



International Oil Pollution  
Compensation Funds

<b>Agenda Item 5</b>	IOPC/NOV21/5/4	
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<b>Original</b>	English	
<b>1992 Fund Assembly</b>	92A26	●
<b>1992 Fund Executive Committee</b>	92EC77	
<b>Supplementary Fund Assembly</b>	SA18	●

## REPORT OF THE JOINT INVESTMENT ADVISORY BODY

### Note by the joint Investment Advisory Body

<b>Summary:</b>	The joint Investment Advisory Body reports on its activities since the December 2020 sessions of the governing bodies of the 1992 Fund and the Supplementary Fund.
<b>Action to be taken:</b>	<u>1992 Fund Assembly and Supplementary Fund Assembly</u>  Information to be noted.

### 1 Introduction

- 1.1 Pursuant to the mandate of the joint Investment Advisory Body (IAB) of the 1992 Fund and the Supplementary Fund, this Body shall submit, through the Director, to each regular session of the governing bodies, a report on its activities since the previous regular session. The report is set out at the Annex to this document.
- 1.2 In view of the fact that the governing bodies decided in March 2005 that there should be a joint IAB for the 1992 Fund and the Supplementary Fund, it has been considered appropriate for this Body to present a single report to the governing bodies for the two organisations.

### 2 Action to be taken

#### 1992 Fund Assembly and Supplementary Fund Assembly

The 1992 Fund Assembly and Supplementary Fund Assembly are invited to take note of the information provided in the joint IAB's report contained in the Annex.

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## ANNEX

### REPORT OF THE JOINT INVESTMENT ADVISORY BODY OF THE 1992 FUND AND THE SUPPLEMENTARY FUND FOR THE PERIOD NOVEMBER 2020 TO OCTOBER 2021

#### **1      Introduction**

- 1.1      This report has been issued in the name of the joint Investment Advisory Body (IAB) of the 1992 Fund and the Supplementary Fund. The data included in this report reflects the position as at 31 July 2021, and any material updates will be included in the IAB's verbal presentation.
- 1.2      The mandate of the IAB as laid down by the governing bodies of the two Funds is:
- (a)      to advise the Director in general terms on investment matters;
  - (b)      in particular, to advise the Director on the tenor of the Funds' investments and the suitability of institutions used for investment purposes;
  - (c)      to draw the Director's attention to any developments which may justify a revision of the Funds' investment policy as laid down by the governing bodies;
  - (d)      to advise the Director on the management of currency exposure relating to incidents; and
  - (e)      to advise the Director on any other matters relevant to the Funds' investments.
- 1.3      At its December 2020 session, the 1992 Fund Assembly appointed the following persons as members of the IAB for a term of three years:
- Mr Alan Moore, a financial and investment consultant, formerly head of Global Markets, State Street Bank (Europe) and co-founder and advisor to Molten Markets Inc.; and
  - Ms Beate Grosskurth, an experienced international banker, having held senior positions with State Street Bank of Boston, Brown Brothers Harriman and CME Group.
- 1.4      In addition, Mr Brian Turner, a treasury consultant, and formerly Group Director Treasury, Henderson Global Investors Ltd; was reappointed for a period of two years.

#### **2      Meetings**

- 2.1      At the time of preparing this report the IAB had held four meetings with the Secretariat during the period covered by this report: namely on 17 November 2020, 3 March, 30 June and 30 September 2021. The four meetings were held remotely. The Director, the Deputy Director/Head of the Finance and Administration Department and the Finance Manager were present at these meetings.
- 2.2      The members of the IAB hold virtual meetings among themselves regularly and also prior to the quarterly meetings with the Secretariat. There has also been frequent contact between members of the IAB and the Secretariat on various treasury management issues.
- 2.3      The members of the IAB met remotely with the External Auditor on 2 March 2021 to provide an update on the IAB's activities with a particular focus on credit risk management. Members of the IAB also attended an Audit Body meeting held remotely on 9 July 2021 to provide the newly elected members with details of the IAB's mandate and an overview of its activities.

### **3 Main issues considered**

The main issues are detailed under the following headings:

- Economic summary;
- Credit markets;
- Hedging the currency risk arising from incidents;
- Other important issues;
- Objectives for the coming year.

