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1. Introduction

1.1 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 Funds 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 initial levy contributions paid into the Fund and does not address the investment of assets transferred into the Fund from eligible pension schemes. Future investment principles of the Fund concerning the investment of assets arising from eligible pension schemes are addressed in Annex 3.

1.5 This Statement will be published and made available upon request.

2. Governance of the Pension Protection Fund

2.1 Investment powers and compliance with the Pensions Act 2004

2.1.1 Section 113 of the Pension 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,

[1] Statutory Instrument 2005 No 675

information, and resources to carry out its role effectively. The Chair of the Board and at least one third of the Board are familiar with investment issues. The Board has access to in-house investment expertise equivalent to at least one full-time member of staff who is familiar with investment issues. Attached at Annex 2 is a breakdown of the governance structure and the associated responsibilities.

2.1.3 The Board has 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. The Board will monitor and review the performance of the Fund's investment adviser at least annually.

2.2 Investment Committee

2.2.1 The Board has established an Investment Committee to manage, consider and make recommendations on investment issues and the Investment Committee is accountable to the Board.

2.2.2 The initial investment strategy for the Fund is the responsibility of the Board, acting on the recommendation of the Investment Committee and is driven by the Board's investment objective as set out in Section 3. After the initial investment strategy is established, the strategic management of the Fund's assets is the delegated responsibility of the Investment Committee acting on advice from the appointed investment adviser, with only material changes in investment strategy requiring Board approval. The Investment Committee has delegated authority from the Board to implement and generally ensure adherence to the strategic investment policy. The Investment Committee also has responsibility for the allocation of the Fund's assets held between the various available fund managers' funds and accounts.

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 described in Annex 1, and appointed in accordance with Section 113(4) of the Act. The Board is satisfied that the appointed fund managers have sufficient expertise and experience to carry out their role.

2.3.2 The initial appointment of professional fund managers is the responsibility of the Board. From 31st December 2006 the appointment and termination of professional fund managers will be the responsibility of the Investment Committee.

3. Strategic management of the Fund's assets

3.1 Objective

3.1.1 The Board's investment 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.

3.1.2 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 whilst setting a fair and proportionate levy.

3.1.3 Specifically, the Board will target the Fund towards reaching an appropriate ongoing funding level, to be achieved by adopting suitable investment strategies, setting a levy on eligible schemes and the prudent management of the Fund's assets.

4. Risk measurement and management

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

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

- The risk of a significant difference in the sensitivity of asset and liability values to changes in financial and demographic factors ("mismatching risk"). The Board will monitor key risk characteristics and set appropriate tolerances.
- The failure by the fund managers to achieve the rate of investment return assumed by the Board ("manager risk") These issues have 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.
- The failure to spread investment risk ("risk of lack of diversification"). The failure of any of the investments (if they constituted a significant proportion of the assets) would jeopardise the Board's ability to meet the objectivesThe Board has set diversification guidelines for the fund managers.
- The possibility of failure by a number of companies or organisations (who sponsor pension schemes) in particular sectors or industries, those failures being interlinked ("systemic risk"). 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.

All of these risks have the potential to cause a deterioration in the funding level of the Fund (defined as the balance between assets and liabilities), therefore potentially creating "funding risk".

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 Initial asset allocation

5.2.1 Prior to any eligible pension schemes entering the Fund, the initial assets of the Fund will be represented by cash received in respect of initial levy contributions.

5.2.2 The Board has considered the kind of available investments and determined that initial levy contributions will be invested in government bonds, non-government bonds, index-linked bonds and cash or derivative instruments relating to these, although the underlying specific investments may change to reflect the obligations facing the Fund.

5.3 Strategic asset allocation

5.3.1 The strategic asset allocation is set by taking into account the nature and timing of both actual and potential future liabilities. The nature and timing of these liabilities are sensitive to interest rates, inflation, mortality and other financial and demographic factors. The strategic asset allocation includes financial asset classes (gilts and index linked gilts) that have similar characteristics to the liabilities.

5.3.2 The liabilities of the Board will change periodically as a result of the Board accepting the legal obligation to pay compensation to eligible pension schemes. The strategic asset allocation will change accordingly to take into account these changes. The strategic asset allocation in the first year will be notionally liability driven and will include fixed coupon and inflation linked bonds and cash. The Board will use derivatives with similar pay-off profiles to improve the matching of potential liabilities.

5.3.3 This asset allocation strategy is believed to be appropriate to meet the investment objectives set out in 3.1 above, whilst mitigating the investment risks set out in 4 above.

5.3.4 The strategy will be reviewed annually and after each actuarial valuation. An earlier review may be conducted in the inter-valuation period in the event of any significant change in capital markets, the liabilities of the Fund, or governing legislation.

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 provides 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.

