



Draft Bulletin - Statement of Investment Policies and Principles

This is a draft Bulletin prepared by the Financial Services Commission (“FSC”) on which comments are invited prior to its issue.

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Draft Bulletin - Statement of Investment Policies and Principles (SIPP)

Overview:

The Statement of Investment Policies and Principles (“SIPP”) is required by the regulations promoting sound governance because it serves as a roadmap and the basis for determining the guidelines for managing the investments of pension assets. The SIPP identifies and articulates the various principles to be used by those responsible for making choices concerning management structure, policies and the selection and monitoring of Investment Managers for approved superannuation funds (“funds”) and approved retirement schemes (“schemes”). A pension investment policy is essentially then a governing document in which the Board of Trustees sets broad policy parameters.

The SIPP should therefore provide the Trustees and any other fiduciary serving on any Investment Committee with the basic philosophy for investing the assets of the fund or scheme. Detailed guidance about implementation of the investment programme may be contained in the SIPP or other documents such as procedure manuals or agreements with third parties.

It is important that the SIPP be drafted with great care and be reviewed by an Attorney. Trustees, who are ultimately responsible for its preparation, must act prudently and issue investment policies that govern how they will carryout their investment programme in order to strengthen the financial position of the pension fund or scheme and the promise to deliver retirement benefits to the members.

This guide will review what may be considered the basics of an investment policy and should provide some assistance to Trustees in understanding the development, implementation and management of the investment policy. Pension funds vary considerably in size and complexity. While not all of the considerations raised in this guide will be relevant to all pension funds, the framework described will nonetheless be of significant value to trustees in the proper performance of their fiduciary responsibilities.

Statement of Investment Policy and Principles:

The investment policy statement quite often is a reference point for discussions relating to the investment of the assets of an approved fund or scheme. In conducting an examination the Financial Services Commission (“FSC”) will often use the SIPP as its starting point and so may request to see this document. The SIPP should be valuable to a number of persons such as:

Investment Committee - Committees are often made up of individuals who are either Board members that have expressed an interest or skill in investing, internal officers who are asked to serve because they have some experience or contact with pension plans, or retired employees who would like to retain some contact with the company. The SIPP allows the Chair of the Investment Committee to retain consistency as committee members' change and it supports the ability to point to the SIPP as the standard that must be followed.

Investment Manager - The SIPP should provide the Investment Manager(s) with the strategy for the investment of pension monies. That is, the Investment Manager(s) should be able to determine the investment horizon (timeline), the reason for the investment in certain assets, the benchmark (i.e., the goal to be met or surpassed), and the amount of "risk" the trustees are willing to accept in the portfolio.

FSC Examiners - The SIPP can serve as an excellent example of compliance to an examiner appointed by the FSC. An examination by the FSC often consists of requests for routine documents so as to determine if there are any violations present (e.g., to determine if decisions are being made in the best interests of the plan members). If the SIPP is clearly written and is being followed, the plan may have the presumption of compliance as the examiners continue forward. Presenting the SIPP to an examiner is a sound strategy as it shows organization, thoughtfulness, and process.

Auditors and Actuary - A clearly written SIPP which is being followed gives a fund or scheme a presumption of compliance also as auditors and actuaries conduct their reviews.

Benefits of the SIPP

The SIPP offers a number of benefits to funds and schemes:

- (i) investment policies are a clear demonstration of fiduciaries' due diligence;
- (ii) it is a communication tool for conveying investment goals and priorities;
- (iii) it strengthens the internal controls of the pension fund.

A pension investment policy must be viewed as a long term governing document and as such should be designed with long term issues in mind and should not require frequent changes. Notwithstanding this however, Trustees must keep in mind the fact that this document will keep changing as plan demographics are altered by changes in the sponsor's workforce, market conditions and other factors over time.

Content of the SIPP

Development of the investment policy must be made within the framework of legal restrictions and fiduciary standards. In aiding understanding of the investment policies it may be useful for a pension plan to have one policy for assets and another for liabilities. A pension plan may also be segmented on the basis of active lives and retired lives. In the case of retirement schemes which

use a Master Trust Deed for the investment of the pension assets for several individual plans, a split between the different liability structures may also be considered.