### **4 Economic summary (covering the period up to August 2021)**

- 4.1 The end of 2020 made sombre economic reading with the global gross domestic product (GDP) falling by 4.2% in 2020, a worse contraction than had occurred during the 2008/9 financial crisis. The downturn stemmed from the COVID-19 outbreak, the first global pandemic in a century, and the national lockdowns that followed in 2020 and beyond.
- 4.2 The year 2021 has given reasons to be more confident about the state of the global economy, with growth expected to hit 5.8% according to the latest projections of the Organisation for Economic Co-operation and Development (OECD). This is markedly higher than the 4.2% increase that was originally predicted by the OECD in December 2020, representing the fastest rate of global economic growth since 1973.
- 4.3 The sharp upwards revision has been attributed to the rollout of vaccines in advanced economies, in addition to historic fiscal stimulus bills that have been passed in the United States of America (USA).
- 4.4 However, the recovery has proven uneven so far, with differences in the strength of the recovery being driven by varying levels of government support for businesses and gaps between vaccination programs in different countries. There is still great uncertainty over how the global economy will perform throughout the remainder of 2021; if OECD projections for the following year prove correct, global income will still be USD 3 trillion less by the end of 2022 than it would otherwise have been if the global pandemic had never occurred.

#### *United Kingdom*

- 4.5 With the vaccination program well underway, the economy of the United Kingdom (UK) has started to show signs of recovery. The first quarter performance of 2021 saw GDP shrink by 1.5%, a much smaller contraction than the 4.25% figure that the Bank of England had predicted in February 2021.
- 4.6 The momentum was sustained in the months that followed. March and April saw the biggest increase in jobs in almost six years. The UK grew by 2.3% in April, the fastest monthly growth since July 2020, thanks to the continued easing of lockdown measures. In its May report, the Bank of England revised up its expectations for the second quarter of 2021, with the UK's GDP rate of growth to hit 5.5% up from the 4.25% rate estimated earlier. The OECD also predicted that the UK GDP annual rate of growth would be 7.2% in 2021, up from its previous forecast of 5.3%.

#### *United States of America*

- 4.7 The United States of America (US) has seen its highest rate of growth (6.8%) in more than 35 years, due in large part to the impact of the federal stimulus payment program, with the latest cheque rollout at

the time of writing expecting to boost spending in the latter half of 2021, the other contributing factor being the mass vaccination rollout.

- 4.8 Over 50% of Americans were fully vaccinated as of August 2021. The vaccination roll-out programme is widely credited as having restored a degree of normality into the labour market and driven some of the positive economic news in the first half of 2021.
- 4.9 The OECD projects that the US economy will grow by 6.9% in 2021 from its March forecast of 6.5%, regaining its losses from the COVID-19 outbreak earlier than expected.
- 4.10 For some economic analysts, it indicates a sound resilience in the US economy and confirms that the US dollar should keep its status as the world's reserve currency and a safe haven for global investors.

#### *European Union*

- 4.11 Whilst the first quarter of 2021 showed a contraction in GDP across the Eurozone, the outlook for the remainder of the year provides grounds for cautious optimism.
- 4.12 The World Bank revised its rate of growth upwards to 4.2% in its Global Economic Prospects report of June 2021. Whilst the projected rates of growth for 2021 are lower in the Eurozone due to slower vaccine rollout, there are signs of the Eurozone catching up with its industrialized peers.
- 4.13 Much of the growth has been fuelled by the European Union's Coronavirus recovery fund which received sign off in June 2021.
- 4.14 Europe's industrial performance appears to be showing the same signs of recovery as in the USA, with much of the positive news fuelled by Germany. However, it seems likely that the economic recovery in the individual countries of the European Union (EU) will move at different speeds.

#### *China*

- 4.15 The Chinese economy has performed well so far in 2021. China is looking at an annual growth forecast of 8.5%, with much of its growth powered by the resurgence of Chinese exports. Compared to the first quarter of 2020, exports increased by 38.7% in the first quarter of 2021.
- 4.16 Whilst the overall picture is positive for China, the global recovery has led to a rise in costs of raw materials due to unprecedented demand, causing pain for a number of Chinese companies which in turn has slowed their rates of production. Producer price inflation has risen to its highest level in 13 years, impacting costs on a global level in the form of higher raw material and production prices worldwide.

