INTERNATIONAL
OIL POLLUTION
COMPENSATION
FUND

ASSEMBLY
15th session
Agenda item 15

FUND/A.15/12
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REVIEW OF INVESTMENT POLICY

Note by the Director

1 Introduction

1.1 At its 14th session, in view of recent events in the London banking market, the Assembly discussed whether the principles laid down in Internal Regulation 10.2 and Financial Regulation 7.1 which govern the IOPC Fund's investments contained adequate safeguards. It was noted that the IOPC Fund would in the future be holding significant sums of money. The Assembly instructed the Director to examine the IOPC Fund's investment policy, in consultation with the External Auditor, and to submit a report on this issue to the Assembly at its 15th session (document FUND/A.14/23, paragraphs 5.2 and 5.3).

1.2 At the Director's invitation, the External Auditor has carried out an examination of the IOPC Fund's investment policy and procedures. The External Auditor has appraised the current policies governing investments, as set out in the Financial Regulations and the Internal Regulations, and analysed the IOPC Fund's internal management procedures for placing investments. In the Report on his study, the External Auditor has made a number of observations on the procedures and practices applied by the IOPC Fund as well as certain proposals and recommendations. The Report of the External Auditor is annexed to the present document.

1.3 The Director has carried out an examination of the investment policy, as requested by the Assembly. The present document sets out the results of this examination. It contains some proposals for amendments to the Financial Regulations and reports some modifications of the internal management procedures relating to investments.

1.4 As can be seen from the present document, the Director agrees with the observations made by the External Auditor and is also in agreement with the External Auditor's proposals and recommendations relating to amendments to the Financial Regulations and modifications of the practices and procedures to be followed for investment purposes.

2 Relevant Provisions of the Internal and Financial Regulations

2.1 Under Internal Regulation 10.2, the Director may invest any funds which are not required for the short-term operation of the IOPC Fund. In making investments, all necessary steps should be taken to ensure the maintenance of sufficient liquid funds for the operation of the IOPC Fund, to avoid undue currency risk and generally to obtain a reasonable return on the investments.

2.2 Financial Regulation 7.1 states that the assets of the IOPC Fund shall be invested by the Director in accordance with Internal Regulation 10.2 and the following principles:

(a) the IOPC Fund's assets shall be held in pounds sterling or, as appropriate, in the currencies required to meet claims arising out of a specific incident;

(b) the assets shall be placed on term deposit with banks or building societies enjoying a high reputation and standing in the financial community, or they shall be invested with discount houses which are members of the London Discount Market Association by the purchase of bank bills; the term of these investments shall in neither case exceed one year;

(c) the maximum investment in any bank, building society or discount house shall not normally exceed £2 million;

(d) any exceptions to the normal limit in paragraph (c) shall be reported to the Assembly at its next meeting.

2.3 Financial Regulation 7.1 also provides that the principles laid down therein shall be reviewed from time to time.

3 Previous Reviews

3.1 Financial Regulation 7.1, in its original version, only permitted investment with banks. At its 5th session, in 1982, the Assembly approved a proposal by the Director to broaden the IOPC Fund's investment policy so as to allow investments with certain discount houses by the purchase of bank bills (documents FUND/A.5/4 and FUND/A.5/15, paragraph 5.2).

3.2 At its 12th and 13th sessions, the Assembly reviewed the IOPC Fund's investment policy on the basis of documents prepared by the Director (documents FUND/A.12/16 and FUND/A.13/14). At its 13th session, in 1990, the Assembly approved the Director's proposal to broaden further the IOPC Fund's investment policy by allowing investments with building societies enjoying a high reputation and standing in the financial community (document FUND/A.13/21, paragraph 17.1).

4 Possible Types of Investments

4.1 There are different types of investments, such as cash, stocks and shares, bonds and commodities. As a general rule, investments yielding higher returns normally involve greater risks.

4.2 In the view of the Director, investments in stocks and shares, bonds and commodities would involve too high a degree of risk for the IOPC Fund. He submits therefore that only cash investments involving minimal risks should be considered by the IOPC Fund.

