition will increase the overall contribution from it US segment.

These strengths are tempered by a business mix which includes fixed annuities and segregated funds (i.e., variable annuities) that expose SLA to equity market and interest rate risks, which could drive future earnings volatility. In addition, SLA has adjusted financial and total leverage ratios are above the average of similarly rated peers, largely driven by the group's acquisition activity. Goodwill and intangibles as a percent of SLA's consolidated shareholders' equity remains high at 37% as of December 31, 2021. At SLF, SLA's parent, there has also been a strategic focus on building asset management capabilities.


Exhibit 1
**Higher net income and return on capital in 2021**




*Sources: Moody's Investors Service and company filings*

## Credit strengths

» Excellent market position and brand recognition in Canadian life insurance, with top three market shares in all its market segments;

» Stable profitability from its Canadian operation;

» Diversified business model, offering a broad range of protection products.

## Credit challenges

» Meaningful exposure to secondary guarantees on segregated funds;

» High total leverage compared to similarly rated peers;

» A business mix that includes a significant wealth management component, exposing the company to equity market and interest rate risks, although wealth management generates low-risk recurring fee-based earnings, and is a low capital intensity business.

## Outlook

The outlook on SLF and its insurance subsidiary SLA are stable reflecting the stable profitability of its Canadian operations reflecting its leading market shares, its diversified business model and solid capitalization. Items to watch include future significant expansion/ acquisitions of lower-rated, more volatile insurance operations outside of Canada, its ability to reduce leverage following recent acquisitions, as well as the challenging macroeconomic outlook due to Russia-Ukraine conflict.

## Factors that could lead to an upgrade

The following factors could lead to an upgrade of SLA and SLF:

» Maintenance of stable and sustainable consolidated profitability with a return on capital consistently above 12%;

» Consolidated financial leverage at SLF below 20%;

» Earnings and cash flow coverage above 10x and 7x, respectively;

» SLA consistently maintains capital adequacy above 145% total LICAT ratio.

## Factors that could lead to a downgrade

The following factors could lead to a downgrade of SLA and SLF:

» Decline in return on capital below 8% on a sustained basis with increased earnings volatility;

» Reduction of SLA's total LICAT ratio below 115% for a sustained period;

» Consolidated financial leverage at SLF exceeding 30% for a sustained period;

» Consolidated earnings and cash flow coverage below 8x and 5x, respectively, for a sustained period;

» Significant expansion/acquisition of lower-rated, more volatile insurance operations outside of Canada or excessive reliance upon asset management earnings.

## Key indicators table

Exhibit 2

| Sun Life Assurance Company of Canada [1][2] | 2021 | 2020 | 2019 | 2018 | 2017 |
|---|---|---|---|---|---|
| **As Reported (Canadian Dollar Millions)** | | | | | |
| Total Assets | 339,286 | 322,625 | 293,430 | 268,012 | 265,923 |
| Total Shareholders' Equity | 23,751 | 21,708 | 18,188 | 17,967 | 16,939 |
| Net Income (Loss) Attributable to Common Shareholders | 2,792 | 1,318 | 1,719 | 2,005 | 1,546 |
| Total Revenue | 27,527 | 35,801 | 33,693 | 22,619 | 23,421 |
| **Moody's Adjusted Ratios** | | | | | |
| High Risk Assets % Shareholders' Equity | 140.4% | 139.4% | 107.7% | 106.8% | 119.3% |
| Goodwill & Intangibles % Shareholders' Equity[3] | 37.3% | 35.1% | 34.3% | 30.8% | 31.6% |
| Shareholders' Equity % Total Assets | 5.3% | 5.1% | 5.4% | 5.9% | 5.5% |
| Return on Average Capital (ROC) | 10.8% | 5.6% | 7.4% | 8.8% | 7.6% |
| Sharpe Ratio of ROC (5 yr.) | 413.4% | 637.5% | 1191.7% | 1170.8% | 1334.9% |
| Adjusted Financial Leverage[3] | 25.5% | 23.0% | 18.7% | 18.3% | 20.8% |
| Total Leverage[3] | 28.8% | 27.5% | 30.4% | 31.0% | 33.4% |
| Earnings Coverage[3] | 12.6x | 8.0x | 8.3x | 8.8x | 8.0x |
| Cash Flow Coverage[3] | 6.3x | 4.1x | 6.4x | 7.1x | 8.4x |