#### *Oil*

- 4.17 The Organization of the Petroleum Exporting Countries (OPEC) left its 2021 global oil demand forecast unchanged (July 2021) at six million barrels per day for the third consecutive month. There is a more positive demand outlook, which is expected to support production until the end of 2021.

#### *Monetary Policy and Inflationary Pressures*

- 4.18 With major stimulus bills being passed across the world, disruptions in production and rising raw material costs, governments and central banks are growing increasingly concerned by the recent increases in inflation.
- 4.19 The Eurozone saw an increase in inflation in May 2021, rising to 2.0% year-on-year from 1.6% the previous month and again increasing up to 2.2% in July 2021, which was above the target set by the European Central Bank and attributed mainly to a rebound in energy prices, which are now 13% higher.

- 4.20 Meanwhile the USA has also seen its highest inflation rate since August 2008, with the consumer price index rising by an alarming 5.4% year-on-year in June 2021, much higher than the 4.9% rate forecast, and up from 5% reported in May 2021. The sharp rise in consumer prices was attributed to increasing demand, supply chain bottlenecks and the after-effects of lockdown.
- 4.21 However, despite these unsettling increases in consumer and productions costs, so far, and at the time of writing, central banks are holding firm with no interest rate hikes on the horizon.

*Third quarter and beyond*

- 4.22 The global outlook remains uncertain, but positive trends have emerged from a variety of different markets that give reason for optimism. Whilst the beginning of the year saw a decline in GDP across the board, there are signs of recovery in the UK, the US and the Far East - with a similar recovery widely anticipated throughout the Eurozone.

**5 Credit markets**

- 5.1 In the aftermath of the US elections and protracted Brexit negotiations, credit markets were surprisingly sanguine, especially as the effects of the global pandemic continued to weigh on both the global economy and social interaction.
- 5.2 Risk appetite remained robust, with banks in general reporting better-than-expected earnings - which supported their equity valuations, and in turn, softened credit default swap (CDS) spreads across the board. The prevailing risk-on sentiment was also enhanced by the regular announcements of breakthroughs in COVID-19 vaccine development.
- 5.3 Increasing bad debt provisions were having a detrimental effect on the capital adequacy levels of some of the major banks at the start of the first quarter of 2021, which was reflected in the credit rating agency – Fitch’s downgrade of Cooperatieve Rabobank’s short-term credit rating from F1+ to F1. This resulted in the bank dropping from the Group One (maximum twelve months tenor) list of the Funds’ banking counterparties into Group Two (maximum six months tenor).
- 5.4 Towards the middle of the first quarter volatility picked up in the asset markets as concerns over rising inflation created a vicious spike in bond yields and caused a sharp drop in the equity prices of growth and technology stocks. Confidence in equities slowly returned as market commentators soothed investor fears by saying that the pick-up in inflation was temporary, and that the major global economies were in a reflationary, rather than an inflationary cycle. This was a repeating theme, supported by the central banks, who shied away from talk of near-term increases in interest rates, agreeing that the current inflationary cycle was likely to be transitory.
- 5.5 Qatar National Bank was added to the Group Two list of banking counterparties, with short-term credit ratings of F1 (Fitch)/P1 (S&P)/A1 (Moody’s) and a 2020 fourth quarter CET1 capital adequacy ratio of 12.8%.
- 5.6 Credit markets remained stable throughout the second quarter of 2021, with CDS spreads, on an average basis, relatively unchanged across the board. Bank earnings continued to show signs of recovery, along with the global economy, which was a story reflected in the credit assessments, and multiple ratings adjustments of the three main credit ratings agencies.
- 5.7 Only one of the Funds’ banks was adversely affected by the rating adjustments, with the S&P short-term rating for Landesbank Hessen-Thüringen Girozentrale being lowered to A-2 from A-1 with a stable outlook, citing persistent profitability challenges and the slow adoption of digital banking technology. Despite the downgrade, however, the bank maintained its current Group One position.

