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International Oil Pollution Compensation Funds

Agenda Item 5	IOPC/OCT22/**5/4**	
Date	9 September 2022	
Original	English	
1992 Fund Assembly	92A27	●
1992 Fund Executive Committee	92EC79	
Supplementary Fund Assembly	SA19	●

REPORT OF THE JOINT INVESTMENT ADVISORY BODY

Note by the joint Investment Advisory Body

Summary:	The joint Investment Advisory Body reports on its activities since the November 2021 sessions of the governing bodies of the 1992 Fund and the Supplementary Fund.
Action to be taken:	1992 Fund Assembly and Supplementary Fund Assembly 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 OCTOBER 2021 TO SEPTEMBER 2022

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. This report was prepared in July 2022 in order to be distributed on a timely basis, 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.;

- Ms Beate Grosskurth, an experienced international banker, who has 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.

1.5 On 20 June 2022, the Director and a recruitment panel interviewed three candidates to replace Mr Brian Turner at the upcoming October 2022 meeting of the governing bodies. The position has been offered to Mr Marcel Zimmermann, who is Head of Money Markets and Foreign Exchange at the Swiss National Bank in Zurich, Switzerland. The full proposal for Mr Zimmermann's appointment to the joint Investment Advisory Body is contained in document IOPC/OCT22/6/2.

2 Meetings

2.1 At the time of preparing this report, the IAB had held three meetings with the Secretariat during the period covered by this report, namely on 15 November 2021, 8 March and 23 May 2022. Another meeting is scheduled for 8 September 2022. The meetings in November and March were held remotely, but the May meeting was held in the IOPC Funds' offices to enable the IAB members to meet the new Director, Mr Sivertsen.

2.2 The IAB met regularly on Zoom 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 issues.

2.3 The members of the IAB met remotely with the External Auditor on 8 March 2022 to provide an update on the IAB's activities with a particular focus on credit risk management. Members of the IAB attended an Audit Body meeting on 8 July 2022 to provide the newly elected members with details of the IAB's mandate and an overview of its activities with a particular focus on the hedging guidelines.

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; and
- Objectives for the coming year.

4 Economic summary (covering the period up to August 2022)

4.1 While the end of 2021 gave rise to some positive market trends on the horizon, with the end of COVID-19 measures in sight, the subsequent war in Ukraine has driven up the price of oil, gas and other commodities—leading to weakened global growth.

4.2 Also factoring in soaring inflation and tight global monetary policies, the economic outline during 2022 has so far proven far from robust.

4.3 In mid-July, the euro (EUR) fell to its lowest level versus the US dollar (USD) since 2002, after breaching a technical support level around 1.0340, and sinking below parity to trade briefly around 0.9950, before consolidating back above the crucial parity level.

4.4 Multiple factors have contributed to the decline in Europe's single currency:

- **Monetary policy:** The US Federal Reserve (Fed) has been tightening monetary policy much more aggressively than the European Central Bank (ECB).
- **Trade balances**: While both the US and Europe have seen a deterioration in their trade balances, the eurozone has seen an especially sharp decline in its trade surplus in recent months, as European natural gas prices have soared.
- **Fiscal**: The US budget deficit has been shrinking much more quickly than deficits in Europe.
- **Intra-European bond spreads**: Increasing tension within the eurozone debt market also appears to have been weighing on the euro. Low interest rates have been helping Europe avoid a debt crisis for a decade. However, with the ECB finally raising interest rates out of negative territory in July by 0.5% to 0.0%—and planning further rate hikes, analysts have again started talking about a sovereign debt crisis, which could yet unfold. Italian public debt has hit 151% following the pandemic, compared to 96% in the UK and 69% in Germany.

4.5 Supply chains are still facing severe cross-currents, even if inflationary pressures might ease in the remainder of the year, regardless of tightening from the Federal Reserve. Price pressures have been concentrated in durable goods, especially motor vehicles and electronics. However, geopolitical events overseas may further complicate the normal flow of goods.

4.6 China's recent COVID-19 shutdowns have caused new disruptions in global merchandise flows, and the ongoing war in Ukraine is also roiling commodities markets and food supplies. Energy markets are especially tumultuous as the war redirects global food and energy supplies.

4.7 These disruptions have caused growth forecasts to be downgraded for the eurozone and China. This also includes the European Union (EU) economic powerhouse of Germany, with its economy predicted to only grow by 1.9% in 2022 and 1.7% in 2023, according to the Organisation for Economic Co-operation and Development (OECD). Industrial production and exports in Germany have declined, despite a large backlog amid a severe reduction of gas imports from Russia. In 2022, second quarter growth declined from 0.8% to 0% and missed estimates of 0.1%.