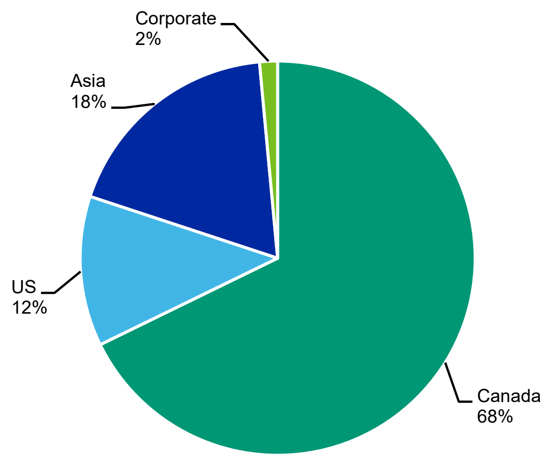
[1] Information based on IFRS financial statements as of the fiscal year ended 31 December. [2] Certain items may have been relabeled and/or reclassified for global consistency. [3] Information based on IFRS financial statements of Sun Life Financial, Inc. as of the fiscal year ended 31 December.
*Sources: Moody's Investors Service and company filings*

## Profile

SLA is one of three leading life insurers in Canada offering a wide range of products and services. The US segment offers group benefits, dental benefits and in-force management. Through joint ventures and subsidiaries, SLA also operates in Hong Kong, the Philippines, Indonesia, India, China, Malaysia, Vietnam and most recently, Singapore. The product offerings in these geographies are oriented towards straightforward protection products distributed through independent agency channels and a growing bancassurance capability. SLA plans to expand its presence in Asia, with these operations becoming a more significant contributor to earnings, providing geographic diversity to its earnings base. However, the operating environments in some of these countries are weaker than Canada's and SLA does not enjoy the same market position as it does in Canada.