- 5.8 Towards the end of the reporting period, credit markets continued to trade sideways but with equity valuations looking increasingly stretched and volatility picking up. Despite the *status quo* nature of central-bank policy, the inflation story still continued to unnerve investors, with the spectre of higher interest rates hanging over the debt markets ominously.

## **6 Hedging the currency risk arising from incidents**

- 6.1 Hedging activity to minimise the risk of adverse currency movements has been minimal in the past twelve months, but the exchange rates of currencies to which the Funds have an exposure are monitored on a daily basis.
- 6.2 The Director updates the IAB with regard to all incidents on a quarterly basis, although some may not have a financial impact on the Funds.

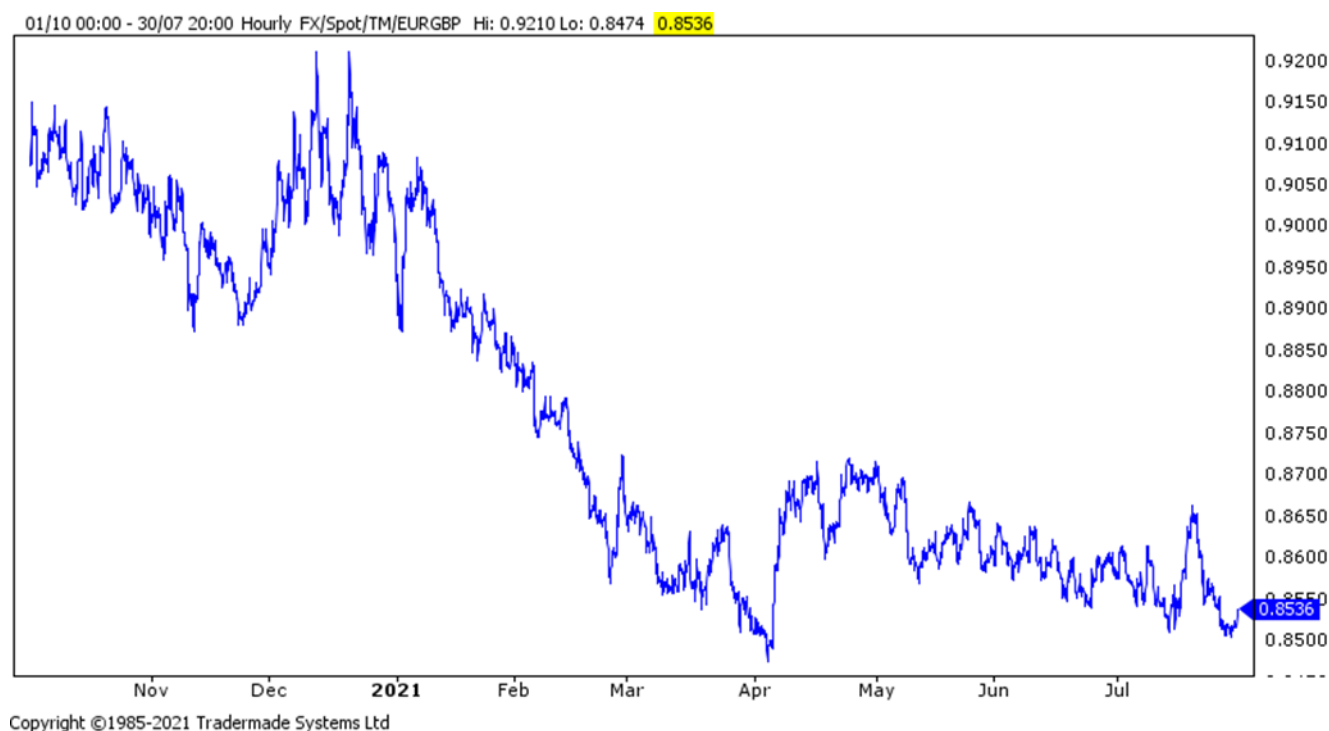
### *Agia Zoni II incident*

- 6.3 This is the only incident at present for which compensation is payable and requires currency management.
- 6.4 The compensation payable for this incident is estimated to be EUR 54.6 million, but this amount is not permanently fixed. A total of approximately EUR 15 million has been paid and a balance of approximately EUR 20 million is currently held, which represents 49% of the amount required. It has been decided not to increase this hedging ratio until there is further clarity on the amount of compensation payable.
- 6.5 The 1992 Fund has a Dual Currency Investment (DCI) of £5.5 million which matures on 21 December 2021. The counterparty currency is the euro, and the principal amount of this investment will be repaid in euros if the exchange rate between these currencies is higher than GBP : EUR 1.11 when the investment expires. If the proceeds are received in euros some of these funds will be added to the euros required for the *Agia Zoni II*, thereby increasing the amount held to meet the euro liability.

