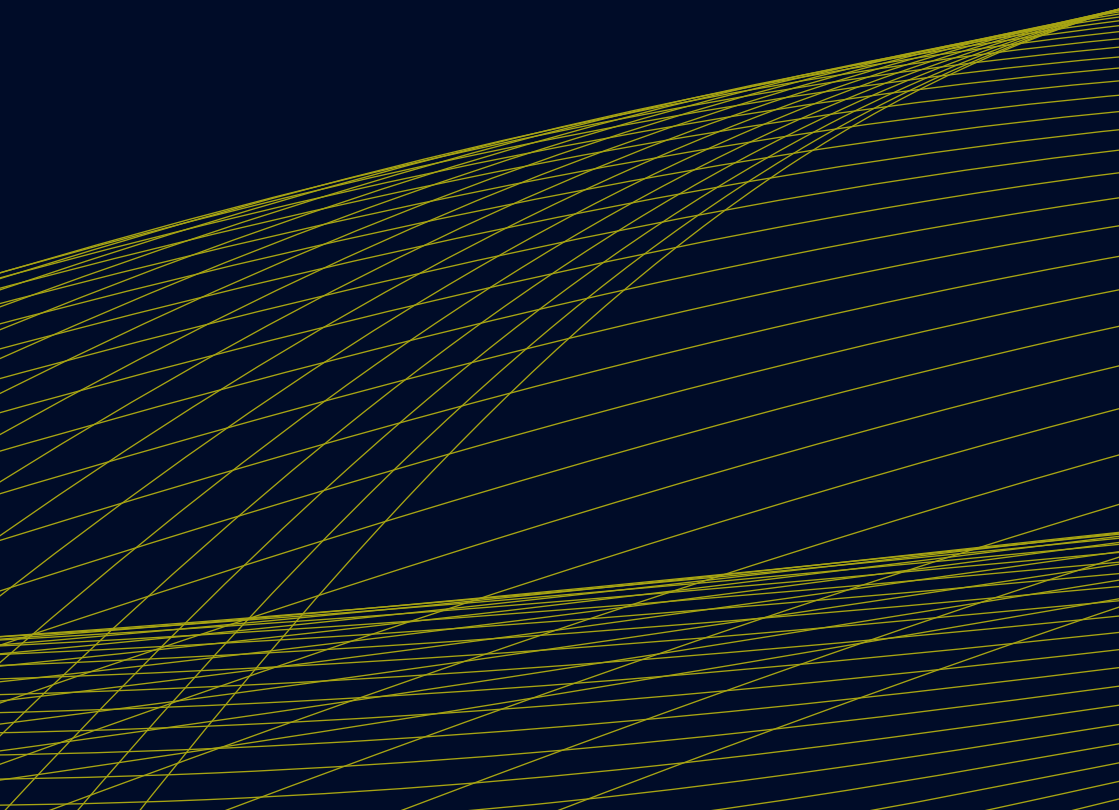


Pension
Protection
Fund

SIP

Statement of Investment Principles

November 2010



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This Statement of Investment Principles is produced to meet the requirements of the Pensions Act 2004 and to reflect the Government’s voluntary code of conduct for Institutional Investment in the UK (“the Myners Principles”). The Board also complies with the requirements to maintain and take advice on the Statement and with the disclosure requirements.

1 Introduction

1.1

1
Statutory Instrument
2005 No. 675

The Board (“the Board”) of the Pension Protection Fund (“the Fund”) has prepared this Statement of Investment Principles (“the Statement”) in accordance with Section 114 of the Pensions Act 2004 (“the Act”) and the Pension Protection Fund (Statement of Investment Principles) Regulations 2005 (“the Regulations”)¹.

1.2

This written statement outlines the principles and policies governing determinations about investments made by or on behalf of the Board in the management of the Fund’s assets. This Statement also reflects the Myners Principles for institutional investment decision-making.

1.3

This Statement will be reviewed annually or when there is, or the Board anticipates that there might be, a significant change in relation to any matter contained in this Statement or to any of the matters which this Statement is required to cover by the Regulations.