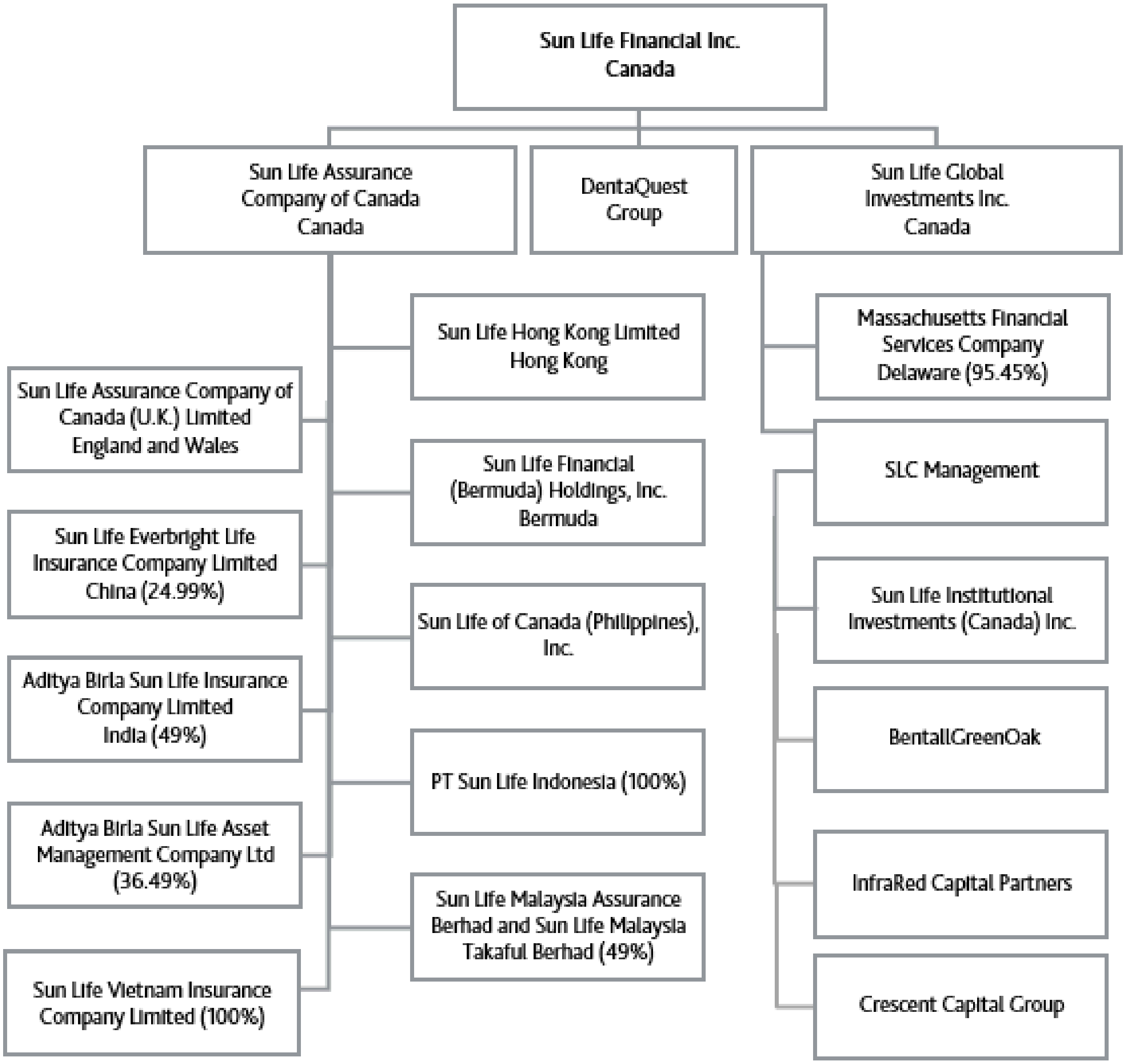
At SLA's parent, SLF, there has been a strategic focus on building asset management capabilities, both organically and through acquisition. Asset management generates low-risk recurring fee-based earnings, it is a low capital intensity business, and is very scalable. Management is notably repositioning the business mix of SLF towards asset management, which could increase earnings volatility during periods of market volatility, such as what has been experienced year to date 2022. The asset management operations of SLF could also be subject to net fund redemptions due to weak economic conditions, as well as recent trends away from actively managed investments towards passively managed investment alternatives. While we view AUM growth as a net credit positive, increased reliance on asset management could shift SLF's credit profile up or down, depending on the size and credit quality of the asset manager relative to the insurance operations of the combined group.

Exhibit 3
**SLA revenue dominated by Canada**
**fiscal year 2021**




*Source: Moody's Investors Service, data from company reports*

Exhibit 4
**SLA organizational chart as of June 1, 2022**




*Source: Moody's Investors Service, data from company reports*

## Detailed credit considerations

Moody's rates SLA Aa3 for insurance financial strength, which is in line with the adjusted scorecard-indicated outcome.

## Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

### Market position and brand: Favorable Canadian industry structure supports a high score

The Canadian life insurance market is an oligopoly with three dominant players - Great-West Life Assurance Company, Manufacturers Life Insurance Company, and SLA - who Moody's estimates together account for approximately 75% of the industry's total premiums and deposits. In 2021, we estimate that SLA captured approximately 15% of total gross premium generated in Canada. This market structure results in a rather formidable entry barrier, as does federal government legislation which currently limits the ability of Canadian banks, the Canadian life insurers' most significant external threat, from selling insurance in their bank branches.

SLA has very different market positions across its operating segments. In Canada, it scores Aa on Moody's relative market share ratio, while in Asia and the UK (which is in runoff), which are very small relative to Canada, these score A and Ba, respectively. SLA also operates in the US through a branch, and is subject to local regulatory supervision. Weighting by total revenue - the best readily available method - Moody's calculates a weighted relative market share ratio in the A range, which we believe accurately reflects SLA's blended market presence. We expect growth in the US and Asia to accelerate in 2022, although growth in Canada is expected to remain strong reflecting new group benefits mandates and higher non-par life sales. However, insurance sales in Asia are likely to remain pressured due to heightened COVID-related lockdown measures in the region. We have adjusted the score up to Aa from A to reflect SLA's strong and sustainable market position in Canada, which we believe will act as a buffer to any negative pressures stemming from offshore markets.