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[2] Statutory Instrument 2005 No 1610

5.4.2 In order to fully meet the Fund's compensation payments it may be necessary for the Board to rebalance the proportions of money invested and held for compensation payments. The weighting in any asset class may be changed to ensure that future transferred liabilities will be well matched by the assets.

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

5.4.4 This policy will be reviewed annually and after each actuarial valuation. In addition if there is a significant change in the liabilities or circumstances of the Fund, then an earlier review will be conducted.

6. Day to day investment management of the assets

6.1 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 selected fund managers are Insight Investment and PIMCO. Goldman Sachs Asset Management has also been selected with a deferred appointment.

6.2 Investment performance benchmark

6.2.1 The investment performance benchmark reflects the strategic asset allocation and is based on a composite index as follows:

Asset class	Weight	Benchmark
UK Gilts	2/3	FTSE Fixed Interest Gilts Over 10 Years Index
UK Index Linked Gilts	1/3	FTSE Index Linked Gilts Over 15 Years Index

The benchmark and investment restrictions are outlined in the investment management agreements between the Board and the fund managers. The benchmark is intended to reflect the long term nature of the Board's liabilities and is designed to be correlated with the Fund's potential future liabilities. The benchmark will evolve into a liability driven benchmark once these liabilities have been determined (see Annex 3).

6.2.2 The fund managers have been set a specific benchmark and performance objective by the Board. As a way of monitoring risk in portfolios, the Board has agreed tracking error ranges with the fund managers for their portfolios. The portfolios' tracking errors are expected to fall within these ranges and, if not, the fund manager is mandated to explain to the Board why this is so and if any action is required. The Board has also set underperformance floors for the managers' mandates, breaching of which triggers a review of the mandate by the Board. Performance of the fund managers is monitored in detail by the Investment Committee on a quarterly basis and the managers meet the Board to report on their performance at least once annually.

6.2.3 Given the benchmark in 6.2.1 and the performance targets agreed with the fund managers, the Board's expected return on investments is broadly equivalent to 1.25% per annum above the return on the benchmark.

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 2005[2] – the current fee arrangements are set out in Annex 1.

6.3.2 The Board will annually review and if necessary renegotiate the costs of management and transactions.

7. Day to day custody of the assets

7.1 The Board has appointed State Street Bank as custodian with regard to the safekeeping of the assets in the Fund. The Board will assess and consider the actions by the custodian ("custody risk") at outset and on an ongoing basis. Custody risk involves any 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.

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 – the current fee arrangements are set out in Annex 1.

7.3.2 The Board will annually review and if necessary renegotiate the costs of management and transactions.

8. Socially responsible investment and corporate governance

8.1 Socially responsible investment

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

8.1.2 The Board believes that companies and governments with positive social, environmental, ethical and political principles can reasonably be expected to offer strong long term financial performance and stability. It therefore regards a preference for investment in securities issued by such organisations as consistent with the best financial interests of the Fund and its beneficiaries.

8.1.3 In its regular review of fund managers' performance, the Board will monitor the way that managers take account of social, ethical, environmental and political considerations in their investment decisions.

8.2 Corporate governance

8.2.1 The Board's policy on corporate governance is to exercise any rights (including voting rights) attaching to investments in accordance with the guidelines set down in the Institutional Shareholders' Committee statement of principles on the responsibilities of institutional shareholders and agents.

8.2.2 The Board has advised the Fund's fund managers that they should normally be expected to exercise any rights attaching to investments (including voting rights) on behalf of the Board.

8.2.3 The fund managers have full discretion to act outside these guidelines but would be expected to report to the Board with an explanation of their actions.

9. Compliance with this statement

9.1 The Investment Committee will monitor compliance with this Statement by the Board 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.

9.2 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.

Annex 1

Investment guidelines and benchmarks

Benchmark	2/3 FTSE Fixed Interest Gilts Over 10 Years Index 1/3 FTSE Index-Linked Gilts Over 15 Years
Style of management	Active management: Target outperformance of 1.25% and degree of risk with maximum active risk of 1.5% at the overall portfolio level.

Allowable investments and limitations	Allow the following types of investments	• Investment grade bonds (Goverment bonds, Government inflation linked bonds, non-government bonds) • Cash • Bond, interest rate and currency futures, forwards and swaps • Options on interest rates, interest rate futures • Credit derivatives
	Do not allow the following types of investments	• Currency risk • Bonds rated below BBB-/Baa3 (sub investment grade bonds) • Convertible bonds
	Limit exposure to the following investments	• Cap asset allocation to bonds rated A/BBB (maximum 25% and 15% respectively) • Cap individual issuer allocation: - AAA/Aaa supranational max 5% - AAA/Aaa corporate max 2.5% - AA/Aa max 2.0% - A/A max 1.5% - BBB/Baa max 1%

The balance of investments is limited to the ranges outlined in the table below.

