

***The Employees' Provident Fund***

***Central Bank of Sri Lanka***

***Investment Policy Statement***

***&***

***Standards of Professional Conduct***

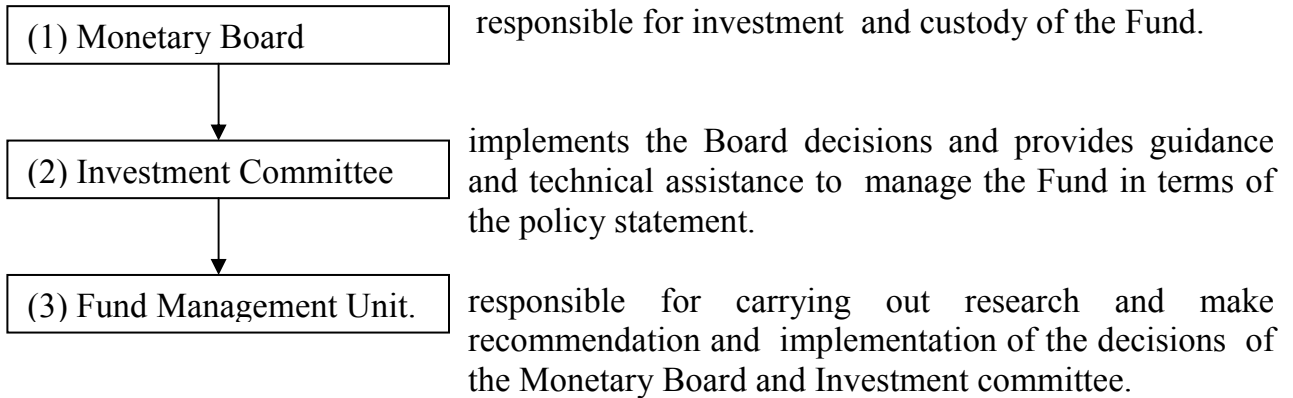
**Revised on December, 2002**

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## 1. Management of Fund and Decision Making Process and Assignment of Responsibilities and Duties



### 1.1. The Monetary Board

The objective of the Monetary Board, in relation to EPF, is to safeguard the interest of the members. This will be achieved through the adoption and implementation of a prudent investment policy. The Monetary Board comprises of Governor-Central Bank of Sri Lanka, Secretary to the Ministry of Finance and three Members appointed by the President of Sri Lanka

Powers and duties of the Monetary Board, in relation to the Fund has been laid down in section 5 of the Employees' Provident Fund Act No. 15 of 1958.

The Monetary Board is responsible for Custody (Section 5 (1) (c)) and Investments (Section 5 (1) (e)) of the funds. The Monetary Board will also be responsible to establishing the basic investment policy, allocation of funds among different asset classes to control the risk through portfolio diversification and by taking into account the mission and investment objectives of the Fund, in conjunction with the investment time horizon, cash flows and other trends in the economy and will establish reasonable guidelines for each asset class and investment account, specifying acceptable and /or prohibited investments, limits on asset class exposures, and risk tolerance.

The Monetary Board shall, on a monthly basis, review and approve an Investment Plan for the Fund. The Plan shall be prepared by the Fund Management Unit and recommended by the Investment Committee. The Plan shall summarise the following months cash flows and possible investment activities.

### 1.2. Investment Committee

The objective of the Investment Committee is to guide the Fund to make prudent investment decisions within the guidelines stipulated in the policy statement. The Investment Committee established by the Monetary Board shall consist of the Deputy Governor and

Assistant Governor of the Central Bank who are in charge of EPF, the Superintendent and Additional Superintendent of the EPF, and Head of the Fund Management Unit. An officer from the Fund Management Unit shall serve as Secretary to the Investment Committee.

The Investment Committee monitors the investment activities of the Fund to ensure that such activities are in compliance and consistent with the policy statement, the investment plan and Investment Committee guidelines. Investments made by EPF should be approved by the Monetary Board/ Investments Committee from time to time.

### **1.3. Fund Management Unit (FMU)**

The objective of the FMU is to manage the Fund's portfolio to optimise the total rate of return in line with the terms and condition conditions of the investment policy statement. Further, Fund Management Unit is responsible for the implementation of the decisions of the Monetary Board and Investment Committee. In addition to the above, FMU is also responsible to provide research assistance and recommendations with regard to investment and asset allocation strategies, accounting and legal matters, macro economic factors, and capital market expectations.

## **2. Investment Policy Statement**

### **2.1. Investment Objectives of the Fund**

The main investment objective of the Fund is to earn a 4% real rate of return over the annual average inflation measured in terms of GDP deflator. Since the EPF is a defined contribution plan with several statutory and regulatory requirements, the Fund's portfolio risk should be below average while ensuring to pay refund benefits in full and on time.

Although occasional years of negative real returns if incurred in the framework of achieving long-term objectives are tolerable, nevertheless the Fund should avoid multiple consecutive years of negative real returns for the investment Portfolio.