### Distribution: Largest propriety sales force in Canada, with strong digital offerings

SLA has good diversity of distribution, utilizing three major distribution channels: (1) its captive sales force, now branded as Sun Life, which is the largest proprietary sales force in Canada; (2) third party distributors, a category that includes national brokerage houses and independent managing general agencies; and (3) the institutional channel for sales of group life and health products. SLA has made substantial investments in digital channels and processes, including leveraging the use of artificial intelligence driven underwriting. This has positioned the company well for the growing trend as a result of the pandemic the last two years, which has driven greater adoption of digitally assisted sales.

In the US, group benefits products are distributed by a network of over 32,000 independent brokers who are supported by around 175 SLF sales representatives, while the recently acquired DentaQuest has a presence in 36 states. In Asia, SLA has a multi-channel distribution strategy, including agency, bancassurance, brokerage and growing digital and telecom capabilities. The company organizes its Asia business into two segments: 1) Local markets, which includes the Philippines, Indonesia, India, China, Malaysia, Vietnam and Singapore, and 2) International Hubs, which combines the previous International and Hong Kong segments. Given its proprietary sales force and position in the Canadian market, Moody's regards SLA's distribution control as excellent, which promotes favorable policyholder persistency and in our view, more than offsets a lesser level of distribution diversity.

We have adjusted the distribution score up to Aa from A.

### Product focus and diversification: Low risk par reserves a key strength, although high relative exposure to equity market and interest rate risks

Overall, SLA's product risk and diversification scores A on an unadjusted basis, largely reflecting the broad range of protection products offered by the company. A sizable block of SLA's actuarial liabilities are participating reserves (approximately one-third) that are low-risk for the company. However, these products are priced based on mortality rates about twice what is normally experienced, although they guarantee 3% to 5% interest on cash surrender values.

In the US, SLA provides group insurance products and services, including life, long-term and short-term disability, absence management, medical stop-loss, dental, vision and voluntary insurance such as accident and critical illness.

In Asia, SLA operates in Hong Kong, the Philippines, Indonesia, India, China, Malaysia and Vietnam, with product offerings in these geographies focused on straightforward protection products distributed through independent agency channels and a growing bancassurance capability. SLA plans to grow these operations to become a more significant contributor to earnings.

In terms of product diversification, the breadth of SLA's position in the Canadian market means that four lines of business provide 10% or more of premiums and deposits (individual life, health, segregated funds, and group pensions). However the potential volatility associated with the equity-related businesses of SLA remains a concern, particularly given the current challenging environment which has resulted in considerable market volatility. In addition, SLA has a high degree of sensitivity to interest rates at long durations, which it hedges, although most of this exposure is related to its individual insurance products, fixed annuity and segregated funds products.

Reflecting the aforementioned risks, we have left the product risk and diversification score at A, in line with the unadjusted score.

### Asset quality: Portfolio dominated by high quality bonds and mortgages

SLA's unadjusted asset quality score of Baa is comprised of sub-factor scores of A for Goodwill and Intangibles to Shareholders' Equity (37.3% for 2021), and Baa for High Risk Assets to Shareholders' Equity (140.4%). We note that a good portion of the company's goodwill and intangibles is attached to its very profitable Canadian and Asset Management franchises, which provide the vast majority of SLF's earnings (note: goodwill and intangibles are measured at SLF, SLA's parent holding company). At year-end 2021, SLF's investment portfolio was largely comprised of bonds (48%), mortgages and corporate loans (28%), with the remainder in cash and other short term investments (7%), policy loans and other invested assets (7%), equities (5%), real estate (5%), and derivatives (1%). The proportion of private placements in invested assets (excluding derivatives) increased from 13% to 20% between 2011 and 2021. While we view this higher reliance on private placements as modestly increasing liquidity risk, this is offset by the benefit of protective covenants.

