Agenda item: 5	IOPC/OCT10/5/4	
Original: ENGLISH	9 September 2010	
1992 Fund Assembly	92A15	•
1992 Fund Executive Committee	92EC49	
Supplementary Fund Assembly	SA6	•
1971 Fund Administrative Council	71AC25	•

REPORT OF THE JOINT INVESTMENT ADVISORY BODY

Note by the Director

Summary:	The joint Investment Advisory Body reports on its activities since the October 2009 sessions of the governing bodies of the 1992 Fund, the Supplementary Fund and the 1971 Fund.
Action to be taken:	1992 Fund Assembly, Supplementary Fund Assembly and 1971 Fund Administrative Council: The governing bodies are invited to take note of the information provided in the joint Investment Advisory Body's Report (Annex I).

1 Introduction

1.1 Pursuant to the mandate of the joint Investment Advisory Body (IAB) of the 1992 Fund, the Supplementary Fund and the 1971 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 IAB for the 1992 Fund, the Supplementary Fund and 1971 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 Hedging Guidelines

The joint IAB recommended to the Director that an additional clause should be added to the Hedging Guidelines to cover exceptional circumstances where amounts held with a financial institution may exceed the investment limits set out in the Funds' Financial Regulations for substantial periods of time. This may happen in particular where an incident occurs in a Member State whose currency is not freely convertible. The revised Hedging Guidelines are incorporated in the Internal Investment Guidelines which are attached to the report.

3 Action to be taken

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

The governing bodies are invited to take note of the information provided in the joint IAB's Report (Annex I with attachment).

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ANNEX I

REPORT OF THE JOINT INVESTMENT ADVISORY BODY OF THE 1992 FUND, THE SUPPLEMENTARY FUND AND THE 1971 FUND FOR THE PERIOD OCTOBER 2009 TO SEPTEMBER 2010

1 Introduction

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

1.2 The mandate of the IAB 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 IAB has held four meetings with the Secretariat during the period covered by this Report, namely on 26 November 2009, 25 February, 27 May and 9 September 2010. The Director, the Head of the Finance and Administration Department and the Finance Manager were present at 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 two representatives of the External Auditor on 27 May 2010 and attended a meeting of the Audit Body on 4 June 2010.

3 Main issues considered

At their October 2009 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 €28 million in respect of the *Prestige* incident. The balances of Euros currently held on deposit in relation to the two incidents represent some 48% of the ultimate liabilities.

The IAB is aware that the Hedging Guidelines implemented in the latter part of 2009 suggest that, in principle, up to 50% of the liability of any incident should be held in the relevant currency but the Director may determine a hedging level higher or lower than 50%. The IAB is of the view that, given the volatility in the foreign exchange markets, the current 43% holding of Euros in respect of the *Erika* incident and a 63% holding of Euros in respect of the *Prestige* incident is satisfactory. Additionally the 1992 Fund continues to transact Euro/GBP Dual Currency Deposits (DCDs) when appropriate, which may result in the original Sterling deposit being repaid in Euros (refer to paragraph d).

The IAB has also kept under review developments in relation to the *Volgoneft 139* and the *Hebei Spirit* incidents. In respect of the *Volgoneft 139* incident, which could result in a Russian Rouble liability, the Director has informed the IAB that he had not received authorisation from the Executive Committee to commence making payments. When such authorisation is received, the IAB would recommend to the Director that as there is no forward market for purchasing Russian Roubles, the hedging for this liability should be transacted by way of Non-Deliverable Forwards (NDFs). A NDF is a contract for difference and was explained in the joint IAB Report to the governing bodies in October 2009 (document IOPC/OCT09/5/4). In respect of the *Hebei Spirit* incident, the Director had visited the Republic of Korea in May 2010 and had met with representatives of both Korea Exchange Bank and Barclays Bank in Seoul. Following these meetings, Mr Turner, representing the IAB, together with the Secretariat, met with the London representatives from Barclays Bank, Seoul and Barclays Bank, London, to discuss the processes of how future purchases of Korean Won (KRW) should be handled. In June 2010, the 1992 Fund entered into two NDF transactions in the sums of £5 million each with maturities in November and December 2010. In July 2010, a KRW bank account was opened with Barclays Bank, Seoul and the 1992 Fund has since sold £6 million for KRW. At the date of this report, £16 million has been hedged in respect of claims totalling some £100 million. To date, an amount of some £50 million has been levied in relation to the *Hebei Spirit* Major Claims Fund. An amount of £12 million of claims-related expenditure is estimated to be paid from this Major Claims Fund to the end of 2011, potentially leaving an amount of some £38 million available for payment of compensation. The amount hedged so far for making compensation payments for the *Hebei Spirit* incident is some 42% ie £16 million out of £38 million. It is expected that compensation payments by the Fund would commence in the latter part of 2010. The IAB has been kept fully informed by the Secretariat of the developments arising from both of these incidents.

