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REPORT OF THE INVESTMENT ADVISORY BODIES

Note by the Director

Summary:	The Investment Advisory Bodies report on their activities since the October 2002 sessions of the governing bodies.
Action to be taken:	Report to be considered.

1 Introduction

- 1.1 Pursuant to the respective mandates of the Investment Advisory Bodies of the 1992 and the 1971 Funds, these Bodies shall submit, through the Director, to each ordinary session of the respective Assembly, a report on their activities since the previous session.
- 1.2 In view of the fact that the mandate and composition of the two Investment Advisory Bodies are the same, it has been considered appropriate for these bodies to present a joint report to the governing bodies of the two Organisations. This report is reproduced at the Annex.

2 Action to be taken by the governing bodies

The governing bodies are invited to consider the Report of the Investment Advisory Bodies.

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ANNEX

REPORT OF THE INVESTMENT ADVISORY BODIES OF THE 1992 FUND AND 1971 FUND FOR THE PERIOD OCTOBER 2002 TO AUGUST 2003

1 Introduction

- 1.1 The mandate of the Investment Advisory Bodies as laid down by the Assemblies of the 1992 Fund and 1971 Fund is:
- (a) to advise the Director in general terms on investment matters;
 - (b) in particular, to advise the Director on the tenor of the respective Organisation's 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 investment policy of the Organisations as laid down by the respective Assembly; and
 - (d) to advise the Director on any other matters relevant to the IOPC Funds' investments.
- 1.2 At their October 2002 sessions, the governing bodies of the 1992 Fund and the 1971 Fund appointed the following persons as members of their Investment Advisory Bodies for one year:
- (a) Mr David Jude, Vice Chairman, Family Assurance Friendly Society Ltd, and formerly Director of Cater Allen Ltd;
 - (b) Mr Brian Turner, a treasury consultant, and formerly Group Director Treasury, Henderson Global Investors Ltd;
 - (c) Mr Simon Whitney-Long, Managing Director, The Seven Alliance Limited and formerly Managing Director, Global Treasury Services (Management) Ltd and Director, The Bank Relationship Consultancy.

2 Meetings

- 2.1 The Investment Advisory Bodies have held four meetings with the Secretariat during the period covered by this Report, namely on 22 November 2002 and 25 February, 27 May and 29 August 2003. The Director, the Head of the Finance and Administration Department and the Finance Officer were present at these meetings.
- 2.2 The members of the Bodies have met further, formally on four occasions and informally on other occasions. There have also been frequent contacts between members of the Bodies and the Head of the Finance and Administration Department and the Finance Officer on various issues.
- 2.3 The members of the Bodies attended a meeting of the Audit Body on 7 March 2003 and met with a representative of the External Auditor on 20 May 2003.

3 Main issues considered

- 3.1 At their October 2002 sessions, the Assembly of the 1992 Fund and the Administrative Council of the 1971 Fund were informed that the Investment Advisory Bodies of these Organisations intended to address the following issues in the coming year.

- (a) to consider the extent of the use of spot purchases of currencies other than pounds sterling in anticipation of meeting specific claims in any currencies;
- (b) to monitor the internal procedures for investment and cash management controls and recommend such amendments to these procedures as may be required;
- (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 Assemblies;
- (d) to review regularly the investment and foreign exchange exposures of the 1992 and 1971 Funds and the quotations for investments in order to ensure that reasonable investment returns are achieved without compromising the safety of the Funds' assets; and
- (e) to liaise with a representative of the External Auditor and with the Audit Body, when set up.

3.2 The following main issues were considered by the Investment Advisory Bodies during the period covered by the Report:

- (a) The Investment Advisory Bodies have always monitored the financial positions of the Funds to ensure that there was sufficient liquidity to meet claims and other expenses as they arise. The Bodies recommended to the Director that this monitoring process should become more formalised by adding a new paragraph to the Internal Investment Guidelines to read as follows: 'For liquidity purposes a minimum amount equivalent to the respective Fund's working capital should be maturing within 3 months'. The Director accepted this proposal.

Over the last few years, there have been many mergers and acquisitions within the banking industry which have resulted in a reduced number of financial institutions that meet the investment criteria. However some of these merged or acquired banks have retained their separate legal statuses and their credit ratings which could lead to the Funds investing more than the normal limit of £15 million in any one banking group. The Investment Advisory Bodies recommended to the Director that this anomaly should be corrected by an amendment to the Internal Investment Guidelines. This proposal was also accepted by the Director.

