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International Oil Pollution Compensation Funds

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1992 Fund Assembly	92A24	●
1992 Fund Executive Committee	92EC73	
Supplementary Fund Assembly	SA16	●

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 October 2018 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.

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 of the two organisations. The report is attached to this document (see Annex).

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 2018 TO SEPTEMBER 2019

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.

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 October 2017 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.;
- Mr Brian Turner, a treasury consultant, and formerly Group Director Treasury, Henderson Global Investors Ltd;

1.4 In addition, Mr Simon Whitney-Long was reappointed for a period of six months, during which time the Director sought a suitable replacement.

1.5 In April 2018, the 1992 Fund Administrative Council approved the Director's proposal to appoint Ms Beate Grosskurth to the joint Investment Advisory Body until October 2020. Ms Grosskurth is an experienced international banker and has held senior positions with State Street Bank of Boston, Brown Brothers Harriman and CME Group.

2 Meetings

2.1 The IAB held four meetings with the Secretariat during the period covered by this Report; namely on 5 December 2018, 18 March, 19 June and 24 September 2019. The Director, the Deputy Director/Head of the Finance and Administration Department and the Finance Manager were present at these meetings.

2.2 The IAB met on four occasions 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 attended a meeting of the Audit Body on 26 April 2019 and gave an update on events since attending the June 2018 Audit Body meeting. The currency hedging process was the principal topic raised at the meeting which followed the IAB's verbal report. The IAB members also met with the External Auditor, BDO International, on 18 March 2019 for a full review of the IAB's activities.

3 Main issues considered

In recent reports to the Assembly, the IAB addressed matters under the various headings of its mandate. This year, the IAB has taken the opportunity to restructure the report 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

4.1 Over the reporting period, the global economy has been dominated by two main themes, the undertaking by the United States of America (USA) to realign its perceived trade imbalances with the rest of the world and the United Kingdom's (UK) withdrawal from the European Union (Brexit).

4.2 With the International Monetary Fund (IMF) reporting a continued period of strong global growth in the first half of 2018, economic activity slowed notably in the latter part of the year, dropping from around 4% to 3.2% as tariff hikes and trade tensions between the USA and China escalated. Combined with a slowing economy in Europe, driven in part by the uncertainties surrounding the UK's withdrawal from the European Union and a decline in business confidence in Germany and Italy, the IMF was forced to lower its 2019 forecast for global growth on multiple occasions. The latest forecast called for a growth rate of 3.2% in 2019 and was accompanied with warnings that the ongoing trade dispute could endanger growth further still, with current trade volumes falling to their lowest levels since 2012.

4.3 The IMF's warnings were materialising in the domestic economies of both China and the USA. The gross domestic product (GDP) in China fell to 6.2% in the second quarter of 2019, its lowest level of growth since the first quarter of 1992, amid retaliatory tariff hikes with the USA and rather alarmingly, against a backdrop of spiralling off-balance-sheet borrowings by local governments. Meanwhile, in the USA, 2019 second quarter growth dropped a full 1% to 2.1% from the revised first quarter print of 3.1%, with economists speculating that the Federal Reserve would enact one of the quickest turnarounds in monetary policy in recent financial history of the USA. The speculation proved accurate with the Federal Reserve, cutting interest rates by 25 basis points at the end of July, just 223 days after raising them by the same margin.

4.4 Europe also faced its own challenges. Germany marked the first half of 2019 with a slump in sentiment indicators and a collapse in both industrial output and exports, as the vehicle omissions scandal took effect, and Brexit uncertainty continued. Germany later reported that its economy had contracted by 0.1% in the second quarter. Italy was mired in a budget stand-off with the European Union, with yields on its sovereign bonds rising as burgeoning debt and deficit levels alarmed investors and prompted speculation that the European Commission was set to take punitive action against the Italian Government. The flagging European economy prompted the European Central Bank (ECB) to announce a return to an accommodative monetary policy with the prospect of additional stimulus pushing euro interest rates further into negative territory.

4.5 In the UK, GDP was surprisingly resilient with a 2019 first quarter rate of growth of 1.8%, although the Brexit malaise caught up with the economy in the second quarter as it contracted by 0.2%. Investors continued to shun the pound sterling as it sunk below USD 1.20 and to levels not seen since early 2017, weighed down by political upheaval and ongoing concerns over a smooth departure from the European Union.

4.6 All in all, it has been a difficult year for the global economy, with growth faltering in an environment of subdued inflation and growing protectionism. In addition, the rising tension in the Gulf region and the impact that an oil price shock could have on an already faltering global economy did nothing to dispel the gloomy tone of economists and central bankers alike.