United Kingdom

4.8 In the Bank of England's financial stability report (July 2022), inflation is forecast to rise to 11% by October. The Bank of England also warns that the UK will potentially enter a recession later this year. A smaller labour pool has made the labour market less flexible and driven up wage-price inflation. Despite this backdrop, according to a recent poll by Citi/YouGov, long-term UK consumer inflation expectations (5–10 years) have fallen from 4% to 3.8%, representing the first drop in four months.

United States of America

4.9 The fight against inflation has been compounded by fears of the US economy going into recession. In 2022, the US economy shrank for the second quarter in a row, declining by 0.9% in the last three months. In the first quarter of 2022, the economy shrunk by 1.6%, thus confirming a technical recession.

4.10 At the time of writing, upcoming US market data releases will determine when and by how much the Fed is likely to further raise interest rates, notably upcoming payroll data. So far, the tight labour market has boosted confidence in the overall state of the US economy, despite obvious weaknesses emerging, such as in the housing market and consumer confidence.

4.11 However, any signs of weakness in the US labour market will add to fears over the emergence of 'stagflation'.

Third quarter and beyond

4.12 The International Monetary Fund (IMF) has warned that inflationary risks will have a negative impact on global economic growth, particularly impacting the US and the euro area.

These risks include:

- Complete stoppage of Russian gas flow
- A spike in debt crises in emerging markets
- Tighter labour markets (especially in advanced countries)

4.13 In addition, as per IMF estimates, if these risks do materialise, the global growth rate will fall to between 2.6% and 2% next year, while the US and the eurozone may experience near-zero growth in 2023.

5 <u>Credit Markets</u>

5.1 At the end of the fourth quarter of 2021, the main ratings agencies were quiet, with credit markets lacking a little impetus and direction. China's property issues continued to attract headlines in the financial press, and workforce pressures in both the UK and the US underlined that the knock-on effects of the global pandemic were far from over. Global equities continued to recover, despite rising inflation data, ongoing supply issues, and a deteriorating global economic outlook.

5.2 After a quiet start to 2022, credit markets were dominated by the geopolitical events unfolding in Russia and Ukraine. Credit default spreads—the most sensitive and reactive of the credit criteria tools—rose across the board as volatility spiked and equity markets plunged. Financial institutions associated with Russian trade were particularly under the spotlight as the threat of sanctions loomed.

5.3 The Singaporean banks, Oversea-Chinese Banking Corporation (OCBC), United Overseas Bank (UOB) and DBS Bank Ltd (DBS) were all involved in providing commercial loans to the Russian commodity sector and promptly suspended their lending activity over fears of sanctions. Share prices for all three banks fell, with OCBC's share price slumping 15%, while UOB and DBS saw falls of around 10%.

5.4 In a research note concerning western European banks and their exposure to Russia, Fitch, one of the main rating agencies the Funds use, concluded that the European banks' asset quality would be pressured, but high levels of pre-impairment operating profit would likely mitigate the impact. Citing data from the Bank for International Settlements (BIS), Fitch reported that Italian and French banks had the largest cross-border exposure to Russia, at about USD 15 billion and USD 10 billion, respectively.

5.5 Towards the end of the second quarter of 2022, credit activity at the three main ratings agencies remained fairly subdued. As inflation continued to climb, central banks began to see the inflation threat as more ingrained and less transitory. As a result, the pace and margin of interest-rate increases picked up, with the cost of credit default insurance rising between 15%–20% for most of the banks on the Funds' counterparty list.

5.6 Although several of the Funds' counterparty banks had downgraded to their long-term credit and issuer default ratings, there were no major changes to the short-term credit ratings of the funds' Group One and Group Two list of banking counterparties. The banks all continued to report robust balance sheets, with no real deterioration in credit quality or capital adequacy. The number of constituents of the overall lending list remained stable at 35, with 18 banks in Group One and 17 banks in Group Two.

6 <u>Hedging the currency risk arising from incidents</u>

6.1 Hedging activity to minimise the risk of adverse currency movements has been minimal in the past 12 months, but the exchange rates of currencies to which the Funds have an exposure to, 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.

6.3 There are two incidents at present for which compensation is payable and require currency management.

Agia Zoni II incident

6.4 The compensation payable for this incident is estimated to be EUR 54.6 million, but this amount is not cast in stone. A total of approximately EUR 15 million has been paid, and a balance of approximately EUR 22.6 million is held, which represents 57% 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.