The Investment Advisory Bodies reviewed the Internal Investment Guidelines and the Internal Foreign Exchange Transaction Guidelines on 27 May and 29 August 2003. The current texts of these Guidelines are attached to this report.

- (b) The Investment Advisory Bodies considered that Certificates of Deposit (CDs) would be very useful financial instruments for the Funds to hold as even with a 12 months maturity, CDs could be sold at any time prior to maturity so satisfying the liquidity requirements set out in of the Internal Investment Guidelines. They confirmed to the Director that CDs were as safe as normal bank deposits, as CDs at maturity always realised their full face value and would not in any way compromise Financial Regulation 10.1. The Director accepted the recommendation of the Bodies (see paragraph 4.2 below).
- (c) The Investment Advisory Bodies have at each meeting 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 contains 60 financial institutions. It should be noted that between November 1996 and August 2003, 48 institutions have been deleted and 29 institutions have been added to this list – a net reduction of 19 institutions. It should also be noted that Barclays Bank plc and Bank of Scotland remain in-house banks.

- (d) In the light of the reduced number of financial institutions that meet the Funds' strict investment criteria, the Investment Advisory Bodies considered whether the Funds' normal limit of £15 million for investments with a given institution or banking group was sufficient in practical terms for the Funds to manage the placing of deposits. The Bodies were aware that the total sums currently invested in financial institutions were approximately £200 million. They recommended to the Director that no change to the normal limit of £15 million should be made for the time being. However they were concerned that if there were more major incidents and that when the Supplementary Fund Protocol came into force, the sums invested with financial institutions could rise sharply. In such circumstances, the Bodies would recommend to the Director that the normal limit of £15 million should be increased to £20 million or even £25 million as necessary and appropriate. In no circumstances would the Bodies recommend to the Director that the investment criteria should be weakened in order to accommodate a greater number of less creditworthy financial institutions.
- (e) As previously reported to the governing bodies, the members of the Investment Advisory Bodies had met with a representative of the External Auditor on three occasions and a fourth meeting was held on 20 May 2003. Issues discussed at the May meeting included all the points mentioned in paragraph 3.2 (a), (b), (c) and (d). Other issues discussed included the practical aspects of the investment process, namely the criteria for selection of institutions with which investments were made and the reporting process. The members of the Bodies explained that they made recommendations to the Director on the internal procedures for the wording of confirmation letters, signing authorities and the use of security PINs for authorising payments transacted electronically. They reported that at their meetings they considered the benefits that might arise from swaps, options and hedging opportunities.
- (f) The Investment Advisory Bodies met with the newly established Audit Body on 7 March 2003 at which two representatives of the External Auditor were also present. The Audit Body sought assurances from the Investment Advisory Bodies of how risks were managed, risks being credit risk, market risk and operational risk. All these points were covered in a presentation and a question and answer session. The Audit Body wished to know about the scope of the Investment Advisory Bodies activities and their procedures, the criteria for their recommendations, the follow up of the advice given and the relationship between the management of the IOPC Funds and the Bodies. All these questions were answered to the apparent satisfaction of the members of the Audit Body.
- (g) Financial Regulation 10.4 (a) 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 which have been settled or are likely to be settled in the near future. The Advisory Bodies have kept under review the holding of currencies other than pounds sterling, as part of the Funds' normal assets.

The 1992 and 1971 Funds held Japanese yen in respect of the *Nakhodka* incident and the 1992 Fund held euros in respect of the *Erika* and *Prestige* incidents which were bought for sterling and invested. Payments made in the foreign currencies were 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.

- (h) At each meeting, the Investment Advisory Bodies have monitored the internal procedures for investment and cash management controls, which have always appeared to be satisfactory. In particular during February 2003 the Investment Advisory Bodies were asked to review a draft internal Investment Manual which was intended to be used as a procedures manual for the Finance and Administration Department. A number of amendments to the draft text were proposed by the Bodies and the document was

finalised in February 2003. The Investment Manual was circulated to the members of the Audit Body.