1.4

This Statement is specifically concerned with the investment of the:

- accumulated levy contributions paid into the Fund, and
- assets transferred into the Fund from eligible pension schemes.

Although this Statement does not apply to the assets of schemes in an assessment period (as defined in Section 132 of the Act), the Board, where appropriate, will work with the trustees of such schemes to encourage co-ordination with the investment strategy of the Board and to minimise the costs of transitions.

This Statement covers the Fund as defined in Section 114 of the Pensions Act 2004. It does not cover the Fraud Compensation Fund for which the Board is also responsible. A separate Statement of Investment Principles is in place for the Fraud Compensation Fund.

1.5

This Statement will be published and made available upon request.

2 Governance of the Fund

2.1 Investment powers and compliance with the Pensions Act 2004

2.1.1

Section 113 of the Pensions Act 2004 provides that the Board may invest for the purpose of the prudent management of its financial affairs. When exercising its power to invest the Board will consider the interests of current and potential beneficiaries of the Fund and the interests of persons affected by the rate of the levies.

2.1.2

The Board is responsible for the governance and investment of the Fund's assets. The Board is satisfied that it has sufficient expertise, information and resources to carry out its role effectively. Several members of the Board have significant working experience in the investment industry. The Board also has access to in-house investment expertise within the Financial Risk Management Team. Attached in Annex 2 is a breakdown of the governance structure and the associated responsibilities.

2.1.3

In preparing this Statement, the Board considered written advice received from the Fund's investment adviser, Mercer Investment Consulting, who is believed to be suitably qualified and is authorised under the Financial Services and Markets Act 2000. The written advice considers the suitability of the investments, the need for diversification and the principles contained in this Statement. Actuarial advice relating to the assets and liabilities of the Fund is sought from the Board's Chief Actuary.

2.2 Investment Committee and Asset and Liability Committee

2.2.1

The Board's funding objective, and the appetite for investment risk, are the responsibility of the Board.

2.2.2

■■■■■■■■■■

The Board has established an Investment Committee to set an appropriate mix of assets consistent with the Board's funding objective and appetite for risk, and provide oversight of its implementation. The Investment Committee is accountable to the Board.

2.2.3

■■■■■■■■■■

The Chief Executive has also established an executive committee, the Asset and Liability Committee, to oversee the day-to-day investment activities of the Fund. Oversight of the Asset and Liability Committee is provided by the Investment Committee.

2.3 Day-to-day fund management

2.3.1

■■■■■■■■■■

The day-to-day fund management of the assets is performed by professional fund managers, each of whom is authorised and regulated by the Financial Services Authority and appointed in accordance with Section 113(4) of the Act. The Investment Committee is satisfied that the appointed fund managers have sufficient expertise and experience to carry out their role.

2.3.2

■■■■■■■■■■

The appointment, monitoring and termination of professional fund managers is the responsibility of the Investment Committee, acting on the recommendations of the Asset and Liability Committee.

3 Funding objective

3.1

The Board's primary objective is to have sufficient funds to pay compensation to the members of eligible defined benefit occupational pension schemes or defined benefit elements of hybrid occupational pension schemes, where these schemes have been transferred into the Fund.

3.2

In setting a funding objective, the Board envisages the Fund becoming, over a period of years, sufficiently mature such that the profile of liabilities is dominated by members who are receiving compensation.

3.3

The Board will target the Fund towards reaching an appropriate level of funding at that time, to be achieved by adopting suitable low risk investment strategies, setting a levy on eligible schemes and the prudent management of the Fund's assets.

3.4

This objective is to be met by the Fund achieving a balance between protecting and securing the compensation payments for actual and potential members of schemes that come into the Fund while setting a fair and proportionate levy. Specifically, the investment strategy is designed to match current estimates of the Board's liabilities and provide some outperformance over the estimated liabilities. Any outperformance should contribute to the long-term sustainability of the Fund and therefore reduce the burden on the levy payer. The Board regards a long-term target investment return of 1.8 per cent pa in excess of the liabilities to be consistent with these objectives.