The company's projected credit losses under a base case and severe stress scenario are consistent with companies scoring at the Baa-level. With the challenging macroeconomic outlook, we anticipate that high risk assets may increase marginally in 2022 due to negative credit migration while shareholders equity growth is expected to moderate since OSFI lifted its moratorium on dividend increases and share buybacks in November 2021.

As a result, the adjusted Asset Quality score of Baa is in line with the unadjusted score.

### Capital adequacy: Capital strength remains resilient

Although SLA's capital as a percent of total assets places the company in the Baa category, it has historically maintained its Canadian regulatory capital ratio well above required minimums with SLF and SLA reporting Life Insurance Capital Adequacy Test (LICAT) ratios of 145% and 124%, respectively, in Q4 2021. Furthermore, capital levels have remained relatively stable over time, reflecting low sensitivity to interest rates and stable, recurring earnings from the company's asset management businesses. As of Q4 2021, SLA's LICAT ratio represents approximately CAD5.9 billion of excess capital above the supervisory minimum. SLF's Q4 2021 LICAT ratio differs from the operating entity due to CAD4.7 billion of cash and liquid assets at the holding company, largely as a result of the pre-funding of its DentaQuest acquisition. We expect SLA to maintain its strong capital level in 2022 as it integrates the DentaQuest acquisition. The company targets a dividend payout ratio in the 40%-50% range.

As a result, we view SLA's capital strength to be at an Aa level, and have adjusted the capital adequacy score to Aa.

### Profitability: Diversified business mix, with stable profitability

In 2021, SLF reported net income of CAD3.9 billion, a 64% increase from 2020 driven by favorable market conditions and a $297 million after-tax gain on the initial public offering of its India joint venture. SLA has achieved an 8.0% five-year average return on capital (2017-2021), although this historical performance is at the lower end of our expectations for the Aa category (8% to 12%). We expect profitability to be pressured due to the challenging macroeconomic outlook as equity markets are expected to remain volatile due to the Russia-Ukraine conflict. The company remains committed to improving efficiency through simplying its organizational structure and processes. We note that earnings should benefit from a rising interest rate environment, particularly at the long end of the curve, although high inflation could weigh on expenses and operating efficiency.

Part of parent SLF's US business is written out of SLA's US branch, which has been the predominant piece of the SLF U.S. segment reported in the SLA financial statements prior to the Assurant acquisition, which added critical mass to the U.S. segment. The other business units include International Hubs, which was combined with the Hong Kong business in Q1 2020 and offers products to high net worth clients in international markets, and in-force management.

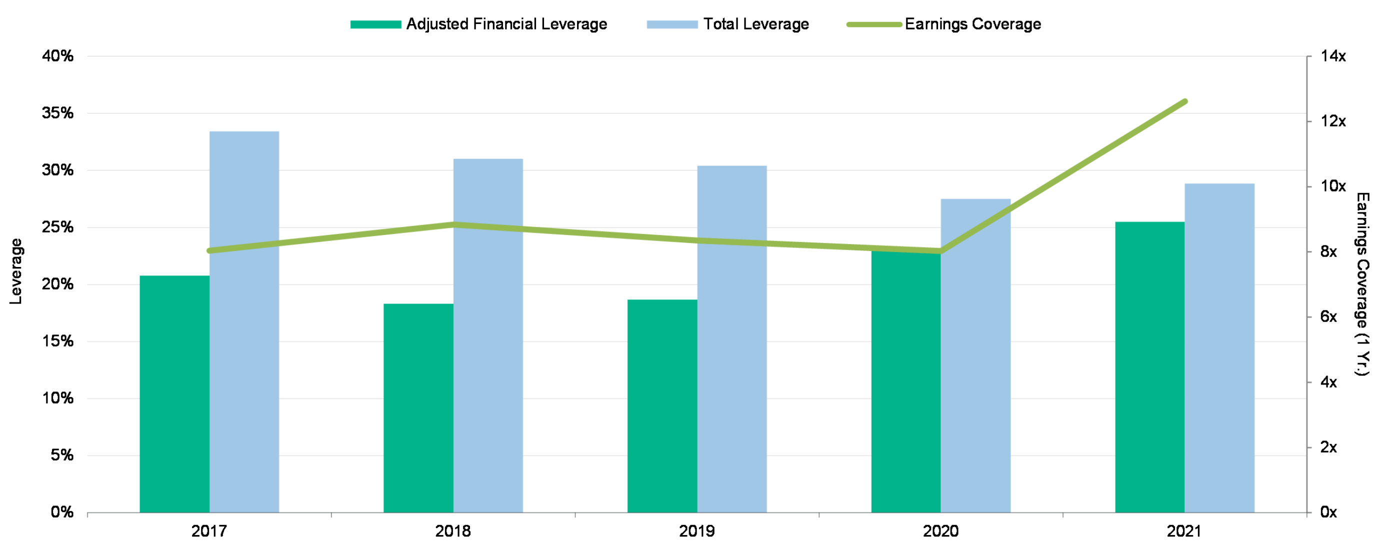
On an unadjusted basis, SLA's profitability factor scores Aa, reflecting its diverse business model and the relatively stable earnings generated by its Canadian business. We have kept the adjusted score in line with the unadjusted score to account for our expectation that, given the challenging macroeconomic outlook, profitability will remain pressured.

