INTERNATIONAL OIL POLLUTION COMPENSATION FUNDS	Agenda item: 5	IOPC/OCT09/5/4	
	Original: ENGLISH	4 September 2009	
	1992 Fund Assembly	92A14	●
	1992 Fund Executive Committee	92EC46	
	Supplementary Fund Assembly	SA5	●
	1971 Fund Administrative Council	71AC24	●

REPORT OF THE JOINT INVESTMENT ADVISORY BODY

Note by the Director

Summary:	The joint Investment Advisory Body reports on its activities since the October 2008 sessions of the governing bodies of the 1992 Fund, the 1971 Fund and the Supplementary Fund.
Action to be taken:	<u>1992 Fund Assembly, Supplementary Fund Assembly and 1971 Fund Administrative Council:</u> The governing bodies are invited: (a) to take note of the information provided in the joint Investment Advisory Body's report (Annex I); and (b) to approve the proposed change to Regulation 10.4 (d) of their respective Financial Regulations (Annex II).

1 Introduction

1.1 Pursuant to the mandate of the joint Investment Advisory Body of the 1992 Fund, the 1971 Fund and the Supplementary Fund, this Body shall submit, through the Director, to each regular autumn session of the governing bodies, a report on its activities since the previous autumn session.

1.2 In view of the fact that the governing bodies decided in March 2005 that there should be a joint Investment Advisory Body for the 1992 Fund, the 1971 Fund and the Supplementary Fund, it has been considered appropriate for this body to present a single report to the governing bodies of the three Organisations. This report is attached to this document (Annex I).

2 Amendment to Internal Investment Guidelines

The joint IAB recommended to the Director that a more structured but flexible approach to hedging should be introduced which would ensure that, in principle, 50% of the assessed currency exposure of any incident should be hedged within a six month period from the date that the governing bodies approve a levy in respect of that incident. The hedging guidelines are incorporated and detailed in the revised Internal Investment Guidelines which are attached to the report (Annex I, Attachment).

3 Amendment to Financial Regulation 10.4(d)

Financial Regulation 10.4(d) of the 1992, Supplementary and 1971 Funds sets the maximum investment in any bank or building society by the three Funds together at £15 million, or when the three Funds' combined assets exceed £300 million at £25 million. The £15 million limit is normally fully utilised in respect of the IOPC Funds' house banks as the Funds have fixed term deposits, current and call accounts in Pounds sterling and euros as appropriate with these house banks. Given the recent banking crisis, the number of financial institutions with whom the Funds place investments has reduced. The joint IAB has therefore recommended that the maximum investment with each of these house banks should be increased from £15 million to £20 million and that Financial Regulation 10.4(d) of the three Funds should be amended accordingly.

In line with this recommendation, the Director proposes an amendment to Financial Regulation 10.4(d) of the three Funds which is set out in Annex II.

4 Action to be taken

1992 Fund Assembly, Supplementary Fund Assembly and 1971 Fund Administrative Council:

The governing bodies are invited:

(a) to take note of the information provided in the joint IAB's Report (Annex I with attachment);

(b) to approve the proposed change to Regulation 10.4 (d) of their respective Financial Regulations as set out in Annex II.

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ANNEX I

REPORT OF THE JOINT INVESTMENT ADVISORY BODY OF THE 1992 FUND, THE 1971 FUND AND THE SUPPLEMENTARY FUND FOR THE PERIOD OCTOBER 2008 TO SEPTEMBER 2009

1 Introduction

1.1 This report has been issued in the name of the joint Investment Advisory Body of the 1992 Fund, the 1971 Fund and the Supplementary Fund.

1.2 The mandate of the joint Investment Advisory Body as laid down by the governing bodies of the three 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; and

(d) to advise the Director on any other matters relevant to the Funds' investments.

1.3 At its October 2008 session, the 1992 Fund Assembly appointed the following persons as members of the joint Investment Advisory Body for a term of three years:

(a) Mr David Jude retired as Vice Chairman, Family Assurance Friendly Society Ltd in May 2007 and formerly Director of Cater Allen Ltd;

(b) Mr Brian Turner, a treasury consultant, and formerly Group Director Treasury, Henderson Global Investors Ltd; and

(c) Mr Simon Whitney-Long, a treasury consultant and formerly Managing Director, Global Treasury Services (Management) Ltd and Director, The Bank Relationship Consultancy.