The exact contents of the investment policy document will vary from plan to plan. The SIPP however should provide the rationale for the investment process put in place. The most important message to convey through the contents of the SIPP¹ is that the Trustees or the Investment Committee, if any, clearly understands:

- (i) The purpose of the plan;
- (ii) The type of plan and how benefits accrue and are paid;
- (iii) The demographics of the participants of the plan;
- (iv) The funding status and solvency requirements;
- (v) The actuarial assumptions being utilized, where applicable;
- (vi) The cash flow needs of the plan (i.e., when the liabilities must be paid);
- (vii) The strategy needed to ensure assets are available to meet the cash flow needs (appropriate match of the assets and the liabilities);
- (viii) The appropriate risk and return relationship for the portfolio;
- (ix) Exposure to interest, liquidity, credit and other financial risks;
- (x) The business trend of the plan sponsor, including the ability to make contributions, the employment trend line, and the competition for employees;
- (xi) The asset classes to be utilized, including ranges;
- (xii) Whether investment professionals will be utilized, and in what capacity;
- (xiii) The appropriate benchmarks for performance;
- (xiv) The process for reevaluating the investment policy.
- (xv) Expenses
- (xvi) The lending of cash or securities; and
- (xvii) Retention or delegation of voting rights acquired through investments

There are a number of benefits that will flow from addressing these issues in the SIPP. Surely, the most important will be that the trustees have a disciplined approach to the management of the investment process; thereby maximizing yields and minimizing risks on behalf of the pension plan. Other benefits² include:

- (i) A paper trail that evidences proper processes.
- (ii) Consistency among successor Investment Committee members.
- (iii) Protection for the Board of Trustees, which ultimately has responsibility for all investment decisions and actions including those of any committees.
- (iv) A process by which investment professionals' performance may be closely monitored.

Bearing the above in mind it is recommended that the Statement of Investment Policies and Principles should contain at least the sections discussed below.

Identification

The name of the fund or scheme and the associated sponsor(s) should be identified in an introductory statement.

Purpose and background:

Generally, the purpose of the SIPP is to assist the Trustees, and if any, the Investment Committee, in supervising, monitoring, and evaluating the investment of the pension assets. This would usually include:

- (i) The Board or Committee's attitudes, expectations, objectives, and guidelines for investing;
- (ii) An outline of the asset classes, including management styles, asset allocations, and ranges for investments to produce the appropriate diversification of investments within the proper risk tolerance levels;
- (iii) Guidelines for each investment portfolio to control the risk and liquidity;
- (iv) A discussion of the process of communication between and among the Committee (if any), the Board of Trustees, any investment consultants, Investment Managers, actuaries, attorneys, and accountants;
- (v) The establishment of a process to monitor, evaluate, and compare performance results, which should include criteria and benchmarks;
- (vi) A statement that all of the applicable laws, including the Trustee Act and the Securities Act are being followed.

A detailed description of background information should, at least, include the following information:

- a) The type of plan (e.g., Defined Benefit or Defined Contribution);
- b) When the plan was established;
- c) What employees are covered;
- d) How many employees are covered;
- e) Anticipated employment trend (e.g., increase, decrease, remain stable);
- f) Current size of the assets;
- g) Expected growth rate of the assets;
- h) Contribution data as projected by the actuary, where applicable;
- i) Legal name of the plan;
- j) Plan sponsor;
- k) Plan FSC Identification Number;
- l) Board of Trustees or Committee Members;
- m) Custodian and nominee;
- n) Investment Managers and Administrators;
- o) Investment Consultant;
- p) Legal Counsel; and
- q) Accountant, Auditor, and Actuary as is applicable

Statement of Objectives:

The objectives of a pension plan should always begin with a simple statement regarding the maintenance of the plan for the benefit of the participants and their beneficiaries. The objectives should also include statements regarding:

- (i) Funding status (e.g., fully funded) including a determination of status vis-à-vis accrued benefit obligation and projected benefit obligation;
- (ii) Asset and liability management (e.g., strict matching, ability to pay all liabilities when they come due);
- (iii) Contributions (e.g., to maximize contributions in the short term); and
- (iv) Earnings (e.g., to meet or exceed actuarial assumptions).

Investment Guidelines:

The investment guideline should include a number of important factors relating to investment decisions. One of the most important factors for Investment Committees to understand is that the investments in ongoing pension plans are made for the long term³. To that end, it is appropriate to state that the investment horizon is over an extended period, such as at least twenty years, for example.

This is especially useful at a time when markets are experiencing large peaks and valleys. Maintaining a long-term investment horizon will remind the Committee Members that investments are made for the long term; ranges are given within each asset class (see "Securities Guidelines," below) in order to allow the decision makers to adjust to changes in the economy and markets.

Trustees should keep in mind that a long-term investment horizon does not necessarily speak to current cash considerations. A fund or scheme may be considered to be funded for all employees for the next 35 years, but that does not speak to how much cash is needed to pay benefits and expenses each month. Accordingly, short-term liquidity requirements should also be addressed, including whether such requirements will be met by quarterly contributions, by selling existing securities, or by investing in short-term instruments.