5 Credit markets

5.1 Annual Review

5.1.1 By historical standards, credit markets had a quiet year with Credit Default Swap (CDS) spreads in general, fairly stable. The cost of default insurance rose marginally for UK banks at the start of 2019 as stress test results from the European Banking Authority put UK banks in a negative light, which carried over into the second quarter, primarily because of the continuing uncertainty over Brexit.

5.1.2 Non-UK banks were also struggling, with the increase in yields on Italian bonds and concerns over Italian debt levels also underpinning CDS prices for the European banks most exposed to Italian debt.

5.1.3 Capital adequacy levels continued to rise more or less across the board, with regulators citing the success of the various 'stress tests' on the improved capital strength of banks, increasing their resilience and 'ability to absorb financial shocks' (ECB, February 2019).

5.1.4 The three main ratings agencies (Standard & Poor's, Moody's and Fitch) were busy as usual, with the credit outlook for banks more positive than normal, mostly down to higher earnings capacity, capital restructuring and improved cost efficiency. Moody's issued a research note on the Singaporean banks and cautioned that 2019 would be a more challenging year because of the global economic slowdown, fewer earning opportunities and the negative impact of a stronger US dollar (USD).

5.1.5 The only short-term ratings change to affect the counterparty listings, was the Fitch upgrades to the short and long-term credit ratings of ING Bank NV, which promoted the bank into the Group 1 tier of counterparties.

5.2 Counterparty Banks

5.2.1 The number of counterparty banks remained at 34, with the promotion of ING Bank NV into the top tier resulting in 18 banks in the Group 1 list of counterparties, and 16 banks in Group 2. Lending to Group 1 banks has a maximum maturity of 12 months and lending to Group 2 has a maximum maturity of 6 months.

5.2.2 Lloyds Bank and Santander UK were made temporary house banks in relation to euro-related incidents, underlining the difficulty in making placements in euros (EUR) in a negative interest-rate environment.

5.2.3 The temporary £500 000 limit for CaixaBank SA (which had been set up in June 2018 to accommodate VAT reimbursements from the Spanish tax authorities) was increased by £500 000 to £1 million to accommodate the receipt of outstanding contributions in euros from the Islamic Republic of Iran.

5.3 Dual Currency Investments

Since 2002, the 1992 Fund has invested pounds sterling in the form of Dual Currency Deposits (DCDs), now more commonly referred to as Dual Currency Investments (DCIs), in line with the recommendation of the IAB. These transactions have been undertaken with financial institutions that met the investment criteria of the 1992 Fund. There is currently one outstanding pound sterling/euro DCI for £6 million maturing in December 2019.

6 Hedging the currency risk arising from incidents

Prestige incident

6.1 In April 2019, EUR 27.2 million was paid to the Spanish Court resulting in 99.5% of the total amount in relation to this incident having been paid, with a small balance of euros retained for future court settlements in France and Portugal. During the year, the hedging ratio on the outstanding balance had gradually risen from 78% to 100%, thus removing the risk of any adverse currency movements during the final stages of settlements.

Hebei Spirit incident

6.2 In April 2019, the sums of KRW 22 billion were paid to the P&I Club (Skuld Club) and KRW 27.5 billion to the Government of the Republic of Korea. The final balance of KRW 3.5 billion will be paid to the Skuld Club when the legal proceedings have been concluded. The hedging ratio for the Korean won payable to the Government had risen to 88%, while payments to the Skuld Club, which were required in US dollars, were hedged at 59%.

Agia Zoni II incident

6.3 The amount levied to date for this incident is £36 million. Approximately EUR 8 million has been paid in compensation from the amount levied and the hedging ratio on the balance is currently 52%.

6.4 Currency charts

6.4.1 Charts for the EUR/GBP and GBP/USD currency pairs covering the period 1 October 2018 to 30 August 2019 to illustrate the movements that have taken place (Attachment I).

6.4.2 The pound sterling weakened against the US dollar and the euro during this 11-month period, closing at USD 1.2182 and EUR 1.09 respectively. The ongoing Brexit negotiations weighed heavily on the pound sterling, while the dollar gained momentum from a higher interest rate structure and a stronger economy. The euro also weakened against the US dollar during this period, with talk of more economic stimulus and Italian debt concerns taking their toll. However, despite economic growth in the Eurozone falling by 50% it remained positive, with the GDP growth in the second quarter confirmed at 0.2% compared with the UK's GDP shrinking 0.2% during the same three-month period.

7 Other Important Issues

7.1 Internal procedures for investment and cash management controls

7.1.1 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 £61 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.

7.1.2 The IAB has reviewed the Internal Investment Guidelines and the Hedging Guidelines at each of its meetings since its report to the October 2018 sessions of the governing bodies. These guidelines were last reviewed at its meeting on 24 September 2019 and copies of both sets of Guidelines are attached to this report (Attachment II and Attachment III).