2 Meetings

2.1 The joint Investment Advisory Body (IAB) has held four meetings with the Secretariat during the period covered by this Report, namely on 28 November 2008, 20 February, 29 May and 4 September 2009. The Director and the Head of the Finance and Administration Department were present at these meetings and the Finance Manager was present at three of these meetings.

2.2 The IAB has met on four occasions prior to the quarterly meetings with the Secretariat. There have also been frequent contacts between members of the Body and the Head of the Finance and Administration Department and the Finance Manager on various issues.

2.3 The members of the IAB met with a representative of the External Auditor on 29 May 2009 and attended two meetings of the Audit Body on 6 April and 5 June 2009.

3 Main issues considered

At their October 2008 sessions, the governing bodies noted that the joint IAB intended to address the following issues during the coming year. The issues and the actions taken were:

(a) *To consider the need to hedge the currency risk from anticipated future claims in any currencies.*

Financial Regulation 10.4(a) of the 1992, Supplementary and 1971 Funds provides that the Funds' assets should be held in Pounds sterling or, if the Director considers it appropriate, in the currencies required to meet claims arising out of a specific incident that have been settled or are likely to be settled in the future. The IAB has kept under review the holding of currencies other than Pounds sterling as part of the Funds' normal assets, noting that there was a further net currency exposure of approximately €55 million in respect of the *Erika* incident and approximately €29 million in respect of the *Prestige* incident. The balances of euros currently held on deposit in relation to the two incidents represent some 36% of the ultimate liabilities. Payments made in foreign currencies are, for accounting purposes, converted into sterling at the rate of exchange at which the currency was purchased, on a first in first out basis, and not at the date of the payment. The gain or loss in exchange at the date of the payment is therefore not recorded. Any gains or losses at the end of the financial year arising from these deposits are credited or debited to the respective Major Claims Funds.

For some time, the IAB has been concerned about the 1992 Fund's exposure to euro liabilities arising from the *Erika* and *Prestige* incidents and more recently to the Korean won and Russian rouble liabilities arising from the *Hebei Spirit* and *Volgoneft 139* incidents. The IAB recognised that normal market practice was for a minimum hedging level of 50% of any currency liability, against the Fund's current practice of purchasing foreign currency to finance compensation claims that were likely to be settled within the ensuing six month period.

The IAB recommended to the Director that a more formal but flexible approach to hedging should be introduced which would ensure that up to 50% of the assessed currency exposure of any incident should be hedged within a six month period from the date that a levy has been approved in respect of that incident. The IAB maintains that a 50% hedge constitutes a neutral position as whichever way exchange rates move, half of the position would benefit from a positive currency fluctuation while the other half of the position would suffer from a negative currency fluctuation. The IAB shared its rationale and recommendation at its meeting on 5 June 2009 with the members of the Audit Body, who understood the reasons for introducing such a hedging policy. The hedging guidelines are incorporated and detailed in the revised Internal Investment Guidelines which are attached to this report. (Attachment)

The IAB has been kept fully informed by the Secretariat of the developments arising from the *Hebei Spirit* incident and one member of the IAB together with the Director, the Head of the Finance and Administration Department and the Finance Manager attended a meeting with representatives of Korea Development Bank (KDB) on 29 January 2009. Discussions centred on the procedures and costs involved in paying out Korean won to a very large number of claimants in Korea. As there is no forward foreign exchange market in Korean won, the ability to hedge this liability is transacted by way of Non Deliverable Forwards, which are contracts for difference. Further discussions and meetings with KDB will continue. The Secretariat continues to update the IAB on developments arising from the *Volgoneft 139* incident.