The guidelines should also include a discussion of **risk**. Although risk may be defined in different ways, risk is generally considered to be the probability of loss in relative or absolute terms. The Trustees or the Investment Committee if any, must based on the objectives of the fund or scheme, determine whether the fund or scheme can tolerate the level of risk in each of its investments. It is important to keep in mind that in a properly diversified portfolio, investments should be correlated in such a fashion that the **overall** risk to the portfolio is acceptable.

The risk tolerance section of the investment guideline also should address what factors were considered when determining the acceptability of a certain risk level. At a minimum, the following factors should be addressed:

- a) Business factors, including the sponsor's industry, financial condition, employment turnover, and general fiscal health;
- b) Demographic characteristics of the workforce, thereby providing an indication of how long the investment time horizon will be over the long term;
- c) The ability of the sponsor's Board of Directors to tolerate losses during the investment horizon;
- d) The actuarial assumptions, including the data related to expenses and liquidity. It is important to review these assumptions with one eye on the past in order to determine how conservative and accurate the actuary has been previously.

Performance expectations should also be addressed in this section⁴. These expectations may be measured in a variety of ways such as a certain percentage added to the Consumer Price Index, a flat target rate of return, a certain percentage added to the actuarial assumption of return, or the amount calculated as return in the risk/return analysis. While the above are examples of actual performance expectations being utilized in the marketplace, they should not be considered the only alternatives.

Investment expectations are set for the investment horizon. It is not prudent to judge investment returns over a one-or two-year period. What constitutes a reasonable period of time depends upon the circumstances, but again, if the process for selection has been prudent, the probability of fiduciary liability is low, and the probability of a successful investment result should be increased.

Asset allocation guidelines should speak to the asset classes, including the ranges within which the asset classes may vary, that will comprise the portfolio. These classes will be chosen after reviewing the risks and returns to create an efficient frontier. The portfolio will contain securities from domestic large and small capitalization equities, international equities, domestic fixed income, real estate, and cash equivalents. Within these categories there may also be other subcategories.

The range for each asset class will allow the Investment Committee to adjust to market conditions, yet not provide the freedom to attempt to "time" the market; that is, to buy and sell based on short-term market trends. By limiting the range the Committee is forced to continually look at the long-range investment horizon.

Procedures detailing the person responsible, timing, and method for rebalancing the portfolio should also be outlined in this section⁵.

Securities Guidelines:

It should also be prudent to set forth guidelines for securities. For some Investment Committees, there may be an aversion to certain higher-risk investments such as non-rated bonds or equities in emerging markets. Other restrictions may include unregistered securities, futures, margin transactions, securities lending, or certain speculative investments.

Other guidelines may relate specifically to the underlying investments, for example:

- (i) **Equities:** the maximum percentage of the market value of any one holding, the maximum percentage of the market value in any one economic sector, limitations of any Investment Manager to not invest in equities and stay in cash due to market conditions (and for a certain period of time). With international equities, there may be limitations relating to companies, industry category, country, or directions regarding foreign exchange contracts.
- (ii) **Domestic fixed income:** credit rating, the maximum percentage of the market value based on credit, the exposure to any one issuer, or any concerns about liquidation.
- (iii) **Cash or cash equivalents:** ratings and investment vehicles, including the process for investing small amounts of cash.

Selection of Investment Managers:

The SIPP should outline the process for the selection of Investment Manager(s). This should include addressing such issues as:

- a) Minimum qualifications;
- b) Minimum amount of funds under management;
- c) Ability to follow the investment strategy;
- d) The absence of legal judgments that reflect negatively on the critical components of the firm;
- e) The ability to provide reports on a timely basis;
- f) The ability to provide a stated minimum number of references from current and former clients.

In addition, a standard Request For Proposal (RFP) should be utilized by the Committee in order to document the process. Assistance in creating an RFP can be obtained from an investment consultant as well as from Investment Managers who will also have access to a file of RFPs they have received.

Duties and Responsibilities of the Parties:

This critical section must address each area of the investment process.

Investment Managers

This section may include a reference to the underlying contracts, which should include custody of information, the necessity for reports and due diligence, a description of the company, the process for proxy voting, the level of care, the designation of Investment Managers as accepting delegated duties under the fund or scheme, how trades will be done, and compliance with the laws. This is, of course, only a partial list, but the emphasis again should be on the process

necessary to ensure that the Investment Manager(s) comply with the guidelines of the Committee.