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 notional gains or losses arising from revaluation of foreign currencies held at the end of the financial year are credited or debited to the respective Major Claims Funds.

(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. Following the IAB's recommendation at the October 2009 sessions, 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 three Funds was amended accordingly. As the Funds' combined assets on the date of this report are some £142 million, the normal limit for investing in any one financial institution of £15 million remains applicable, except for the three house banks, namely Barclays Bank, Bank of Scotland and BNP Paribas, whose normal limit is £20 million.

In respect of the Hedging Guidelines, the IAB, at its meeting on 27 May 2010, considered the practical implications of the settlement of claims for incidents such as the *Hebei Spirit* incident, where payments would take place in KRW. It is certain that the KRW deposits together with other deposits with Barclays Bank, one of the Funds' house banks, would structurally exceed the £20 million limit laid down in Financial Regulation 10.4 (d). It was therefore decided that these instances should be included in the appropriate Annex to the Funds' Report on Investments document that is presented annually to the regular sessions of the governing bodies, giving explanations regarding the need to exceed the applicable investment limits for the purpose of applying the Funds' Hedging Guidelines. The IAB recommended that an appropriate clause should be added to the Hedging Guidelines to cover this exceptional situation, where amounts held with any financial institution may exceed the investment limits set out in the Funds' Financial Regulation 10.4 (d) for considerable periods of time as a result of hedging for an incident in a Member State whose currency is not freely convertible. The revised Hedging Guidelines are incorporated in the Internal Investment Guidelines.

The IAB reviewed the Internal Investment Guidelines at its meeting on 9 September 2010 and a copy is attached to this report (Attachment I).

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 a further update of the Risk Register was presented by the Secretariat for consideration at the IAB's February 2010 meeting. The IAB noted that following its recommendation at the 2009 review, a current account had been opened with Bank of Scotland, in addition to the current 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.*

Financial markets remain nervous about bank credit ratings globally, following concerns over exposure to certain sovereign debt and the risk of contagion within the sector. A programme of stress testing European banks' balance sheets undertaken in July 2010 has gone some way to alleviate concerns in this sector. 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.

The current list of financial institutions which meet the Funds' investment criteria has reduced from 43 in September 2009 to 29, a reduction of 14 banks which either failed to meet the investment criteria or with whom the Funds never placed deposits.

At the time of the last report by the IAB, the maximum term of any deposit was temporarily restricted to six months, with possible exceptions on a case-by-case basis. At its meeting on 25 February 2010, the IAB recommended to the Director that this temporary investment restriction should be lifted, so that the maximum term of any deposit is twelve months, in line with the investment criteria.

(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 ongoing 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, Attachment II and 71FUND/AC.15/4, Attachment II).

At its meeting on 25 February 2010, the IAB reviewed the DCD limit of £20 million and recommended to the Director that there should not be any change to this limit.

The terms of each DCD transaction have been discussed between members of the IAB and the Head of 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 54 DCDs had been transacted of which two remained 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 two representatives of the External Auditor on 27 May 2010 and with the Audit Body on 4 June 2010 at which all the above issues were discussed. At its previous meeting with the External Auditor on 5 June 2009, a long discussion had taken place regarding the implementation of International Public Sector Accounting Standards (IPSAS) in 2010, which was fully reported by the IAB to the governing bodies at their October 2009 sessions. After further discussion during the year, a mutual agreement has been reached whereby the accounting treatment for interest income under IPSAS on an accrued basis would be included along with an appropriate note to the Financial Statements regarding the valuation of any outstanding DCDs at the year end.

Both the External Auditor and the members of the Audit Body at their respective meetings with the IAB sought reassurance from the IAB that the Funds were not at risk from the £45 million foreign exchange limit set out in Paragraph 7 of the Hedging Guidelines (Attachment II). The IAB explained that if a financial institution counterparty went into administration during the period of the forward deal and therefore was unable to deliver the appropriate currency on the due date, then the Funds would not deliver the appropriate Sterling payment. The IAB added that the risk, which could be a loss or a profit, arose from the movement in the currency to be purchased between the time that the deal was transacted and the forward due date. The IAB gave the example that if a forward foreign exchange deal was transacted for £45 million with one bank that went into administration and the currency to be purchased had appreciated by 10%, then the cost to the Funds (lost opportunity) would be £4.5 million but no capital would be lost. Both the External Auditor and the members of the Audit Body accepted this reassurance.

The IAB had noted that the Barclays internet banking product had been installed on 24 February 2010. The External Auditor had verified that all controls and procedures were in place in respect of the system.

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 section 3 during the coming year.

David Jude

Brian Turner

Simon Whitney-Long

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ATTACHMENT I

Internal Investment Guidelines

As reviewed on 9 September 2010

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 £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 amended on 27 May 2010 and reviewed on 9 September 2010

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 joint 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 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.

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.