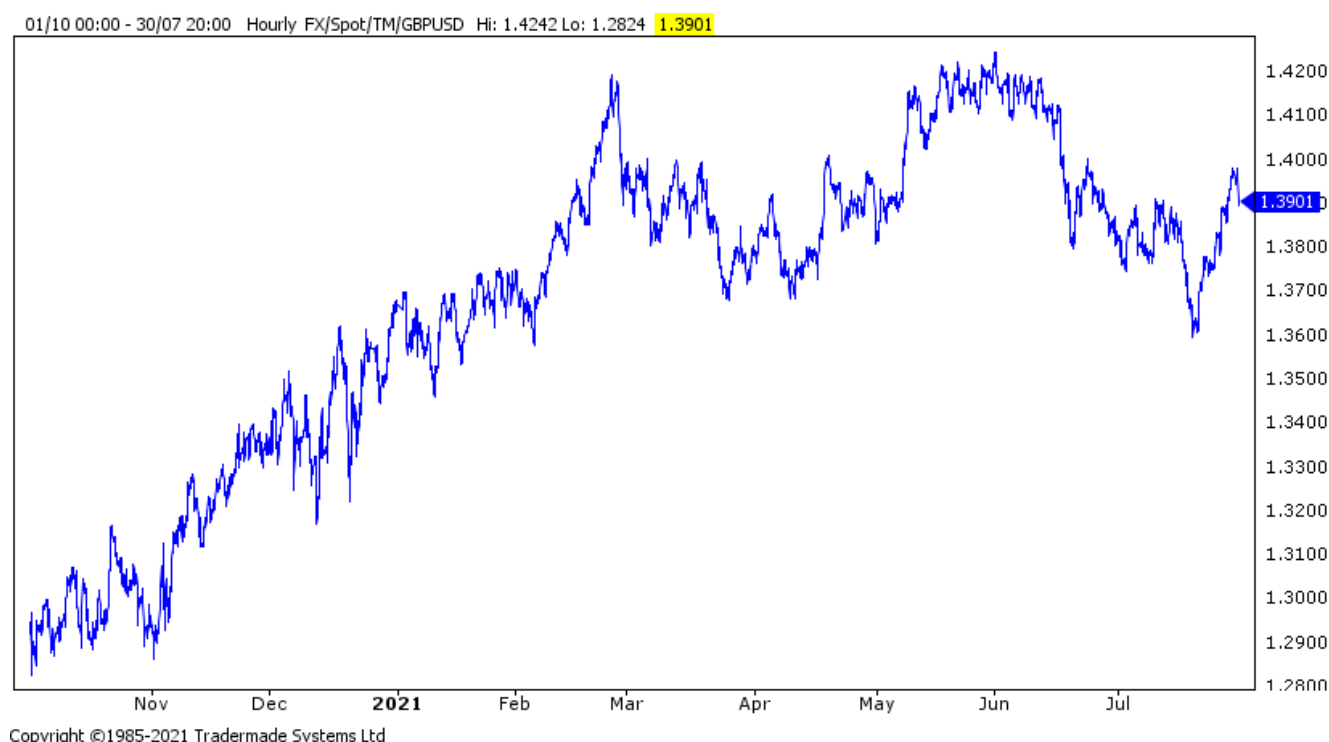
### Currency charts

- 6.6 Charts for the EUR/GBP and GBP/USD currency pairs covering the period 1 October 2020 to 31 July 2021 have been included to illustrate the movements that have taken place.

## EUR/GBP



## GBP/USD



- 6.7 The pound sterling strengthened against the euro and the US dollar during the first six months of this period and has held on to these gains since then.
- 6.8 The EUR/GBP exchange rate was trading at 0.9150 on 1 October 2020 and rallied briefly to the 0.9210 level before falling away to record a low of 0.8474 in early April 2021. The euro managed to recover to 0.8650 before weakening again to its current level of 0.8536.