**Liquidity and asset/liability management: Robust liquidity offset by potential margin demands from hedging activities**
Applying the liquidity stress test approach to SLA results in a liquidity score in the Aaa range, calculated on a raw basis. Moody's believes liquidity at SLA (and the larger SLF group) remains robust and that the company uses sophisticated ALM and hedging strategies to keep any asset-liability mismatches within reasonable tolerances. Specifically, the hedging strategies utilize derivative instruments to manage the interest rate sensitivity of the duration gap between assets and liabilities, to mitigate the interest and equity related exposure of guarantees on insurance and annuity contracts and segregated funds, and to reduce currency exposure. However, given that variable margin requirements associated with hedging activities add a level of complexity to liquidity management, we have adjusted the raw score down to the Aa range.

**Financial flexibility: Return to historical earnings coverage levels driven by improved profit stability**
SLA's financial flexibility is analyzed at the consolidated SLF level. On a comparative IFRS basis, financial leverage metrics have improved in recent years due to strong earnings, however, during 2021, SLF issued CAD2.0 billion of subordinated issuances largely to fund part of its DentaQuest acquisition, which closed on June 1, 2022. This issuance contributed to the increase in financial leverage to 25.5% at year-end 2021 from 23.0% in 2020. Similarly, total leverage increased to 28.8% from 27.5% in 2020.

SLF's earnings coverage ratio for 2021 was strong at 12.6x, in the Aa range, with consolidated interest expense at the holding company of CAD327 million for 2021. SLF's earnings coverage ratio was 9.2x on a 5-year average, partly reflecting its strong earnings. While SLF has experienced more normalized earnings levels over the last five years, which has restored a healthier level of financial flexibility, SLF's moderate total leverage ratio implies the company could have less marginal debt capacity in a stress period than similarly rated peers. As a result, we have adjusted to the raw financial flexibility score of Aa down to a level of A.

Exhibit 5
**Increased leverage from subordinated debt issuance in 2021, although higher earnings coverage**




*Sources: Moody's Investors Service and company filings*

## Liquidity analysis
SLF's liquidity policies require each operating subsidiary to keep sufficient liquidity to meet expected liabilities in both a one month and one-year stress test. The holding company targets CAD500 million in excess cash and has access to $1.4 billion in fully committed