4.3 Cash investment means that investors make loans to financial institutions. Such loans can be made by various means, such as deposits in pounds sterling or other currencies, as well as the purchase of treasury bills, bank bills, local authority deposits and certificates of deposits. The rate of interest obtainable usually depends on the amount of money invested, the period of investment and the liquidity of the instrument.

4.4 Under the Financial Regulations, the IOPC Fund may only make investments in the form of term deposits and the purchase of bank bills. The Director has periodically had discussions with banks, discount houses and money brokers with a view to examining the advisability of amending the IOPC Fund's investment policy, in order to obtain a better return without any significant increase in risk. A number of options have been considered. These include treasury bills, certificates of deposit and local authority deposits, as well as such schemes as Floating Rate Notes and Euronotes/Euro Commercial Paper investment instruments. During these discussions, the Director has raised the issue of whether there were other types of investments which would be more advantageous. It has been generally agreed that it is not likely that any other kind of investment would at present give higher yields, considering the needs of the IOPC Fund regarding liquidity and security. As a result of these discussions, the Director has concluded that at present term deposits are the most advantageous investments for the IOPC Fund.

4.5 It should be noted that in evaluating suitable types of investments, the Director is guided by the general consideration that the IOPC Fund was not established for the purpose of investing money.

4.6 The purpose of the review of investment policy which took place in 1982 was to allow the purchase of bank bills from discount houses. No bank bills however have been purchased. The reason is that on all occasions when quotations for investments in the form of bank bills were taken, the yield on bank bills was lower than on bank deposits. The Director will continue to take quotations for investments of this kind and intends to make investments in the form of bank bills if the yield on such investments were to justify it.

4.7 In view of the purpose of the IOPC Fund and the considerations set out above, the Director submits that the IOPC Fund should not at present broaden its investment policy to include types of investments other than deposits and bank bills. The Director will, however, continue to review this issue and will bring the matter to the attention of the Assembly if the developments in the investment market justify it.

5 Institutions Used for Investment Purposes

5.1 The Director takes the view that the IOPC Fund should only consider cash investments which involve minimal risks.

5.2 Cash investments can be made not only with institutions of the types so far used by the IOPC Fund in accordance with the Financial Regulations, viz banks, building societies and discount houses, but also with other institutions such as finance houses. The Director considers that institutions of the kind used by the IOPC Fund are in general safer, from an investment point of view, than other institutions with which cash investments could be made. Finance houses may offer higher rates of interest. However, as such higher rates are paid to depositors, funds must be lent at correspondingly higher rates to borrowers who are often involved in above-average risks. The investment of the IOPC Fund's assets with such institutions would, in the Director's view, be incompatible with the policy of avoiding unnecessary risks.

5.3 As a result of the inclusion of discount houses in Financial Regulation 7.1, the IOPC Fund has made investments in the form of term deposits with those discount houses which are also recognised under the United Kingdom Banking Act 1987 as banks. By using the possibility of investing with building societies which was introduced in September 1990, the IOPC Fund has on many occasions been able to obtain higher rates that those offered by banks and discount houses.

5.4 In view of the considerations set out above, the Director considers that the IOPC Fund should maintain, at least for the time being, its present policy of investing only with banks, building societies and discount houses. This matter, however, will be kept under constant review.

5.5 As regards the criteria to be applied for the approval of any given institution, reference is made to paragraphs 10.1 to 10.5 below.

6 <u>Investing in Currencies Other than Pounds Sterling</u>

6.1 As mentioned above, Financial Regulation 7.1 provides that the IOPC Fund's assets should be held in pounds sterling or, as appropriate, in the currencies required to meet claims arising out of a specific incident. The scope for investing the IOPC Fund's assets in currencies other than pounds sterling is thus restricted. The question arises, therefore, whether to broaden the scope for such investments, in order to protect the IOPC Fund against losses resulting from depreciation of the pound sterling against other currencies in which payments will or may have to be made.