Investments that have collateral benefits to the Sri Lankan economy, government or private corporations or individuals are permissible only insofar as they satisfy the objective criteria and the risk return trade off are be designed to achieve the primary goals of the Fund.

### **2.2. Investment Time Horizon of EPF Portfolio.**

Maturity profile of the investments should match with cash outflows of the fund such as, refund payments, income tax and other expenses. Presently, monthly cash inflows are higher than the cash out flows of the fund and according to the forecast, it will not change with in the next five years. Therefore the Fund has a long term time horizon with the ability to take

average risk. Further, EPF has an Infiniti life with a very low probability closure or significant reduction in members.

The existence of a significant number of dormant accounts provides the Fund with an additional level of protection from the potential of negative returns. However, the Fund has not been systematically evaluated from an actuarial perspective and thus, the exact amount and timing of its future liabilities is not definitively known. Given the rate of increase in annual refund payments an assessment of the Fund's future liability is necessary to ensure actuarial soundness.

### **2.3. Constraints in Relation to EPF Investments**

When managing the Fund, Investment Committee, Fund Management Unit and the investment staff should adhere to the following administrative and regulatory constraints, industrial practises and other regulatory requirements laid down in EPF Act/policy statement and guidelines imposed by the Monetary Board and Investment Committee from time to time.

### **2.4. Liquidity Needs**

The Fund needs liquidity to meet refund payments, payments under the housing loan guarantees, tax payment and to meet day to day expenses in full and on time. As the cash inflows from the contributions are higher than the refunds, the need for liquidity is very minimal. Maximum of Rs. 5bn investment in Treasury bill is always maintained in its portfolio to meet the liquidity need. Repo investments and other short-term investments also provides some safeguard with regard to the liquidity needs.

### **2.5. Tax Consideration**

The Fund is subject to an income tax of 10%, on its gross investment income in terms of the Inland Revenue Act. Tax has to be paid quarterly on basis of expected gross income of the Fund and final settlement has made during the first quarter of the following year.

Since the Inland Revenue Department treats the Fund as an individual, EPF can claim the ACT paid by the companies, which declared the dividends.

## **2.6. Regulatory / Administrative Requirement**

### **2.6.1. Regulatory Requirements**

2.6.1.1. The Fund should declare a minimum annual credit of 2.5% to its members as per Section 14(1) of EPF Act.

2.6.1.2. The following categories of investments are not permissible without the Monetary Board's specific prior written approval.

- Foreign security investments
- Options, Futures or Warrants
- Commodities, including foreign exchange, metals, fuels, agricultural goods and livestock
- Real estate equity,
- Unregistered or restricted securities
- Margin transactions or any other borrowing of money
- Short Selling
- Repurchase Agreements against securities that are not permitted to be held

2.6.1.3. The Monetary Board may have the power to establish the reserves out of the income of the Fund, to meet any contingencies or any depreciation in the market value of the assets of the Fund.

### **2.6.2. Administrative Requirements**

2.6.2.1. Guidelines for investments in the Corporate Debentures.

- An authorised Rating Agent should rate the corporate debenture issue, and interest rate should be commensurate with the risk. The Fund may not have power to invest in the Corporate Debentures, which have been rated below "BBB-" unless approved by the Monetary Board.
- In the event of default of interest or capital payment, the issuer should adhere to 'Default Payment Charges' specified by EPF.
- Issuer should be a public limited company and preference given to those who listed the issue in the Colombo Stock Market. The Monetary Board should approve the maturity, yield /price and the amount to be invested
- No investment securities can be sold at capital losses. If such a requirement arises, the Investment Committee should approve it prior to the execution,.

#### 2.6.2.2. Investment in Equities.

- Unless agreed by the Investment Committee, investment in any company should not exceed 5% of its issued share capital. Reasons for this decision are; (a) not sufficient liquidity and (b) avoid undue control of the company by the Fund.
- The Fund must make sure that investment in any company is made only with an intention to increase the return of the Fund and not to take control over the company. As discretion of the Investment Committee, the Fund can vote, at annual general meetings of the invested companies.
- The Fund cannot invest in stocks of the banking and financial sector since the Monetary Board regulates both EPF and banks and financial institutions. But investment in unlisted equity securities of banks and financial institutions shall be permissible only insofar (a) new investment institution with a long-term motive of the investment. (b) the investment account is passively managed and the relevant index contains such securities.
- Investment in common and preferred stocks shall be limited to publicly traded securities, with an emphasis on “Blue Chip” securities.
- The Fund Management Unit must carry a thorough study out of the company and related macro factors, which relate to the future performance of the company, prior to recommend to the Investment Committee.

### **3. Asset Allocation and Related Strategies**

Asset allocation is the most important part of the policy statement and it should prepared by annually with compliance to the policy statement.

#### **3.1. Asset Allocation**

The primary objective of EPF asset allocation policy is to provide a strategic mix of asset classes which produce the highest expected investment return while managing the risk within an acceptable range to the Fund.

