

Basel II, Pillar 3 Disclosure for Sun Life Financial Trust Inc.

Introduction

Basel II is an international framework on capital that applies to deposit taking institutions in many countries, including Canada. The framework is intended to strengthen the capital adequacy of financial institutions through measurement and monitoring of risk sensitive capital requirements.

The Basel II Framework is made up of three pillars:

Pillar 1 establishes rules for the calculation of minimum capital for credit, market and operational risk (capital adequacy requirements).

Pillar 2 is an internal discipline to evaluate the adequacy of the regulatory capital requirement under Pillar 1 and other non-Pillar 1 risks. This pillar requires a supervisory review to assess the robustness of the regulated entity's internal assessment (supervisory review) by the Office of the Superintendent of Financial Institutions (OSFI).

Pillar 3 complements the other pillars and affects market discipline through public disclosure. Expanded disclosure about capital and risk enables interested parties to better understand the risk profile of the individual deposit taking institution and to make comparisons (market discipline).

Capital Structure and Adequacy

Amount & types of Tier 1 capital:

The regulatory capital position of Sun Life Financial Trust Inc., referred to as the "Company" or SLFT was as follows:

	2017	2016
Regulatory capital		
Tier 1 and Total		
Common stock	\$ 98,561	\$ 88,561
Contributed surplus	38,050	38,050
Accumulated deficit	(2,770)	(7,417)
Accumulated other comprehensive income	(3,108)	1,633
Total Tier 1 and Total capital	\$ 130,733	\$ 120,827
Risk-weighted assets for		
Credit risk	\$ 712,753	\$ 673,608
Operational risk	29,025	30,575
Total risk-weighted assets	\$ 741,778	\$ 704,183
Regulatory ratios		
Tier 1 and Total	17.6%	17.2%
Leverage ratio	10.0%	9.8%

All common stock is made up of common shares with no par value. The Company has no additional forms of capital. As at December 31, 2017 and 2016, the Company was in compliance with the OSFI capital guidelines.

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Approach to assessing capital:

Under the Company's capital risk policy and OSFI guidelines, it annually is required to assess the adequacy of current and projected capital resources under expected and stressed conditions. This involves evaluating the Company's strategy, financial plan and risk appetite; assessing the effectiveness of its risk and capital management practices (including Board and management oversight); subjecting the Company's plans and /or actual results to a range of stress tests; and concluding on capital adequacy.

The Company is subject to the guidelines regarding capital framework for regulated financial institutions. These guidelines are consistent with international standards set by the Bank for International Settlements. The Company has adopted the capital framework issued by OSFI under the "International Convergence of Capital Measurement and Capital Standards – A Revised Framework" (Basel II). The Company follows the Standard Approach for calculating credit risk and the Basic Indicator Approach for operational risk, and is exempt from calculating market risk. The Company uses ratings from DBRS, Fitch Group, Moody's and Standard & Poor's, where available, to determine credit ratings for invested assets. In the absence of external ratings, the Company uses an internal quality rating system to assign appropriate credit ratings.

Risk Management Objectives and Policies

The Company is governed by the enterprise-wide risk management policies of its parent, Sun Life Assurance Company of Canada (SLAC). The Company also has its own portfolio policies and parameters which include specific risk management limits by asset class. These specific risk management limits include credit risk, liquidity risk, interest rate risk, and currency risk.

The role of the Board of Directors and Management in risk management

Risk management responsibilities of the Board of Directors (the "Board") and Management can be summarized as follows:

Board of Directors:

- The Board approves Company specific policies ensuring appropriate risk management is in place.
- The Board monitors the activities of the Company on a quarterly basis.
- The Board approves the appointment of all officers to the Company.
- The Board delegates authority for managing the key risk areas to appropriate personnel.
- The Audit Committee of the Company's parent, SLAC, performs the functions of an audit committee for SLFT, as permitted under the Trust and Loan Companies Act.

Management:

- Management implements risk management policies as approved by the Board.
- Management is responsible for identifying risks and estimating their likelihood of occurrence and the resulting impact on the Company's ability to achieve its business objectives.
- Management establishes policies, procedures and controls to ensure appropriate approval processes, mitigation of risks, complete and accurate accounting, safeguarding of assets, and segregation of duties for transaction processing.
- Management establishes management reporting information systems in order to manage the Company's operations and periodically reviews reporting mechanisms to ensure that systems and processes operate as designed.
- Management of the Company reports quarterly to the Board on the internal control practices in place to provide reasonable assurance that the financial and reporting information generated within the Company is accurate and reliable and that prescribed policies, procedures, laws and regulations are complied with throughout the Company.