(b) *To monitor the internal procedures for investment and cash management controls and recommend such amendments to these procedures as may be required.*

At their March 2005 sessions, the governing bodies decided, in accordance with the IAB's recommendation, that Financial Regulation 10.4(c) and (d) of the three Funds should be amended. Under 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 three Funds together at £15 million, or when the three Funds' combined assets exceed £300 million at £25 million. As the Funds' combined assets on the date of this report are some £150 million, the normal limit for investing in any one financial institution of £15 million remains applicable.

Currently the Funds have three house banks, namely Barclays Bank, Bank of Scotland and BNP Paribas, all of whom have extremely strong credit ratings. The £15 million limit is usually fully utilised as the Funds have fixed term deposits, current and call accounts in sterling and euros as appropriate with these three banks. Given the recent banking crisis, the number of financial institutions with whom the Funds place investments has reduced. The IAB has therefore recommended that the maximum investment with each of these three house banks should be increased from £15 million to £20 million and that Financial Regulation 10.4(d) should be amended accordingly for the three Funds.

In last year's report, the IAB stated that it had reviewed the Funds' financial risks. This process has continued during the last year and an update of the Risk Register was presented by the Secretariat for consideration at the IAB's February 2009 meeting. The IAB had noted that one of the new finance risks that had been identified during the 2009 review was, 'Operation of the Funds if the house bank became insolvent'. At its meeting on 20 February 2009, it had considered this risk and had concluded that Barclays Bank, Bank of Scotland and BNP Paribas were as secure as any other banks. As a precaution the IAB recommended that a chequeing account should be opened with one other house bank, namely Bank of Scotland, in addition to the chequeing account with Barclays Bank.

(c) To monitor credit ratings of financial institutions and to review on a continuing basis the list of the financial institutions which meet the investment criteria laid down by the governing bodies.

This last year has been an unprecedented time across all geographical markets, as the severity of the credit and banking crisis and its dramatic impact on the global economy really started to become apparent. No sector was immune from these wider market conditions. The IAB has at each meeting and also between meetings monitored the credit ratings of financial institutions and, where necessary, made recommendations to the Director to amend the list of financial institutions with which deposits may be placed.

At its meeting on 28 November 2008, the IAB recommended to the Director that in view of the very serious credit crunch affecting all banks, that the term for any Money Market Investments should be restricted to a maximum of three months, on a temporary basis, with possible exceptions on a case by case basis Also at this meeting, the IAB was particularly concerned at the creditworthiness of the Irish banks and recommended that no further deposits or roll-overs should be placed with them. At the time of this said meeting the Funds' exposure to the Irish banks was £23 million. At the date of this report no deposits are outstanding with Irish banks.

The IAB reviewed the Internal Investment Guidelines at each of its meetings. The criteria in respect of the long-term credit ratings of banks were reviewed on 28 November 2008 and at its meeting on 20 February 2009, the IAB recommended to the Director that the current long term credit rating of A should be tightened to A+.

All of these measures were considered and monitored between meetings and at its meeting on 29 May 2009, the IAB noted that the reasons for it recommending that deposits should be restricted to a maximum of three months had eased and recommended to the Director that the maximum term should be extended to six months on a temporary basis, with possible exceptions on a case by case basis.

In summary the current list of financial institutions with which deposits may be placed has reduced from 52 in September 2008 to 43 and all banks with whom the Funds have placed deposits have a credit rating of A+ or higher.

(d) *To review regularly the investment and foreign exchange exposures of the Funds and the quotations for investments in order to ensure that reasonable investment returns are achieved without compromising the safety of the Funds' assets.*

At each meeting, the IAB has reviewed the individual investments, maturities and overall exposure. The investment policy has been discussed in the light of the market situation at the time. The IAB has examined in some detail the anticipated cash flow of the Funds before making any recommendations to the Director regarding the placing of deposits or the purchase of currencies. Recommendations have been made with a view to earning a reasonable return on the Funds' investments while avoiding undue currency risks.

Financial Regulation 10.4(b) of the 1992, Supplementary and 1971 Funds permits the Funds to hold Certificates of Deposit (CDs). No CDs had however been purchased during the reporting period.

Since 2002 the 1992 Fund has invested sterling in the form of Dual Currency Deposits (DCDs) in line with the recommendation of the IAB. These transactions have been undertaken with financial institutions that met the 1992 Fund's investment criteria.