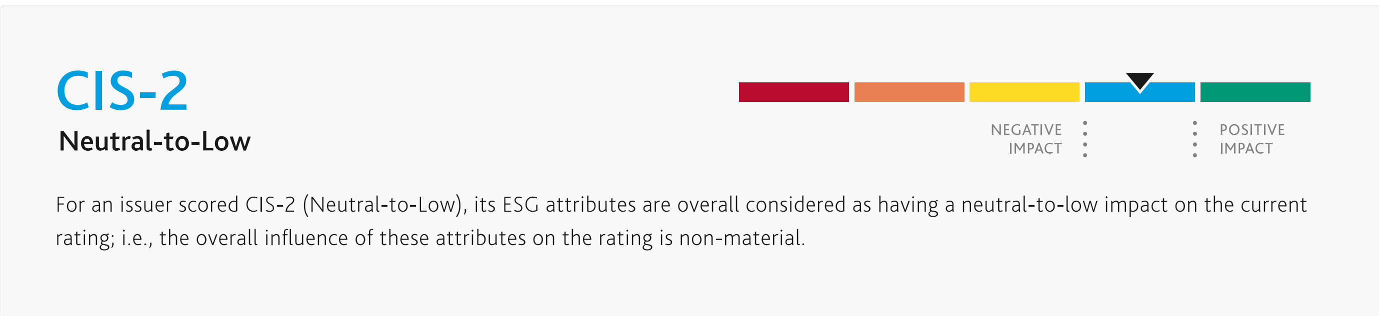
credit facilities as at December 31, 2021. SLF ended 2021 with CAD4.7 billion of cash and liquid assets at the holding company, up from CAD3.1 billion at year-end 2020 primarily attributable to strong earnings, a moratorium on dividend increases and share buybacks imposed by the regulator that ended on November 4, 2021 and the pre-funding of its DentaQuest acquisition. There is dividend capacity available to the holding company from its Canadian life insurance and US investment management franchises. SLF's unrestricted subsidiary dividend capacity totaled approximately CAD3.1 billion at year-end 2021. Moody's calculates SLA's dividend capacity on the basis of the company maintaining its LICAT ratio above 130%.[1]

These sources, in total, exceed the 2021 major uses of cash at the holding company, which included CAD1,428 million in common and preferred share dividends paid as well as CAD187 million of interest expense paid. In Q4 2021, the quarterly dividend was increased to CAD0.66 from CAD0.55. The company's 2021 dividend payout ratio was 35%, down from 54% in 2020. During 2021, SLF redeemed CAD650 million of senior and subordinated debt. Subordinated debt and LRCNs with first par call dates within the next five years (up to 2027) total CAD3.6 billion. The company has no commercial paper outstanding.

## ESG considerations

### SUN LIFE ASSURANCE COMPANY OF CANADA's ESG Credit Impact Score is Neutral-to-Low CIS-2

Exhibit 6
**ESG Credit Impact Score**




*Source: Moody's Investors Service*

Sun Life Assurance Company of Canada's (Sun Life) ESG Credit Impact Score is neutral-to-low (**CIS-2**). The score reflects a limited impact from environmental, social and governance factors on the rating to date. Sun Life's strong risk management and effective governance mitigate its exposure to environmental and social risks, in particular carbon transition, customer relations, and societal and demographic risks.

Exhibit 7
**ESG Issuer Profile Scores**


*Source: Moody's Investors Service*

### Environmental

Sun Life has moderate exposure to carbon transition risk through the long-duration assets held in its investment portfolio and inherent asset leverage, while emerging stakeholder focus on environmental stewardship in its investment portfolio gives rise to strategic and reputational risk. This risk is mitigated by Sun Life's strong governance and risk management practices, along with its developing focus on managing climate risk.

### Social

Sun Life faces high industrywide customer relations risk in relation to the sale of its products and significant interaction with retail customers against a background of regulatory focus on the fair treatment of customers, which is mitigated by well-developed policies and procedures. High cyber and personal data risks are mitigated by a strong technology framework. High exposure to demographic and societal risks, including the effects of an aging population, can make the operating environment more difficult.

### Governance

Sun Life faces neutral-to-low governance risks, and its risk management, policies and procedures are in line with industry best practices. Its management team has demonstrated a strong track record of meeting financial and strategic objectives, and the insurer benefits from a strong and independent board. Organizational complexity inherent to its size and the diversification of its operations presents some governance risks.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

## Support and structural considerations

SLF's ratings were withdrawn on October 6, 2021.