Internal Audit:

- An internal audit function is responsible for assessing the adequacy of and adherence to the systems of internal control. The results of internal audit's reviews are reported to management and the Audit Committee of SLAC regularly throughout the year.

Alignment of operations with SLAC:

The Company's operations are highly integrated with those of SLAC, to maximize the efficiency of operations and the ability to maintain consistent management information systems and internal controls. The alignment of operations is evident in the Asset Liability Management and Investment departments. These departments manage the Company's investment risks.

Investment risk:

The Company manages its investments in accordance with its risk management framework and policies approved by the Board that establish aggregate limits and constraints for credit, interest rate, liquidity, and currency risks.

Liquidity risk:

Liquidity risk is "the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial instruments." The Company generally maintains a conservative liquidity position and employs a wide range of liquidity risk management practices and controls, which are described below:

- Liquidity is managed in accordance with the Company's liquidity policies and guidelines.
- Stress testing of the Company's liquidity is performed by comparing liquidity coverage ratios under one month, three month and one year stress scenarios to Company policy thresholds approved by management and the Board.
- Cash management and asset liability management programs support the Company's ability to maintain its financial position by ensuring that sufficient cash flow and liquid assets are available to cover potential funding requirements. The Company invests in various types of assets with a view of matching them to the Company's liabilities of various durations.
- Target capital levels exceed regulatory minimums. The Company actively manages and monitors its capital and asset levels, and the diversification and credit quality of its investments.
- The Company maintains liquidity contingency plans for the management of liquidity in the event of a liquidity crisis.
- Reporting is submitted to the Board quarterly for oversight and monitoring.

Currency risk:

Foreign currency risk is the result of mismatches in the currency of assets and liabilities (inclusive of capital), and cash flows. This risk may arise from a variety of sources such as foreign currency transactions, foreign exchange hedging, and investments denominated in foreign currencies.

Foreign exchange derivative contracts such as currency swaps and forwards are used as risk management tools to manage the currency exposure in accordance with the Company's asset-liability risk management policy. As at December 31, 2017 and 2016 the Company did not have a material currency risk exposure on a Canadian dollar basis.

Market risk:

The Company is exempt from the application of market risk according to Basel II, as the value of the Company's trading book does not exceed 10% of total assets, nor does it exceed \$10 billion.

Credit risk:

Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

The Company's Investment and Credit Risk Policy defines the acceptable risk profile for the investment portfolio including requirements for adequate diversification of assets by investment type, security type, industry and borrower. Limits are set relative to the capital base of the Company and overall investment objectives.

SLAC's investment policy framework and governance defines required approval authority at various management levels for new loans and refinancing which are commensurate with the credit risk involved.

Individuals involved in loan management have the appropriate level of experience and expertise.

Portfolio performance with respect to credit risk is monitored closely by management and the Board. Detailed reports are provided to the Board on a quarterly basis.

Loans are monitored on an on-going basis. The portfolio is stratified using a risk rating system.

Gross credit risk exposures:

Statement of financial position	2017		2016	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Cash, cash equivalents and short-term securities	\$ 28,257	\$ 28,257	\$ 31,860	\$ 31,860
Debt securities - available-for-sale	674,786	674,786	653,005	653,005
Mortgage and loans - amortized cost	558,493	558,149	507,107	508,814
Derivative assets	1,049	1,049	409	409
Other assets	22,224	22,224	35,389	35,389
Total	\$ 1,284,809	\$ 1,284,465	\$ 1,227,770	\$ 1,229,477

All figures presented are in thousands and Canadian dollars. The figures are as at December 31 of the year indicated.

Geographic distribution of mortgage exposures:

Province	2017 (% of mortgages)	2016 (% of mortgages)
Ontario	50.3%	49.4%
Alberta	12.1%	22.0%
British Columbia	31.2%	18.1%
Quebec	4.5%	7.0%
Rest of Canada	19%	3.5%

Maturity breakdown:

Term to Maturity (2017)						
	On Demand	Within 1 Year	1 to 5 Years	Over 5 Years	No Specific Maturity	Total
Cash, cash equivalents and short-term securities	\$ 718	\$ 27,539	\$ -	\$ -	\$ -	\$ 28,257
Debt securities	-	153,842	464,857	56,087	-	674,786
Mortgages and loans	-	209,080	302,777	46,636	-	558,493
Derivative related assets	-	107	942	-	-	1,049
Other assets	-	-	-	-	\$ 22,224	\$ 22,224
Total	\$ 718	\$ 390,568	\$ 768,576	\$ 102,723	\$ 22,224	\$ 1,284,809