- 6.9 The GBP/USD exchange rate was trading at 1.2824 on 1 October and rallied to 1.42 in February 2021. This currency pair then traded within a six-cent range before closing on 30th July at 1.3901.
- 6.10 The economic summary in section 3 provides a more detailed explanation of events.

## **7 Other Important Issues**

### Internal procedures for investment and cash management controls

- 7.1 Under the 1992 Fund and the Supplementary Fund's respective Financial Regulation 10.4(c), the maximum investment in any bank or building society of each Fund's assets individually shall not normally exceed 25% of these assets or £10 million, whichever is the higher. Financial Regulation 10.4(d) sets the maximum investment in any bank or building society by the two Funds together at £15 million, or, when the two Funds' combined assets exceed £300 million, at £25 million. Following the IAB's recommendation at the October 2009 sessions of the governing bodies, the maximum investment with the Funds' house banks was increased from £15 million to £20 million. The respective Financial Regulation 10.4(d) of the two Funds was amended accordingly. As the Funds' combined assets on the date of this report are some £56.2 million, the normal limit for investing in any one financial institution of £15 million remains applicable, except for house banks, whose normal limit is £20 million. The IAB continually monitors these limits and would recommend any adjustments to the Director.
- 7.2 The IAB has reviewed the Internal Investment Guidelines and the Hedging Guidelines at each of its meetings since its report to the December 2020 sessions of the governing bodies. These guidelines were last reviewed at its meeting on 30 September 2021. Copies of both sets of Guidelines are found in Attachment I and Attachment II to this report.

### Monitoring of the IOPC Fund's financial risks

- 7.3 In last year's report the IAB stated that it had reviewed the IOPC Funds' financial risks, and this process has continued during the current year. The impact of the UK's withdrawal from the EU (Brexit) and the current pandemic are considered to be an ongoing concern and the IAB continues to monitor the impact on the UK economy and the pound sterling.

### Review of the Investment of the Staff Provident Fund

- 7.4 The Staff Provident Fund is made up of two schemes, Provident Fund 1 (PF1) which is invested with the assets of the 1992 Fund, and Provident Fund 2 (PF2) which is managed by an independent financial adviser in the name of the 1992 Fund. Participation in PF2 is entirely voluntary with fees borne by participants in proportion to their share of investment.
- 7.5 The IAB has reviewed the investments in the portfolio of the PF2 on a quarterly basis and commented on their suitability for a fund of this nature.

### Class Action against major foreign exchange banks in the United Kingdom

- 7.6 On 16 May 2019 the European Commission adopted two decisions determining that several major banks had participated in foreign exchange spot trading cartels between December 2007 and January 2013. A class action was put in place for corporate bodies to claim potential losses as a result of these cartels, and the Audit Body questioned whether the Funds had been disadvantaged in any way.
- 7.7 The IAB examined the foreign exchange trades executed on behalf of the Funds during this time and concluded that it was not appropriate for the Funds to be a party to this class action due to the negligible impact on the Funds' assets.



### Negative Interest Rates

- 7.8 The IAB prepared a paper for the Director outlining the history of global negative interest rates and their justification today. The Director asked the IAB to prepare a recommendation on how the impact of negative interest rates on the Funds' euro holdings could be best managed, and this was discussed at the meeting held on 30 September 2021. It was concluded that the Secretariat would continue examining the matter.

### **8 Objectives for the coming year**

The IAB intends to continue to focus on its responsibilities set out in section 1.2 during the coming year.