7.2 Monitoring of the IOPC Funds' financial risks

In last year's report, the IAB stated that it had reviewed the IOPC Funds' financial risks. This process has continued during the last year and a further update of the financial risks was presented by the Secretariat by email for consideration in May 2019. The IAB recommended one small amendment to the wording of Present Safeguards, and this was recorded in the minutes of the June meeting of the IAB. Brexit had been identified by the Secretariat as an ongoing risk and the IAB had reported on this at previous sessions of the governing bodies. This risk is continuously being monitored by the IAB as the outcome of the Brexit negotiations was still very uncertain at the time this report was prepared.

7.3 Working Capital of the 1992 Fund

7.3.1 At the April 2017 sessions of the governing bodies, an amendment to Financial Regulation 10.4(a) was approved to enable the 1992 Fund to diversify the working capital of the 1992 Fund between pounds sterling and another major currency.

7.3.2 The IAB recommended the US dollar as its preferred currency for diversification, as it continues to be the world's major reserve currency and remains attractive due to its relative strength, anticipated positive interest-rate differential and its overall liquidity. At present USD 6.6 million is held on deposit.

7.4 Review of the investment of the Staff Provident Fund

7.4.1 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.

7.4.2 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.

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

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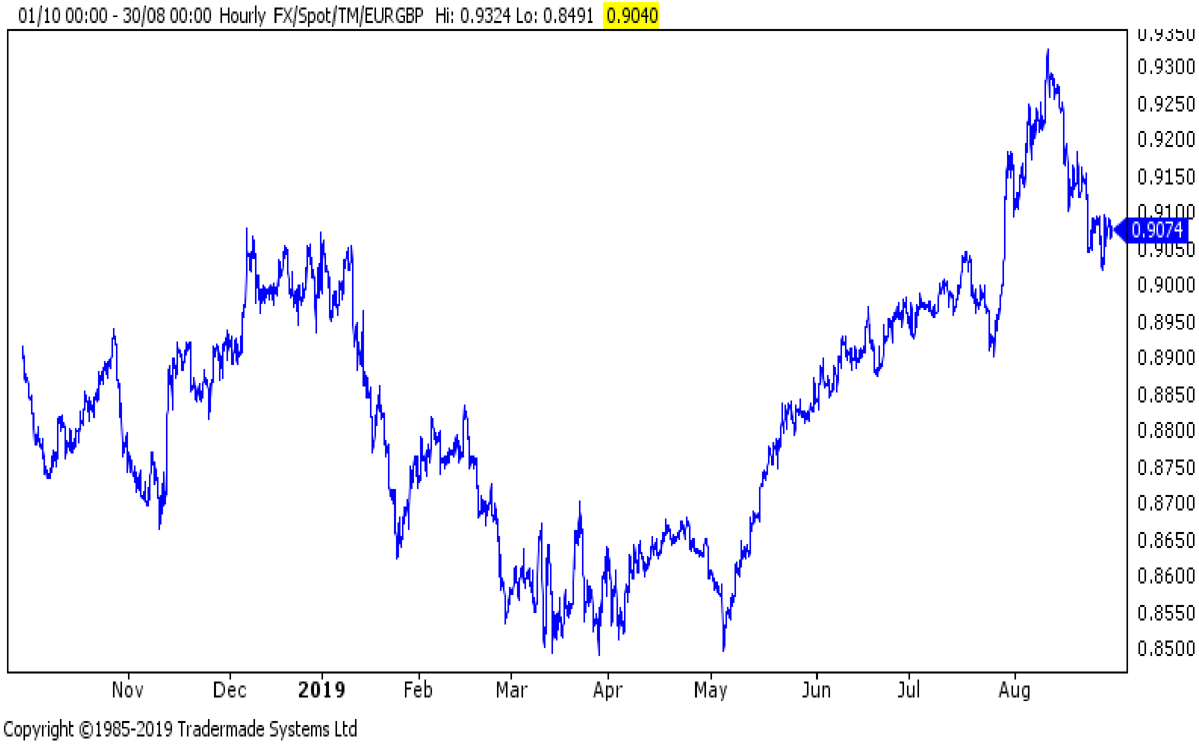
ATTACHMENT I

Currency charts

EUR/GBP chart 1 October 2018 to 31 August 2019



GBP/USD chart 1 October 2018 to 31 August 2019

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ATTACHMENT II

Internal Investment Guidelines

As reviewed on 24 September 2019

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 this would trigger a review to ascertain whether the credit markets were weaker in general, or whether the creditworthiness 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 IOPC 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 IOPC 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 any bank or building society 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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[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 III

Hedging Guidelines

As reviewed on 24 September 2019

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 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 Internal 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.