Sector	Minimum %	Maximum %
UK government bonds	**50%**	**100%**
Non UK government bonds	**0%**	**50%**
Non sterling bonds (hedged into Sterling)	0%	30%
Sub-sovereigns	0%	30%
Covered bonds (including pfandbriefe)	0%	20%
Mortgage backed securities	0%	20%
Asset backed securities (excluding mortgages)	0%	10%
Agency bonds	0%	20%
Corporate bonds	0%	20%
Financial corporate bonds	*0%*	*15%*
Non financial corporate bonds	*0%*	*15%*
Utilities	**0%**	**3%**
Telecommunications	**0%**	**3%**
All other non financial corporate bonds	**0%**	**15%**

In addition, limits are set on the portfolio exposure to individual issuers and portfolio exposure to sectors and individual bonds in terms of the percentage or amount of a particular issue that can be held.

These and other investment restrictions are detailed in full in the Fund Management Agreements in place between the Board and the managers.

The fund managers are paid an ad valorem fee based on assets under management. The custodian's fee basis includes a mixture of ad valorem fees, fixed costs and transaction-based costs.

Annex 2

Governance structure

The Board is responsible for	• Setting structures and processes for carrying out its role • Setting investment structures and their implementation • Initial appointment of fund managers • Establishing an initial investment strategy • Reviewing the content of this Statement of Investment Policy in conjunction with the investment adviser, the Fund's actuary and legal adviser and modifying it if deemed appropriate • Reviewing the investment policy following the results of each actuarial review and/or asset liability modelling exercise • Consulting with relevant bodies when reviewing investment policy issues.
The Investment Committee is responsible for	• Implementing and ensuring adherence to the strategic investment policy • Assessing the quality of the performance and processes of the fund managers by means of regular, but not less than annual, reviews of the investment results and other information by way of meetings with the fund managers and written reports • Appointing (and dismissing) the fund managers (after 31st December 2006) • Monitoring compliance of the investment arrangements with this Statement on an ongoing basis
The investment advise is responsible for	• Advising on all aspects of the investment of the Fund assets including implementation of strategy

	• Providing updates as to its view on the fund managers and their likelihood of achieving the performance objectives • Advising on this Statement • Providing training in investment matters to the Board
The fund managers are responsible for	• Discretionary management of the portfolio, including implementation (within guidelines given by the Board) of changes in the asset mix and selecting securities within each asset class. • Providing the Board 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 Board 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

Investment adviser

Mercer Investment Consulting has been selected as investment adviser to the Board. The Board is satisfied that Mercer Investment Consulting has the knowledge and experience required under the Pension Protection Fund (Statement of Investment Principles) Regulations 2005 and that it has arrangements in place to secure that any individuals who provide advice to the Board have sufficient knowledge and experience to provide that advice. The individuals who will provide advice are Nick Sykes or, in his absence Mark Walker. Mercer Investment Consulting operates under an agreement to provide a service designed to ensure that the Board is fully briefed both to take the decisions it is equipped to do so after training and advice, and to monitor those decisions that it delegates. Mercer Investment Consulting is paid on a fixed fee basis for work which can be anticipated and a time cost basis for projects or additional work.

Annex 3

Future investment principles of the Fund

The investment approach adopted by the Board will become liability led based on the actual liabilities that are transferred into the Fund from eligible pension schemes. The Statement of Investment Principles will be reviewed and updated at that time and will be expected to include the following elements:

Investment objective

The following investment objective will be added:

- Ensure security of benefits by achieving and maintaining adequate solvency.

This objective will take into account the Board's objective to set a levy that is balanced between eligible pension scheme based and risk-based factors, reflecting the degree of risk to the Fund.

Investment strategy

The key principles of the investment strategy will remain as before i.e. the investment strategy will be driven by the nature of the Fund's liabilities (specifically the duration, cash flow profile and inflation-linking). The Board acknowledges that the liabilities of the Fund will change as scheme assets and liabilities are transferred into the Fund following an assessment period. The investment benchmark of the Fund will change annually or more frequently to reflect the materiality of the changes to the Fund's liabilities.

It is expected that most of the Fund's assets will remain invested in fixed interest and index-linked government and non-government bonds, however other assets (such as property, alternative investments and equities etc) will also be considered. The Investment Committee will continue to monitor the overall risk of the investment strategy against a liability led benchmark but may also measure the return of individual asset classes against market benchmarks.

Transition of assets

The Board recognises that the asset allocation of eligible 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 section 3.1. The Board acknowledges that specialist transition managers may be required in order to move from a scheme's specific asset allocation to the Board's strategic asset allocation. The Board recognises the potential impact of these cash flows on the Fund, and the need to ensure cash flows are suitably managed with regards to the objectives, risks and investment strategy of the Fund.

Dated: 23rd June 2005