## Rating methodology and scorecard factors

Exhibit 8
**Sun Life Assurance Company of Canada**

| Financial Strength Rating Scorecard [1][2] | Aaa | Aa | A | Baa | Ba | B | Caa | Score | Adj Score |
|---|---|---|---|---|---|---|---|---|---|
| Business Profile | | | | | | | | A | Aa |
| **Market Position and Brand (15%)** | | | | | | | | A | Aa |
| -Relative Market Share Ratio | | | X | | | | | | |
| **Distribution (10%)** | | | | | | | | A | Aa |
| -Distribution Control | | X | | | | | | | |
| -Diversity of Distribution | | | X | | | | | | |
| **Product Focus and Diversification (10%)** | | | | | | | | A | A |
| -Product Risk | | | X | | | | | | |
| -Life Insurance Product Diversification | | X | | | | | | | |
| Financial Profile | | | | | | | | A | A |
| **Asset Quality (10%)** | | | | | | | | Baa | Baa |
| -High Risk Assets % Shareholders' Equity | | | | 140.4% | | | | | |
| -Goodwill & Intangibles % Shareholders' Equity[3] | | | 37.3% | | | | | | |
| **Capital Adequacy (15%)** | | | | | | | | Baa | Aa |
| -Shareholders' Equity % Total Assets | | | | 5.3% | | | | | |
| **Profitability (15%)** | | | | | | | | Aa | Aa |
| -Return on Capital (5 yr. avg.) | | 8.0% | | | | | | | |
| -Sharpe Ratio of ROC (5 yr.) | 413.4% | | | | | | | | |
| **Liquidity and Asset/Liability Management (10%)** | | | | | | | | Aaa | Aa |
| -Liquid Assets % Liquid Liabilities | X | | | | | | | | |
| **Financial Flexibility (15%)** | | | | | | | | Aa | A |
| -Adjusted Financial Leverage[3] | | 25.5% | | | | | | | |
| -Total Leverage[3] | | 28.8% | | | | | | | |
| -Earnings Coverage (5 yr. avg.)[3] | | 9.2x | | | | | | | |
| -Cash Flow Coverage (5 yr. avg.)[3] | | 6.5x | | | | | | | |
| Operating Environment | | | | | | | | Aaa - A | Aaa - A |
| Preliminary Standalone Outcome | | | | | | | | A1 | Aa3 |

[1] Information based on IFRS financial statements as of fiscal year ended December 31, 2021. [2] The Scorecard rating is an important component of the company's published rating, reflecting the standalone financial strength before other considerations (discussed above) are incorporated into the analysis. [3] Information based on IFRS financial statements of Sun Life Financial, Inc. as of fiscal year ended.
*Source: Moody's Investors Service*

## Moody's related publications

### Outlook

Life Insurance - Global: 2022 Outlook

### Issuer Comment

Q1 2022 earnings - Credit neutral quarter driven by elevated COVID and market-related impacts despite business growth

Q4 2021 earnings - Credit neutral quarter as elevated COVID-related impacts offset broad-based business growth

Q3 2021 earnings - Strong asset management performance offset by COVID-related impacts

Sun Life acquisition of DentaQuest positions it as a leading dental benefits provider, a credit positive

### Sector in-depth

Insurance – Global: Heard from the Market: Insurance Conference 2022

Financial Institutions – Cross Region: Risks of prolonged high inflation outweigh rate hike benefits

### Issuer profile

Sun Life Financial, Inc. Key Facts and Statistics - FYE Dec 2019

Sun Life Assurance Company of Canada, Inc. Key Facts and Statistics - FYE Dec 2019

**Methodology**

Life Insurers

## Ratings

Exhibit 9

| Category | Moody's Rating |
|---|---|
| **SUN LIFE ASSURANCE COMPANY OF CANADA** | |
| Rating Outlook | STA |
| Insurance Financial Strength | Aa3 |

*Source: Moody's Investors Service*

## Endnotes

1 2017 and prior cash flow coverage metrics are based on MCCSR ratios above 200%.

REPORT NUMBER 1331944

## CLIENT SERVICES

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