Term to Maturity (2016)						
	On Demand	Within 1 Year	1 to 5 Years	Over 5 Years	No Specific Maturity	Total
Cash, cash equivalents and short-term securities	\$ 3,995	\$ 27,865	\$ -	\$ -	\$ -	\$ 31,860
Debt securities	-	210,866	426,262	15,877	-	653,005
Mortgages and loans	-	170,724	308,615	27,768	-	507,107
Derivative related assets	-	-	409	-	-	409
Other assets	-	-	-	-	\$ 35,389	\$ 35,389
Total	\$ 3,995	\$ 409,455	\$ 735,286	\$ 43,645	\$ 35,389	\$ 1,227,770

All figures presented are in thousands and Canadian dollars. The figures are as at December 31 of the year indicated.

Impaired Assets:

Management assesses debt securities and mortgages and loans for objective evidence of impairment at each reporting date. A portfolio monitoring process is employed to identify assets or groups of assets that have objective evidence of impairment, having experienced a loss event or events that have an impact on the estimated future cash flows of the asset or group of assets. There are inherent risks and uncertainties in the Company's evaluation of assets or groups of assets for objective evidence of impairment, including both internal and external factors such as general economic conditions, issuers' financial conditions and prospects for economic recovery, market interest rates, unforeseen events which affect one or more issuers or industry sectors, and portfolio management parameters, including asset mix, interest rate risk, portfolio diversification, duration matching, and greater than expected liquidity needs. All of these factors could impact the evaluation of an asset or group of assets for objective evidence of impairment.

Objective evidence of impairment on debt securities involves an assessment of the issuer's ability to meet current and future contractual interest and principal payments. In determining whether debt securities have objective evidence of impairment, a screening process is employed. The process identifies securities in an unrealized loss position, with particular attention paid to those securities whose fair value to amortized cost percentages have been less than 80% for an extended period of time. Discrete credit events, such as a ratings downgrade, are also used to identify securities that may have objective evidence of impairment. The securities identified are then evaluated based on issuer-specific facts and circumstances, including an evaluation of the issuer's financial condition and prospects for economic recovery, evidence of difficulty being experienced by the issuer's parent or affiliate, and management's assessment of the outlook for the issuer's industry sector.

Management also assesses previously impaired debt securities whose fair value has recovered to determine whether the recovery is objectively related to an event occurring subsequent to the impairment loss that has an impact on the estimated future cash flows of the asset.

Asset-backed securities are assessed for objective evidence of impairment on an alternative basis. Specifically, the Company periodically updates the best estimate of cash flows over the life of the security. In the event that there is an adverse change in the expected cash flows, the asset is impaired. Estimating future cash flows is a quantitative and qualitative process that incorporates information received from third parties, along with assumptions and judgments about the future performance of the underlying collateral. Losses incurred on the respective mortgage-backed securities portfolios are based on loss models using assumptions about key systematic risks, such as unemployment rates and housing prices, and loan-specific information such as delinquency rates and loan-to-value ratios.

Objective evidence of impairment on mortgages and loans involves an assessment of the borrower's ability to meet current and future contractual interest and principal payments. In determining whether an individual mortgage or loan has objective evidence of impairment, a number of triggers are considered that cause management to reassess its creditworthiness and consequent cause for concern, generally based on a decline in the current financial position of the borrower and, for collateral-dependent mortgages and loans, the value of the collateral.

Mortgages and loans causing concern are monitored closely and evaluated for objective evidence of impairment. For these mortgages and loans, information is reviewed that is appropriate to the circumstances, including recent operating developments, strategy review, timelines for remediation, financial position of the borrower and, for collateral-dependent mortgages and loans, the value of security as well as occupancy and cash flow considerations.

In addition to specific allowances, circumstances may warrant a collective allowance based on objective evidence of impairment for a group of mortgages and loans. The Company considers regional economic conditions, developments for various property types, and significant exposure to struggling tenants in determining whether there is objective evidence of impairment for certain collateral dependent mortgages and loans, even though it is not possible to identify specific mortgages and loans that are likely to become impaired on an individual basis.

Management also assesses previously impaired mortgages and loans to determine whether a recovery is objectively related to an event occurring subsequent to the impairment loss that has an impact on the estimated future cash flows of the asset.