## **4. Asset Class Guidelines**

### **4.1. Domestic Equity Investments**

#### 4.1.1. Managing the Equity Portfolio

The Fund will maintain domestic equity investments as a portion of the Fund portfolio with a maximum value equal to 2% of the total value of the portfolio. The actual weighting can fluctuate at the discretion of the Fund Management Unit subject to review and recommendation of the Investment Committee and the Monetary Board.

Equity investments can be managed in accordance with passive or active strategy, as required. Due to low liquid situation of the local share market it is not advisable to follow the passive strategy to manage the equity portfolio.

#### 4.1.2. Investment Instruments and Objective of Equity Portfolio.

The basic objective of the equity investment is to earn a return over the market cycle with a view of capital growth in long term. To achieve this objective, Investment Committee/ Fund Management Unit should adhere to the administrative requirements laid down in section 7.3.6 in this report. Furthermore, equity portfolio should manage by the Fund Management Unit, with the guidelines imposed by the Monetary Board/Investment committee, and according to the investment policy statement. Equity investment covers common stock, preferred stock and convertible securities.

#### 4.1.3. Execution of Trading and Local Stock Brokers

No preference shall be given to any domestic share brokerage firm, which service executes share market trading, the Deutsche Bank shall provide the custodian service to the Fund according to the agreement entered by both parties.

### **4.2. Fixed Income Investments**

#### 4.1.4. Managing of Fixed Income Portfolio

The Fund should maintain a fixed income portfolio with a minimum market value at 90% of the total value of the Fund portfolio. The actual weight can fluctuate at the discretion of the Fund Management Unit subject to the review and recommendation of the Investment committee and the Monetary Board. No more than 10% value of the Fund can be invested in the risky corporate debenture market.

Corporate debenture come under the fixed income securities, when investing in then, the Fund should adhere to the guidelines stipulated in section 7.3.5 of this report.

#### 4.1.5. Investment Instruments and Objective of Fixed Income Portfolio

The basic objective of this portfolio is to earn positive cash flow to the Fund. Fixed income security covers all securities issued by (a) the government of Sri Lanka except T-bill, Repo (b) Local corporate i.e Debenture, Bond, and other long term instruments.

### 4.3. Cash Equivalents

#### 4.1.6. Managing of Cash Equivalents

Cash and cash equivalents should not exceed 10% of total portfolio value at any time and if such circumstances occur, it has to be approved by the Investment Committee. The Fund can hold Rs 5 bn worth of Treasury bill, at any time, to settle contingency payments.

#### 4.1.7. Investment Instruments and Objective of the Portfolio

Short-term investments are intended to be conservatively invested and meet any impending disbursement of the Fund and to accumulate funds for future investment. Cash equivalents covers short-term investment instruments less than one year, Treasury Bill, Commercial Paper, Trust Certificate and Repo investments.

## 5. Standards and Measures of Investment Performance

Investment performance will be measured monthly and evaluated quarterly. Investment performance will be compared with the “General Indexes” which can be applied to evaluate the asset classes. The following investments are evaluated as follows;

- Equity Market

Most liquid, large capitalised stocks may be compared with MILANKA INDEX movements and rest of the investments may be compared with ALL SHARE PRICE INDEX movements while considering the dividend received for the period. For this evaluation, use Annex-07.

- Fixed Income Securities

Fixed income securities should be evaluated with the same investment instruments traded in the market during the period under review. For example; Primary market weighted average Treasury bill rate<sup>1</sup> compared with EPF procured yield rate, for the period.

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<sup>1</sup> Primary market weighted average return, which published by the Public Debt Department of the Central Bank time to time.

## **6. Periodic Review of the Policy Statement**

The Monetary Board shall review the policy statement annually and when required. Change will be made to the extent that such changes are in the interest of the Fund's members or required as a matter of law or prudence. However, such changes are expected to be evolutionary and designed for the long term. Short-term events in the capital markets shall not consider in this policy statement.

## **7. Code of Ethics & Standard of Professional Conduct**

The Investment Committee members, Fund Management Unit staff and all the Investment Division staff have adopted the CFA Institute Code of Ethics and Standard of Professional Conduct (attached)

## **8. Additional Guidelines/Suggestions**

Annually, Investment Committee members, Fund Management Unit staff and Investment related staff must complete a statement of economic interest to disclose all potential investment and business interest for himself /herself and immediate family to the Monetary Board through Investment Committee.

In the prevailing market situation, the Fund does not have a problem in invest total value of the fund within Sri Lanka. But if the Sri Lankan Government reduces borrowings form the local market, it would cause severe problems to the Fund. This situation further will be exaggerated due to underdeveloped corporate debt market and local share market. If the peace process success, certainly the government borrowings will come down significantly and it will affect the interest rate and amount of fixed income investments of the Fund. To overcome this problem the Fund should diversify its portfolio with a long-term view. At the same time, EPF Act should be amended to invest in, off shore markets, Banking Sector stocks in local share market etc. Further, the Fund should train EPF staff to handle international investments while obtaining the services from the external resource persons.