DCDs enable the 1992 Fund to earn an enhanced rate of interest on sterling deposits on the condition that, if at maturity the pre-agreed level of the exchange rate (strike rate) between the euro and Pound sterling is below the actual exchange rate, the principal amount invested will be repaid in euros at the agreed strike rate. This condition is acceptable to the 1992 Fund as it has an on-going requirement for euros to meet claims arising from the *Erika* and *Prestige* incidents. A note explaining the mechanics of a DCD in some detail was included in the IAB's report to the governing bodies October 2004 sessions (documents 92FUND/A.9/7, 71FUND/AC.15/4, Attachment II).

As recommended by the IAB, the Director has set an overall limit of £20 million for DCD transactions. The terms of each DCD transaction have been discussed between members of the IAB and the Head of the Finance and Administration Department or, in his absence, the Finance Manager before the deposit is placed. At the date of this report a total of 45 DCDs have been transacted of which six remain outstanding. DCDs continue to enhance the yield which would be obtainable on normal deposits.

(e) *To liaise with a representative of the External Auditor and with the Audit Body.*

The IAB met with a representative of the External Auditor on 29 May 2009 and with the Audit Body on 6 April and 5 June 2009 at which all the above issues were discussed. At its meeting with the External Auditor, the IAB had raised a question regarding the implementation of International Public Sector Accounting Standards (IPSAS) in 2010. Under IPSAS the recognition of income from investments would be accrued during the financial year and not at maturity as is the case now. The IAB concurred with this accounting procedure. Another question related to the measuring of any value changes and reporting these changes in financial statements. The IAB thought that DCDs, all hedges and revaluation of currency holdings were covered by this particular clause. The IAB informed the External Auditor and the Audit Body that as at 31 December 2008, there had been one DCD outstanding with Barclays Capital in the sum of £3 million and a report by Barclays Capital had revalued this DCD at 31 December 2008 in the sum of £3 133 900; in other words it showed a profit of £133 190 which under IPSAS would have to be shown as income in the 1992 Fund's financial statements. The IAB further explained that from Barclays Bank's perspective, a DCD consisted of a £3 million sterling deposit on which the interest rate would be close to zero and a currency option whereby Barclays Bank would credit the 1992 Fund with a premium for this option. The 1992 Fund had no right to request early repayment of the DCD and even if Barclays Bank agreed to an early repayment, then at best, the repayment would consist of the capital and a small amount of interest but no benefit from the option element. It was the opinion of the IAB that reporting a profit or revaluation surplus on this transaction under IPSAS would be misleading and that only the net interest rate, on an accrued basis, earned during the period should be reported. The External Auditor agreed to confirm the proper treatment of DCDs under IPSAS at a future date.

The Audit Body at its meeting on 12 December 2008 had highlighted a new strategic risk which was that sterling was no longer – at least for the time being – the stable currency that it had been and it suggested that the IAB should look at whether the Funds should be holding moneys in sterling. At its meeting with the Audit Body on 6 April 2009, the IAB acknowledged that sterling was volatile but was not unstable and for all its problems it remained the fourth most important currency in the world. The IAB had considered other currencies in particular the US dollar and the euro. It had discounted the use of the US dollar as the US is not a member of the Funds and there have been very few claims in that currency. It acknowledged that a possible alternative currency might be the euro as there had been two large incidents, the *Erika* and the *Prestige*, although the two current incidents, the *Hebei Spirit* and the *Volgoneft 139* would not involve euros, nor sterling. The IAB pointed out that there would always be sterling liabilities in respect of staff salaries, the Secretariat costs, office rent and overheads. It was also the IAB's view that if the Funds were to move to an alternative base currency, eg euros, then the Accounts would need to be reported in euros, resulting in the sterling operational costs being translated into euros. The IAB concluded that taking all these matters into account, it considered that sterling remained the most appropriate base currency for the Funds.

4 Revision of the IOPC Funds' investment policy

4.1 Under its mandate, the IAB is required 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.

4.2 The IAB had reviewed the Funds' investment policy in the light of Financial Regulation 10.1 of the three Funds and considered it to be entirely appropriate in terms of safety, liquidity and yield. Therefore the IAB recommended to the Director that there should be no amendment to that policy.