Beate Grosskurth



Alan Moore



Brian Turner

30 September 2021

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## ATTACHMENT I

### Internal Investment Guidelines

As reviewed on 30 September 2021

The IOPC Funds may only invest with banks and building societies and the following guidelines should apply:

1. In order to be eligible for investments, a bank or building society should satisfy the following:
  - (a) Common Equity Tier 1 (CET1) capital ratio of at least 9.5% or higher;
  - (b) A five-year credit default swap (CDS) spread of a maximum of 100 basis points. A breach of which would trigger a review to ascertain whether the credit markets were weaker in general, or whether the credit worthiness of the counterparty concerned was subject to a particular credit-negative event, that would warrant its temporary, or permanent exclusion from the lending list;
  - (c) Minimum short-term credit rating from two of the three main credit rating agencies, Fitch, Moody's and Standard & Poor's as follows:
    - For maturities of up to 12 months (Group 1) of F1+, P1 and A1+; and
    - For maturities of up to six months (Group 2) of F1, P1 and A1.
2. A banking institution should be either a parent bank, a full branch of its parent bank or a wholly owned subsidiary meeting the above criteria.
3. The normal limits for investments in any financial institution laid down in Financial Regulations 10.4(c) and 10.4(d)<sup><1></sup> should apply to deposits with any given institution or banking group.
4. The house banks should be the Funds' main operational banks, i.e. with which current accounts are held for the day-to day banking needs and banks used for specific incidents (which meet the Funds' investment criteria) to hold currency other than pounds sterling should be categorised as temporary house banks in order to utilise the higher limit.
5. Subject to the normal limits referred to in paragraph 3 above, deposits with banks and building societies should not exceed 25% of the respective Fund's total deposits.
6. For liquidity purposes a minimum amount equivalent to the respective Fund's working capital should be maturing within three months.
7. Investments should not exceed one year.
8. An initial deposit plus a maximum of three rollovers are permitted providing the initial deposit period and rollover periods cumulatively do not exceed 12 months. The deposits should be repaid after the third rollover. Rollovers through brokers should be treated the same as rollovers with direct contacts.
9. In consultation with the joint Investment Advisory Body, the Director will maintain a list of approved institutions.

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<sup><1></sup> Financial Regulations 10.4 (c) and 10.4 (d) read:

10.4 (c) the maximum investment in any bank or building society of the [1992 Fund's] [Supplementary Fund's] assets shall not normally exceed 25% of these assets or £10 million, whichever is the higher;

10.4 (d) the maximum investment in any bank or building society by the 1992 Fund and the Supplementary Fund shall not together normally exceed £15 million or £20 million in respect to the Funds' house bank(s) or not normally exceed £25 million when the three Funds' combined assets exceed £300 million.

## ATTACHMENT II

### Hedging Guidelines

As reviewed on 30 September 2021

1. For an incident in respect of which compensation will be paid in a currency other than pounds sterling the Director hedges:
    - (a) up to 50% of the levies received for compensation due for an incident (excluding claims related expenses);
    - (b) within a six-month period after the levies have been received.
  2. If circumstances so warrant, the Director may determine a hedging level higher or lower than 50% and/or a period shorter or longer than six months within which the determined hedging level should be reached. The reasons for such decisions will be laid down in the minutes of the next session of the Investment Advisory Body (IAB).
  3. The method of hedging, the percentage of hedging (hedging level) and the period within which that percentage should be reached, is determined by the Director following consultation with the joint IAB.
  4. The determined hedging level is continually monitored by the Director and the IAB to ensure it continues to reflect any changes in the anticipated amount of compensation payable and other relevant circumstances. The hedging level should also be adjusted to take account of any payments made in respect of the relevant incident to ensure that the determined hedging level is maintained.
  5. Foreign exchange transactions for hedging purposes should not exceed a term of two years. Foreign exchange transactions for hedging purposes exceeding a term of one year require the specific authorisation of the Director.
  6. Counterparty banks for foreign exchange transactions should meet the credit criteria set out in the Investment Guidelines. If, for exchange control or operational reasons, a hedging strategy needs to be transacted in a country where these criteria cannot be met, the Director can approve an exception to this guideline.
  7. The total foreign exchange exposure with any one financial institution should not exceed four times the available deposit limit approved for that counterparty without the approval of the Director.
  8. If it is necessary for the Funds to implement their hedging strategy in case of an incident in a Member State whose currency is not freely convertible, the amounts held with any one financial institution may exceed the investment limits set out in the Funds' Financial Regulation 10.4(d) for considerable periods of time. The investments in excess of the normal limits shall be reported to the regular sessions of the governing bodies and explanation shall be given regarding the need to exceed the applicable investment limits for the purpose of applying the Funds' Hedging Guidelines.
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