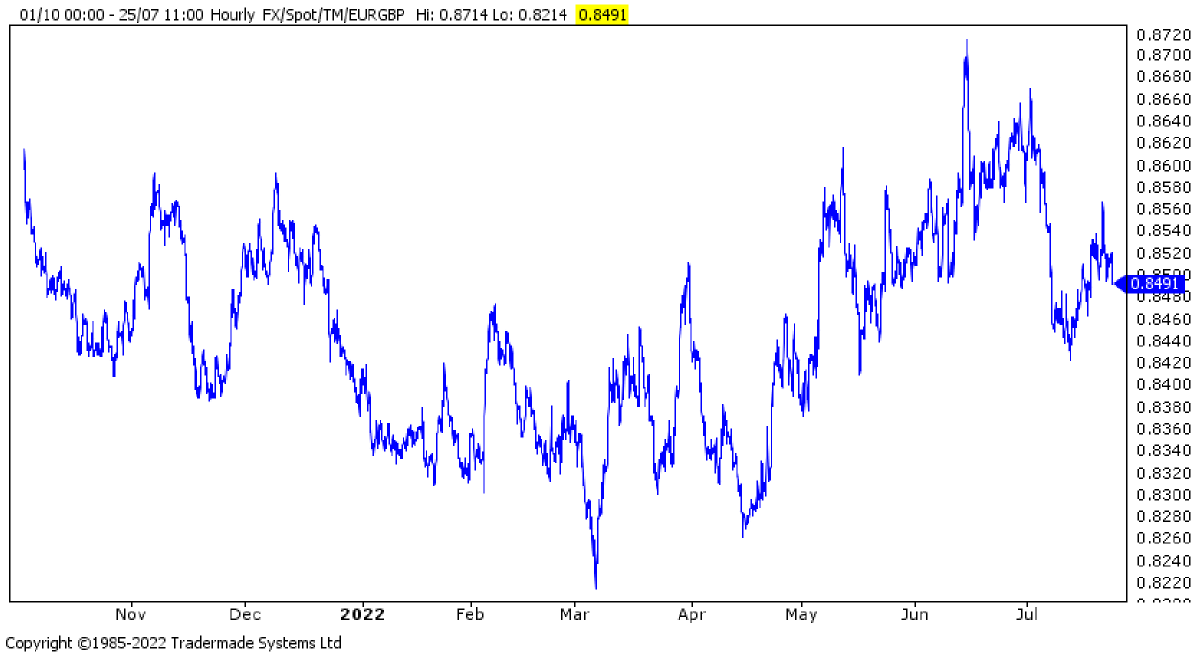
Incident in Israel

6.5 The first levy for this incident was for £4 million on 1 March 2022. An additional levy of £4 million was approved and deferred. The amount of £4 million has been converted into Israeli shekels (ILS) on a spot and forward purchase basis. The total amount of compensation payable is anticipated to be approximately £13 million, of which 30% is hedged.

Currency charts

6.6 Charts for the EUR/GBP and GBP/USD currency pairs covering the period 1 October 2021 to 25 July 2022 have been included to illustrate the movements that have taken place.

EUR/GBP



GBP/USD

6.7 The euro has traded within a range of five pence against the pound sterling. The EU single currency's low point during the period was 0.8212 in March, and it reached a high of 0.8714 in June. On 25 July, its level of 0.8491 was only marginally lower than its level on the first day of the period covered.

6.8 The US dollar has been the strongest currency of all the major currencies during the period covered by this report. In October 2021, it traded at a level of 1.3833 against the pound sterling, and it has continually strengthened since then to reach a high of 1.1782 in July. This currency pair is now trading at 1.2220 (22 August 2022).

6.9 The economic summary in section 4 provides a more detailed explanation of events.

7 Other Important Issues

Internal procedures for investment and cash management controls

7.1 The IAB has reviewed the Internal Investment Guidelines and the Hedging Guidelines at each of its meetings since its report to the November 2021 meeting of the governing bodies. These guidelines were last reviewed at its meeting on 23 May and will be reviewed again at its meeting scheduled for 8 September. Copies of both sets of Guidelines are attached to this report.

Monitoring of the IOPC Funds' financial risks

7.2 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 UK's withdrawal from the European Union (Brexit), the pandemic and increases in interest rates globally are considered to be of particular interest, 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

7.3 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.

7.4 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.

Emergence of ESG principles in Investing

7.5 In October 2021, the IAB produced a document outlining the concept of Environment, Social and Governance (ESG) and its application to corporate and institutional businesses.

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.

8.1.1

Beate Grosskurth	Alan Moore	Brian Turner

8 September 2022

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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)[<1>] 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.

<1> 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.