3.5

The nature and timing of these actual and potential liabilities are uncertain and will vary as schemes transfer to the Fund. Assets will be set to match current estimates of the Board's liabilities and may be adjusted as the pattern of liabilities evolves over time.

4 Risk measurement and management

4.1

The Board targets a level of investment risk equivalent to a tracking error of 4 per cent pa against the liabilities. This is calculated using long-term assumptions used by pension schemes for asset and liability modelling.

4.2

The Board will assess and consider the following risks on an ongoing basis:

- **Cashflow risk**

The risk of a shortfall of liquid assets relative to the immediate liabilities. The Board and its advisers will manage the Fund's cash flows and assets taking into account the timing of future payments and the liquidity of invested assets, and may borrow over the short term in order to minimise the risk that this occurs.

- **Financial mismatching risk**

The risk of a significant difference in the performance of the asset classes in which the Fund is invested, and the liabilities of the Fund, including changes in inflation and interest rates. The Board will control these risks by monitoring their key characteristics, setting appropriate tolerances and taking corrective action when these tolerances are exceeded. The scope for these risk mitigation actions includes the pension schemes in assessment.

- **Manager risk**

The failure by the fund managers to achieve the rate of investment return assumed by the Board. This issue has been considered by the Board on the initial appointment of the fund managers and thereafter will be considered as part of the investment review procedures the Board has put in place.

- **Demographic risk**

Demographic factors include the uncertainty surrounding mortality projections such as future improvements in mortality experience. The Board will continue to monitor the developing market for hedging or mitigating this risk. The Board will measure liabilities using mortality assumptions recommended by the Chief Actuary of the Fund.

4 Risk measurement and management continued

- **Concentration risk**

The risk that the performance of any single asset class or single investment that constituted a significant proportion of the assets would disproportionately influence the Board's ability to meet the objectives. The Board has set diversification guidelines for the fund managers to mitigate this risk.

- **Credit risk**

The possibility of default of a counterparty in meeting its obligations. The Board has set guidelines with fund managers to limit its exposure to investments with high credit risk. It has also set limits on exposure to counterparties for collateral purposes and it monitors and manages the aggregate exposure of the Fund to each counterparty.

- **Systemic risk**

The possibility of an interlinked failure by a number of companies or organisations that sponsor UK pension schemes in particular sectors or industries.

This also includes consideration of the overlap of risk between the investment held and the exposure to scheme deficits, as the failure of investments may also coincide with increasing scheme liabilities to the Fund. The Board will seek to mitigate this risk by limiting its exposure to investments with high credit risk. In addition, the asset allocation is set so as to ensure a low level of correlation between the Fund's assets relative to its liabilities and that of a typical UK defined benefit pension scheme.

- **Transition risk**

The risk of incurring inappropriate costs in relation to the transition of assets of pension schemes in assessment to the Fund. The Board will mitigate this risk by liaising with the trustees of such schemes to eliminate unnecessary transition activity and by using one or more specialist managers to implement transitions of assets with the explicit aim of minimising costs. It also aims to group together separate transitions to achieve the benefits of scale.

- ***Custody risk***

The risk of misappropriation of assets, delivery that is not in accordance with the instructions, unauthorised use of assets for the benefits of other customers of the custodian, inadequate segregation of customer assets, failure to collect income, recover tax or respond to corporate events and custodian default. The Board will assess and consider the actions by the custodian at outset and on an ongoing basis to mitigate “custody risk”.

All of these risks are a potential threat to the achievement of the objective to target an appropriate funding level. These risks are monitored on a regular basis through the Asset and Liability Committee, with periodic review by the Investment Committee.

5 Investment strategy

5.1

The Board regards the selection of asset classes as the decision which has most influence on its ability to achieve its investment objectives.