The Company has invested assets with allowances for credit losses as follows:

	2017			2016		
	Gross Invested Assets	Allowances for Losses	Net Invested Assets	Gross Invested Assets	Allowances for Losses	Net Invested Assets
Cash and cash equivalents	\$ 10,788	\$ -	\$ 10,788	\$ 25,248	\$ -	\$ 25,248
Short-term securities	17,469	-	17,469	6,612	-	6,612
Debt securities	674,786	-	674,786	653,005	-	653,005
Corporate loans	479,789	475	479,314	418,439	395	418,044
Residential Mortgages	13,737	31	13,706	23,435	35	23,400
Commercial Mortgages	65,589	116	65,473	65,777	114	65,663
Total	\$ 1,262,158	\$ 622	\$ 1,261,536	\$ 1,192,516	\$ 544	\$ 1,191,972

All figures presented are in thousands and Canadian dollars. The figures are as at December 31 of the year indicated.

Changes in the allowances are as follows:

	2017			2016		
	Specific	Collective	Total	Specific	Collective	Total
Balance, beginning of the year	\$ -	\$ 544	\$ 544	\$ -	\$ 573	\$ 573
Recoveries	-	-	-	-	-	-
Write-offs	-	-	-	-	-	-
Change in allowance	-	78	78	-	(29)	(29)
Balance, end of year	\$ -	\$ 622	\$ 622	\$ -	\$ 544	\$ 544

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The company has no impaired loans.

Counterparty Credit Risk:

Counterparty credit risk arises from over-the-counter ('OTC') derivatives and securities financing transactions. It is the risk that the counterparty to a transaction may default before completing the satisfactory settlement of the transaction. An economic loss occurs if the transaction or portfolio of transactions with the counterparty has a positive economic value at the time of default. In the instance of a credit rating downgrade applicable to the counterparty on our derivatives, the Company must hold more capital to address the increased risk.

The notional principal amount of derivative instruments represents an amount to which a rate or price is applied in order to calculate the exchange of cash flows. Notional principal amounts are frequently used as an indicator of business activity; however, they are not indicative of credit or market risk exposure.

The notional principal amounts by remaining term to maturity are disclosed below:

Derivative Type	2017					2016
	Within 3 months	3 months to 1 year	1 to 5 years	Over 5 years	Total	Total
Interest rate contracts	\$ -	\$ -	\$ 5,400	\$ -	\$ 5,400	\$ 5,400
Foreign exchange contracts	8,227	95,700	11,882	-	115,809	92,304
Total	\$ 8,227	\$ 95,700	\$ 17,282	\$ -	\$ 121,209	\$ 97,704

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Credit exposure:

Current credit risk exposure represents the current replacement cost of all outstanding derivative contracts with a positive value.

Credit equivalent amount represents the current credit risk exposure plus an estimate of the impact that future changes in interest and foreign currency rates and other indices would have based upon a formula prescribed by OSFI.

Risk-weighted balance represents the credit equivalent amount weighted according to the credit worthiness of the counterparty as prescribed by OSFI.

The following provides a summary of the Company's derivative portfolio and related credit exposure:

Credit Risk	2017				2016			
	Notional Principal	Current Credit Risk Exposure	Credit Equivalent Amount	Risk Weighted Balance	Notional Principal	Current Credit Risk Exposure	Credit Equivalent Amount	Risk Weighted Balance
Interest rate contracts	\$ 5,400	\$ -	\$ 16	\$ 8	\$ 5,400	\$ 104	\$ 131	\$ 65
Foreign exchange contracts	115,809	314	1,261	631	92,304	305	1,400	701
Total by Maturity	\$ 121,209	\$ 314	\$ 1,277	\$ 639	\$ 97,704	\$ 409	\$ 1,531	\$ 766

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Interest rate risk

Interest rate risk is defined as the risk that a movement in interest rates will have an adverse effect on the financial condition of the Company. The Company manages the impact of interest rate changes within self-imposed limits established after careful analysis in order to keep disinvestments and reinvestment losses within acceptable limits. The primary approach for managing interest rate risk is management of the duration gap of assets and liabilities. Duration analysis measures the sensitivity of assets, liabilities and off-balance sheet instruments to changes in interest rates.

Increase/decline in earnings or economic value:

As at December 31, 2017, an immediate 1% increase in interest rates across the yield curve would have resulted in a decrease of \$686 in the Company's income before income taxes (2016 – \$575). An immediate and parallel decrease in interest rates of 1% would have resulted in an increase of \$708 in the Company's income before income taxes (2016 – \$360).

Remuneration

Governance structure over remuneration rests with the parent SLAC. SLFT has no employees and pays no remuneration to staff or directors; instead it is charged an administrative fee by the parent that would include, in part, compensation costs. In 2017, there were 14 officers and directors (2016 – 12) with authority and responsibility for planning, directing, and controlling the activities of the Company, in addition to their responsibilities for SLAC. The aggregate fees charged by SLAC for the services performed for the Company is estimated to be less than \$1,000 (2016 – less than \$1,000).

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