Benchmarks

This section should set forth what benchmarks will be utilized for each of the asset classes. The benchmarks offered by a investment consultant or Investment Manager(s) should not simply be taken as gospel and plugged in. Rather, the Committee should question the benchmarks and ask what other measures are available. After all, these benchmarks will be used to gauge the performance of the Investment Manager(s). In all likelihood, the benchmarks provided will be sufficient. Trustees should keep in mind, for example, the number of different domestic fixed income benchmarks available. The greatest differential will be the duration of the benchmarks. Be sure to roughly match the duration of the fund or scheme portfolio with the duration of the benchmarks.

Adherence to Investment Policy Guidelines

Although the Investment Manager(s) may be outperforming the benchmark and its peers, the Committee should verify that the manager(s) is/are adhering to the investment policy guidelines. For instance, the SIPP may state that one issuer may not account for more than 5% of the entire portfolio. If the fixed income manager has purchased a bond issued by Xerox that was 3% of the entire fund, and the domestic equity manager purchased Xerox stock with 2.5% of the entire fund, the investment policy is not being followed.

Adherence to Investment Discipline

Even where an Investment Manager has been hired to provide a certain investment discipline, that manager must be monitored, at least on a quarterly basis, to ensure he or she adheres to the policies and guidelines.

Description of Liabilities:

This should include the expected short and long term growth of the segments of the fund or scheme. Cash flow characteristics should be described in terms of their predictability and the size of contributions, benefit payments and expenses. Factors impacting cash flow such as member options, pricing horizon and interest costs should also be described.

Regulatory Requirement:

The Pensions (Superannuation Funds and Retirement Schemes) (Investment) Regulations 2005 provides that a SIPP should include but not be limited to the following elements:

- The rate of return objectives, stated gross and net of investment expenses;
- The risks and risk tolerances of the fund or scheme;
- Outlook of continuity and maturity profile of assets and liabilities;
- Liquidity needs and constraining circumstances; and
- Target asset mix consistent with risk return expectations

Additionally, Trustees, when preparing, reviewing or revising a SIPP, are required to consider the following:

- the type, benefits and features of the fund or scheme;
- the management of interest, liquidity, credit, currency and other risks;
- characteristics of the liabilities and demographic circumstances of the fund or scheme;
- funding and solvency levels and requirement;
- prevailing economic conditions and circumstances;
- expenses and the lending of cash or securities;
- portfolio diversification by asset classes and within asset classes;
- the sponsor's financial condition and circumstances;
- the retention or delegation of voting rights acquired through investments; and
- the use of related party transactions with regulatory limits.

A copy of the SIPP must be submitted to the FSC within six months of the date of registration of the fund or scheme and subsequent to any revision within 30 days of those changes being ratified by the Trustees. The SIPP must be available for inspection and copying upon request by members and beneficiaries of the fund or scheme and to the actuary and/or auditor of the fund or scheme. The SIPP is to be reviewed at least annually and within 90 days of any material change in the fund or scheme.

Trustees must be cost conscious giving due consideration to the effects of expenses on investment returns. Monies of a fund or scheme must be kept in accounts separate from those of the Trustees and should not be left idle, except in rare and unavoidable circumstances where it is required to meet payments and then not for a period exceeding one month.

All investments of a fund or scheme must be in the sole name of the Trustees or their nominee. For investments held by a nominee, the title of such investment must indicate that the nominee is holding the asset for the Trustee for and on behalf of the fund or scheme.

Investment transactions must be made at arms length and at rates comparable to those available in the market for similar investment transactions.

Conclusion:

The best investment strategy will not achieve its goal unless it is effectively implemented. Determining the right investment vehicles and optimal mix of investment styles; choosing the best managers, transferring the assets between managers and ensuring safe custody all impact performance and are key aspects of effective management. Investment income is another key component impacting the financial health of a fund or scheme. In selecting investments, Trustees must evaluate them having regard to the rate of return and the risk of loss.

The concomitant regulations of the Pensions (Superannuation Funds and Retirement Schemes) Act, 2004 have numerous provisions relating to investments by pension funds and schemes. The regulations are applicable to all approved superannuation funds and approved retirement

schemes as well as licensed Investment Managers. The pension investment regulations cover a number of areas including:

- specification of eligible investments and investment limits;
- specification of prohibited investments;
- requirements for specific investments;
- permitted borrowing.

It is important that Trustees and their agents are aware of and understand the provisions of the Act and Regulations as failure to invest pension funds accordingly constitutes an offence. Professional advice must be sought by Trustees prior to making decisions on matters for which they do not have the requisite knowledge or expertise. Adequate records are to be maintained in Jamaica of all investment, lending, borrowing and related party transactions.

Questions regarding this Guidance Note may be directed to:

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¹ Synder, M. B., “Qualified Plan Investments”

² Ibid

³ Ibid

⁴ Ibid

⁵ Investment Policy Statement – Merrill Lynch