5.2 Establishing the strategic asset allocation

5.2.1

The strategic asset allocation is set by taking into account the nature and timing of both actual and potential future liabilities, which are sensitive to interest rates, inflation, mortality and other financial and demographic factors. It is also set having regard to the Board's funding objectives. To meet these objectives the Board has set an investment return target, and risk appetite consistent with the Board's low risk investment philosophy. These are laid out below.

5.2.2

The Board targets a long-term investment return of 1.8 per cent pa in excess of the liabilities.

5.2.3

The Board targets a level of investment risk equivalent to a tracking error of 4 per cent pa against the liabilities. This is calculated using long-term assumptions used by pension schemes for asset and liability modelling.

The asset allocation is split into:

- Interest-bearing assets and derivatives that closely match the liability sensitivities to nominal and real interest rates ("matching assets"). A portfolio of swaps reduces the Fund's exposure to interest rate or inflation risk. It also contributes to reduce the level of correlation between the Fund's assets relative to liabilities to that of a standard UK defined benefit scheme, typically exposed to the risk of a decline in long-term interest rates, or increase in inflation expectations.
-

- A diversified portfolio of assets which is expected to generate additional return, avoiding unrewarded risks where possible (“excess return seeking assets”).

5.2.4

The asset classes which form the basis of the return seeking portfolio are:

- cash and global bonds of high credit quality
- publicly quoted equities, and
- alternative assets, which may include property, infrastructure, private equity, and strategies aiming to provide an absolute investment return.

Within the Board’s risk appetite, assets will be hedged back to sterling.

5.2.5

Given the low risk appetite, the strategic allocation to Cash and Bonds is 70 per cent with a tolerance range of 65 per cent to 80 per cent.

5.2.6

At any given time a minimum level of assets of sufficient liquidity and quality will be held to ensure the Fund is able to satisfy collateral or margin calls which may arise as a result of the derivatives positions it holds.

5.2.7

Alongside the strategic asset allocation, the Board also permits tactical investment views to be taken, either to enhance return, or to control risk. The combination of the strategic asset allocation and any tactical positions taken must operate within the overall risk appetite set by the Board.

5.2.8

Protection, or hedging strategies may also be employed, as appropriate, to mitigate the risk of a fall in assets against the liabilities.

5 Investment strategy continued

5.2.9

The performance of the Fund is measured against the liability benchmark. This benchmark will change periodically as a result of the Board accepting the legal obligation to pay compensation to members of eligible pension schemes.

5.2.10

The Board will, where necessary, use a combination of derivatives to adjust assets to better match the liability profile.

This is primarily to control the interest rate and inflation aspects of financial mismatching risk within the tolerance levels set by the Board. The regular adjustment of assets to the sensitivities to real and nominal interest rates is undertaken by specialist fund manager(s) using money market instruments, bonds and derivatives.

5.2.11

The strategy will be reviewed annually by the Investment Committee. An earlier review may be conducted in the event of any significant change in capital markets, the liabilities of the Fund, or governing legislation.

5.3 Schemes in assessment

5.3.1

The Board will also monitor the investment strategies and liabilities of pension schemes in assessment and consider whether, and how, the investment risks associated with these schemes might be mitigated within the asset strategy of the Fund.

5.3.2

Specifically, the Board will:

- Engage, where appropriate, with the trustees of schemes entering an assessment period to encourage co-ordination with the investment strategy of the Board and to minimise the costs of transitions.
-

- Monitor the asset allocation of schemes in assessment and, where necessary, adjust the asset allocation of the Fund to compensate for any imbalance caused by these schemes.
- Consider the use of its programme of interest rate and inflation hedging to mitigate the residual risks not covered by the investment strategies of schemes in assessment. The Board will control these risks by monitoring their key characteristics, setting appropriate tolerances and taking corrective action when these tolerances are exceeded.

The Board also has power to make a direction, under Section 134 of the Act, to the trustees of a scheme in assessment with a view to ensuring that the scheme's protected liabilities do not exceed its assets or, if they do, to keep the excess to a minimum as this poses a risk to the Fund.

The Board is also able to make a loan to a scheme in assessment under Section 139 of the Act where the trustees of such a scheme are unable to pay benefits to the members as they fall due.