5 Objectives for the coming year

The IAB intends to continue to address the issues set out in paragraph 3 during the coming year.

David Jude Brian Turner Simon Whitney-Long

ATTACHMENT

Internal Investment Guidelines

As amended on 4 September 2009

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 at least two of the following three short-term ratings:

Standard & Poor's A1+
Moody's P1
Fitch F1+

In addition, the institution should have a long-term credit rating of A+ (AA3) or better with at least one of these three credit rating agencies.

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 Subject to the normal limits referred to in 3 above, deposits with building societies should not exceed 25% of the respective Fund's total deposits.

5 For liquidity purposes a minimum amount equivalent to the respective Fund's working capital should be maturing within 3 months.

6 Investments should not exceed one year.

In consultation with the joint Investment Advisory Body, the Director will maintain a list of approved institutions which should be updated regularly.

* * *

[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] [1971 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, the 1971 Fund and the Supplementary Fund shall not together normally exceed £15 million, or when the three Funds' combined assets exceed £300 million not normally exceed £25 million.

Hedging Guidelines

1 For an incident in respect of which compensation will be paid in a currency other than Pounds sterling the Director, in principle, hedges:

(a) up to 50% of the liability of an incident but not more than the sum of the levies approved less the Fund's anticipated expenses
(b) within a six month period after a levy has been approved

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 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 Investment Advisory Body (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 £45 million without the approval of the Director.

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ANNEX II

Text of 1992 Fund Financial Regulation 10
(corresponding to Financial Regulation 10 of the Supplementary and 1971 Funds)

Regulation 10

Investment of Assets

10.1 With a view to securing the assets of the 1992 Fund, the Director may invest any funds which are not required for the short-term operation of the 1992 Fund. In making any investments, all necessary steps shall be taken to ensure the maintenance of sufficient liquid funds for the operation of the 1992 Fund, to avoid undue currency risks and generally obtain a reasonable return on the investments of the 1992 Fund.

10.2 The Director shall submit to each regular session of the Assembly particulars of the current investments of the 1992 Fund and of any changes which have taken place since his previous report.

10.3 The 1992 Fund shall have a joint Investment Advisory Body with the 1971 Fund and the Supplementary Fund, whose members are appointed by the Assembly. The Body shall advise the Director in general terms on investment matters, in accordance with the mandate decided by the Assembly set out in Annex 1 to these Regulations.

10.4 The assets of the 1992 Fund shall be held and invested by the Director in accordance with Financial Regulation 10.1 and the following principles:

(a) the 1992 Fund's assets shall be held in Pounds Sterling or, if the Director considers it appropriate, in the currencies required to meet claims arising out of a specific incident which have been settled or are likely to be settled in the near future;

(b) the assets shall be placed on term deposit or by purchase of Certificates of Deposit with banks or building societies enjoying a high reputation and standing in the financial community; the term of these investments shall not exceed one year;

(c) providing that the total of the 1992 Fund's assets exceeds £10 million, the maximum investment in any bank or building society shall not normally exceed 25% of these assets;

(d) the maximum investment in any bank or building society by the 1992 Fund, the 1971 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;

(e) any exceptions to the normal limit in Financial Regulation 10.4(c) and (d), shall be reported to the Assembly at its next regular session.

These principles shall be reviewed from time to time.

10.5 Instructions relating to the 1992 Fund's investments, as well as instructions relating to the transfer of funds from one financial institution to another for the credit of the 1992 Fund's deposit accounts, shall be given by the Director. The Director may authorise another officer or officers to act on his behalf. Instructions shall be given

(a) in writing, signed jointly by two authorised officers, or

(b) orally by one authorised officer followed by written confirmation signed jointly by two authorised officers

10.6 For purposes of investment, all monies in the General Fund, Major Claims Funds, Contributors' Accounts and any special accounts may be merged. Any resulting income shall accrue to the respective fund or account pro rata, provided however that interest on the Contributors' Accounts shall be calculated as set out in Internal Regulation 3.9.