- (i) At their meeting on 27 May 2003, the Investment Advisory Bodies received a presentation from a Senior Risk Advisor and a Treasury Advisor from Barclays Bank plc who presented a document on strategies to deal with foreign exchange risk. Many of the financial strategies proposed to deal with the foreign exchange risk were not considered to be suitable for use by the Funds. Only one financial instrument which is a variation of a forward purchase arrangement could be of interest and this is being explored further. The representatives of Barclays Bank plc also introduced the Bank's Money Market Fund. As in 2002, the IABs recommended to the Director that the Funds should not pursue this type of investment because they represented some risks which in the Bodies' view were not acceptable for the Funds. In any event the active management by the IOPC Funds of their investments produces a better net result than Money Market Funds.
- (j) As was reported to the October 2002 sessions of the governing bodies, the Funds had, as was proposed by the Investment Advisory Bodies, commenced to invest sterling in the form of Dual Currency Deposits (DCDs) operated by banks that met the investment criteria. DCDs allow the Funds to undertake foreign exchange hedging between sterling and euros, both currencies that the Funds require, with a higher return than the normal sterling deposit. At the time a DCD is made a certain conversion rate between sterling and the euro is agreed and if, at the maturity of the deposit, the sterling/euro rate is above the strike price, the capital and interest would be repaid in sterling; if on maturity the sterling/euro rate is below the strike price, the capital would be paid in euros. The interest is normally repayable in sterling. As recommended by the Investment Advisory Bodies the Director has set an overall limit of £15 million for DCD transactions, providing the individual limit of £15 million in any one financial institution is adhered to. Since March 2002 eleven DCD deposits have been made resulting in a better return than that which would have been obtained if the funds had been placed in a normal sterling deposit.
- (k) At each meeting, the Advisory Bodies have reviewed the individual investments, maturities and overall exposure. The investment policy has been discussed in the light of the market situation at the time.

4 Revision of the IOPC Funds' investment policy


- 4.1 Under their mandates, the Investment Advisory Bodies are 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 Assemblies.
- 4.2 The Investment Advisory Bodies have reviewed the Funds' investment policy in the light of Financial Regulation 10.1. As detailed in paragraph 3.2(b) concerning the holding of Certificates of Deposit (CDs) to provide for extra liquidity, the Bodies recommended to the Director that Financial Regulation 10.4(b) should be amended so as to enable the Funds to use CDs. Provided such an amendment was made the Bodies considered Financial Regulation 10.1 to be entirely appropriate in terms of safety, liquidity and yield.

5 Objectives for the coming year

The Investment Advisory Bodies intend to address the following issues during the coming year:

- (a) to consider the extent of the use of spot purchases of currencies other than pounds sterling in anticipation of meeting specific claims in any currencies;
- (b) to monitor the internal procedures for investment and cash management controls and recommend such amendments to these procedures as may be required;

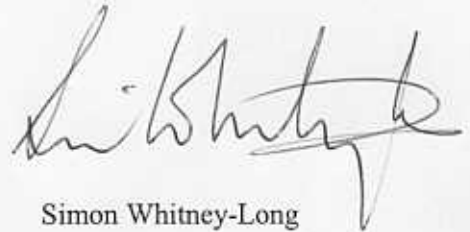
- (c) to monitor credit ratings of financial institutions and to review on a continuing basis the list of the financial institutions which meet the investment criteria laid down by the Assemblies;
- (d) to review regularly the investment and foreign exchange exposures of the 1992 and 1971 Funds and the quotations for investments in order to ensure that reasonable investment returns are achieved without compromising the safety of the Funds' assets; and
- (e) to liaise with a representative of the External Auditor and with the Audit Body.



David Jude



Brian Turner



Simon Whitney-Long

ATTACHMENTS

Internal Investment Guidelines

As amended on 29 August 2003

Money Market Investments

- A 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+
 - 2 Banks should, in addition, have a long-term rating of A or better, with at least one of these three rating agencies.
 - 3 A banking institution should be either a parent bank or a full branch of its parent bank.
 - 4 The normal limit of £15 million laid down in the Financial Regulations should apply to the total amount of the IOPC Funds' deposits with a given institution or banking group.
 - 5 Subject to the normal limit of £15 million, set out in 4 above, deposits with building societies should not exceed 25% of the IOPC Funds' total deposits.
 - 6 For liquidity purposes a minimum amount equivalent to the respective Fund's working capital should be maturing within 3 months.
- B The Director will keep a list of approved institutions, which should be updated regularly, in consultation with the Advisory Bodies.

Internal Foreign Exchange Transaction Guidelines

As amended on 29 August 2003

For foreign exchange transactions by the IOPC Funds, the following guidelines should apply:

- 1 In order to be eligible for foreign exchange dealing, 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 maintain a long term credit rating of A or better with at least one of these three credit rating agencies.

- 2 A banking institution should be either a parent bank or a full branch of its parent bank.
- 3 The total foreign exchange exposure with any financial institution should not exceed three times the limit laid down in the Financial Regulations for investments in any given institution.
- 4 Forward contracts and option contracts should not exceed 12 months.