5.4 Rebalancing policy and cash flow

5.4.1

The Board is satisfied that the spread of assets, the fund managers' policies on investing in individual securities and the Board's investment guidelines to fund managers provide adequate diversification of investments. The Board is also satisfied that the mandates awarded to the fund managers mean that the majority of assets held will be readily realisable to provide cash to meet payments by the Fund.

5.4.2

The Board has the powers to undertake borrowing, with a ceiling of £25m.

6 Day-to-day investment management of the assets

6.1 Fund management

6.1.1

For the management of the portfolios, the Board employs the services of investment experts as its fund managers and has specified investment guidelines to control the level of day-to-day decision making. The fund managers make their trading decisions independently of the Board. These fund managers are selected by a competitive tender process.

6.1.2

The fund managers are set a specific benchmark and performance objective by the Board. As a way of monitoring risk in portfolios, the Board agrees tracking error ranges with the fund managers for their portfolios. Fund manager performance and risk is monitored each month by the Asset and Liability Committee. Material or unexpected deviations may result in a formal review by the Investment Committee.

6.2 Investment performance benchmarks

6.2.1

The overall Fund benchmark is a notional combination of zero coupon bonds and zero coupon inflation-linked bonds that exactly matches the expected liability cash flows. It has been determined taking into account the liability of the transferred schemes and especially its sensitivity to real and nominal interest rates. This portfolio will change over time with future transfers of the pension schemes.

6.2.2

In order to judge the success of any tactical or hedging positions, and the performance of the fund managers, the investment performance of the Fund will also be judged against a composite benchmark calculated with reference to fixed asset allocations to defined Permitted Asset Classes, with performance assumed to follow a benchmark relevant to that asset class. More detail on what constitutes Permitted Asset Classes is included in Annex 1.

6.2.3

The strategic asset allocation of the Fund will be comprised of a portfolio constructed from the Permitted Asset Classes, including interest-bearing assets and derivatives that closely match the liability sensitivities to nominal and real interest rates, and assets allocated as per the following table:

Permitted Asset Class	Strategic allocation	Tolerance range	Asset benchmark index
Cash and Bonds – Cash – UK Gilts – Global Government Bonds – Global Aggregate Bonds (including credit)	70 per cent	65-80 per cent	3 month LIBOR FTSE Gilt All Stocks JP Morgan Government Bond Barclays Global Aggregate Bond
Public Equity	10 per cent	5-20 per cent	FTSE All-World Index
Alternatives (including property)	20 per cent	10-25 per cent	Will vary according to the asset class

The asset allocations above will apply net of (ie ignoring) the mark to market value of the portfolio of interest rate and inflation derivatives.

6.2.4

For the purpose of judging performance, particularly where an asset class is liquid and readily traded, the corresponding performance index will be used. Where no market index or generally accepted benchmark is available, the Investment Committee will define an appropriate performance benchmark.

6.2.5

Any tactical or hedging position taken must be expressed using Permitted Asset Classes, and within strictly defined limits set by the Investment Committee.

6 Day-to-day investment management of the assets *continued*

6.2.6

The Fund will be rebalanced regularly taking into account the need to minimise both transaction costs and risks associated with deviation from this target asset allocation. Tolerance ranges for deviation from the strategic asset allocation (set out in the table on page 13) have been set by the Board to allow flexibility.

6.2.7

Mandates for each fund manager will be agreed prior to their appointment. Strategies relating to the control of transaction costs and soft commission will be specified in these mandates.

6.3 Fund manager fees

6.3.1

The Board will pay such fees and expenses as are negotiated with fund managers from the Fund in accordance with the Pension Protection Fund (Payment to Meet Investment Costs) Regulations 2005².

.....
²

*Statutory Instrument
2005 No. 1610*

6.3.2

The fund managers are currently remunerated by an *ad valorem* fee based on the level of assets under management and, in some cases, a performance-related fee based on out-performance.

6.3.3

The costs of management and transactions will be reviewed from time to time, and if appropriate, renegotiated.

7 Day-to-day custody of the assets

7.1.1

The Board has appointed a custodian with regard to the safekeeping of the assets in the Fund and other investment administrative requirements.

7.1.2

The Fund may participate in securities lending within limits set by the Board.

7.2 Performance

7.2.1

The Investment Committee will consider from time to time, and at least annually, the performance of the custodian according to specifically agreed key performance indicators.

7.3 Custody fees

7.3.1

The Board will pay such fees and expenses as are negotiated with the custodian from the Fund in accordance with the Pension Protection Fund (Payment to Meet Investment Costs) Regulations 2005.

7.3.2

The costs of management and transactions will be reviewed annually and if necessary renegotiated.

8 Transition of assets to the Fund

8.1

The Board recognises that the asset allocation of eligible pension schemes may not reflect the Board's strategic asset allocation but would expect to manage the transition of those assets periodically to be consistent with the investment objectives in 3.1 above. The Board will use a combination of transition managers or appointed passive managers to ensure that the costs and risks of transition are minimised.

8.2

The Board will consider the timing, liquidity and cost of transition of assets of transferring schemes that do not match the asset strategy of the Board. The Board will merge these assets into the Fund at the time it deems most appropriate and may hold up to 2.5 per cent of total assets of the Fund in asset classes which do not form part of the Permitted Asset Classes. The Board may also retain without limit annuity contracts held by transferring schemes to meet specific liabilities.

9 Responsible Investment and corporate governance

9.1

The Board's primary concern, in setting its investment strategy, is to act in the best financial interests of the Fund and its beneficiaries, seeking the best return that is consistent with a prudent and appropriate level of risk.

9.2

The Board believes that in order to fulfill this commitment and to protect and enhance the value of the Fund's investments over the long-term, it must act as a responsible and vigilant asset owner and market participant.

9.3

The Board further believes that environmental, social and governance (ESG) factors can have an impact on the long-term performance of its investments, and that the management of ESG risks and exploitation of ESG opportunities can add value to its portfolio.

9.4

The Board is a signatory of the UN Principles of Responsible Investment (UN PRI), a set of best practice principles on Responsible Investment (RI). The Board intends to use these Principles as a benchmark with which to guide its own approach to RI, and in doing so will seek to apply RI principles across all the assets in which it invests.

9.5

The Board defines ESG factors as the interaction of its investments with:

- the physical environment (environmental)
 - communities, workforces, wider society and economies (social), and
 - the governance structures of the organisations and markets we invest in, as well as of our agents (governance, including corporate governance).
-

9 Responsible Investment and corporate governance **continued**

9.6

The Board will integrate the consideration of ESG issues across all asset classes and markets in which it invests. In particular the Board, or its agents on its behalf, will exercise its ownership rights, including voting rights, in order to safeguard sustainable returns in the long-term.

9.7

The Board expects its fund managers, where appropriate, to have integrated ESG factors as part of their investment analysis and decision-making process. Appropriate weight will be given to ESG factors in the appointment of fund managers. The Board will hold fund managers to account in this regard as part of its regular monitoring process.

9.8

In line with its commitment to transparency, the Board will report to its stakeholders on its responsible investment activities.

10 Compliance with this Statement

10.1

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The Investment Committee will monitor compliance with this Statement annually. In particular it will obtain written confirmation from the fund managers that they have complied with this Statement as supplied to them and the Investment Committee undertakes to advise the fund managers promptly and in writing of any material change to this Statement.

10.2

.....

The National Audit Office will audit and monitor compliance as part of its annual review of the Fund's accounts and statement of internal control.

Annexes



Annex 1

Permitted Asset Classes

The assets of the Fund will be invested in a portfolio taken from the following list of Permitted Asset Classes which are as follows (all global unless specified):

- Cash and Bonds
 - Cash (including currencies)
 - UK Gilts (fixed and inflation linked)
 - Sterling denominated interest rate and inflation swaps
 - Sterling bond repurchase agreements
 - Sovereign Bonds
 - Other Bonds of at least investment grade credit quality
- Public Equities
 - Equities listed on recognized stock markets
- Alternative Assets
 - Property
 - Private Equity
 - Infrastructure
 - Funds aiming to achieve an absolute return

Tactical and hedging positions may be taken using derivatives of the Permitted Asset Classes above.

Annex 2

Governance structure

The Board is responsible for

- Setting structures and processes for carrying out its role
 - Setting the funding framework, including objectives and an acceptable investment risk appetite within that framework
 - Reviewing the content of this Statement in conjunction with the investment adviser, the Fund's actuary and legal adviser and modifying it if deemed appropriate
 - Providing oversight of the Investment Committee
 - Consulting with relevant bodies when reviewing investment policy issues
-

The Investment Committee is responsible for

- Developing the Fund investment principles and strategic approach to investment
 - Approving revisions to the Statement or recommending changes, where these are material, to the Board
 - Developing and maintaining the Fund's responsible investment principles
 - Determining the overall approach to risk management of investments and asset liability matching, including setting the asset allocation strategy, and the flexibility around which any risk budget may be expressed
 - Determining the principles for dealing with the investments of schemes in assessment and subsequent transfer to the Fund
 - Providing oversight of the Asset and Liability Committee
 - Deciding on the appointment, retirement and contractual review of the fund managers (as defined in Section 113(5) of the Act) including the assessment of appropriate knowledge and experience under Section 113(6) of the Act
 - Approving the mandates and performance criteria for fund managers and general oversight of performance
 - Approving the processes for the appointment, retirement and contractual review of any investment advisers
 - Approving the processes for the appointment, retirement and contractual review of the custodian to the Fund
-

Governance structure continued

The Asset and Liability Committee is responsible for

- Monitoring the implementation of the investment strategy and the Statement
 - Reviewing on a monthly basis the investment managers investment performance, compliance with investment mandates and short-term strategies
 - Monitoring the flows of cash and schemes transferred to the Fund making sure the asset allocation does not deviate significantly from the strategic asset allocation
 - Monitoring financial risks including, all investment risks relative to the liabilities, insurance risks and, where necessary, initiate remedial measures
 - Collaborating with the Chief Actuary in the annual valuation of the Fund, including choice of actuarial assumptions
 - Sponsoring the development of specific risk mitigation measures such as liability hedges
 - Recommending to the Investment Committee changes to asset allocation, fund mandates and fund managers
-

The investment advisers are responsible for

- Advising on all aspects of the investment of the Fund assets including implementation of strategy
 - Providing updates on the fund managers and their likelihood of achieving the performance objectives
 - Advising on this Statement
 - Providing training in investment matters to the Board
-

Annex 2 continued

Governance structure continued

The fund managers are responsible for

- Discretionary management of the portfolio, including implementation (within guidelines given by the Investment Committee) of changes in the asset mix and selecting securities within each asset class
 - Providing the Asset and Liability Committee with quarterly statements of the assets together with a quarterly report on actions and future intentions, and any changes to the processes applied to their portfolio
 - Informing the Asset and Liability Committee of any changes in the internal objectives and guidelines of any pooled funds used by the Fund as soon as practicable
 - The safekeeping of the assets within the pooled funds in which the Fund invests
 - Investing income paid to the Fund in a timely manner
 - Reconciling the manager's record of assets held with those of the custodian
-

The custodian is responsible for

- The safekeeping of all the directly held assets of the Fund
 - Undertaking all appropriate administration relating to the held assets of the Fund
 - Processing all income with respect to the Fund in a timely manner
 - Processing all tax reclaims in a timely manner
 - Investing cash in a suitable low risk manner consistent with the provision set out in the investment management agreements as agreed by the Board
 - Reconciling records of assets held with those of the managers
-

The transition managers are responsible for

- Moving assets between fund managers and/or asset types in a cost efficient way while minimising risks
 - Managing the asset transition process when pension schemes in assessment fall into the Fund
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Telephone:

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