6.2 In the private sector it is usual to "match liabilities and assets", ie for a company to invest in various currencies in proportion to its estimated liabilities in the respective currencies. Some of the insurers of shipowners' third party liabilities, the P & I Clubs, have such an investment policy.

6.3 In the case of the IOPC Fund, it is very difficult to assess beforehand in which currencies the Fund will be called upon to pay compensation and indemnification, since it is neither possible to foresee in which Member States incidents involving the IOPC Fund will occur nor the extent of the Fund's financial involvement in various States. For this reason, it would not, in the Director's view, be justified to change the IOPC Fund's policy by allowing for investments in currencies other than pounds sterling so as to match liabilities and assets in respect of incidents which have not yet occurred.

6.4 One method of reducing the risk of losses resulting from currency fluctuations could be to make investments in European Currency Units (ECU). The ECU is a unit based on a basket of currencies of the States which are members of the European Communities. The ECU is generally a very stable unit because the stronger and more stable currencies comprise a greater proportion of the basket than the weaker and more volatile ones. Therefore, although the yield on an investment in ECU may be lower than that on investments in pounds sterling or a given foreign currency, the risk of exchange losses would be considerably reduced. It should be noted, however, that the IOPC Fund's investments are comparatively small in relation to the amounts that are normally invested in ECU and that the periods of the IOPC Fund's investments are relatively short. For these reasons, the Director does not consider that investments in ECU would be of any major advantage to the IOPC Fund, at least not for the time being.

6.5 Another question is whether, after an incident has occurred which will result in the IOPC Fund being called upon to pay compensation or indemnification, the IOPC Fund should make investments in the currency in which these payments are to be made. Such investments are at present permitted under the Financial Regulations. The External Auditor has recommended (paragraphs 7 and 32 of his Report) that the Financial Regulations should set out the circumstances in which such investments may be made. The Director agrees with the External Auditor's recommendation.

6.6 The Director considers that he should retain the possibility of keeping assets in any currency required to meet payments of claims arising out of a particular incident which have been settled or are likely to be settled in that currency in the near future. He should also retain the possibility of buying foreign currencies through forward contracts, as was done in the TANIO case, or through options, to cover payments of such claims.

6.7 It may be worth considering whether in the case of an incident which has given rise to significant claims against the IOPC Fund, the Financial Regulations should permit significant investments in the relevant currency at an early stage. If such investments were to be made, this would necessitate a thorough analysis of likely currency fluctuations as well as predictions as to the relationship between interest rates on investments in pounds sterling and in the other currency concerned. In the Director's opinion, any such investment should need prior approval by the Assembly or the Executive Committee.

6.8 The turbulence which has taken place in the currency markets in the middle of September 1992 shows the difficulties attendant on any investments in foreign currencies. The Director will always take this into account when considering investments in currencies other than pounds sterling.

6.9 In view of the foregoing, the Director invites the Assembly to consider whether the provisions of the Financial Regulations dealing with investments in currencies other than pounds sterling should be amended so as to be more precise. The following text is submitted for consideration (amendments underlined):

> "7.1 (a) the Fund's assets shall be held in pounds sterling or, as 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. Subject to prior approval by the Assembly or Executive Committee, investments may also be made in currencies other than pounds sterling to meet payments in respect of a particular incident which has given rise to significant claims against the Fund."

7 Maximum Investment In Any One Institution

7.1 Under the Financial Regulations, the maximum investment in any one institution should not normally exceed £2 million. Any investments which exceed the normal limit shall be reported to the Assembly at its next session.

7.2 In two cases, the Assembly endorsed the Director's opinion that in view of the special situation he would be entitled to make investments in any one institution in excess of the normal limit of £2 million. The first of these cases was in connection with the IOPC Fund's recovery of £9.5 million as a result of an out-of-court settlement relating to a recourse action in respect of the TANIO incident (document FUND/A.10/14, paragraph 6.2). The second case related to the levy of significant sums of money to the HAVEN Major Claims Fund (document FUND/A.14/23, paragraph 16.5).

7.3 When the Assembly fixed the normal limit for investment with any one institution at £2 million, the IOPC Fund had a working capital of £2 million and an average investment portfolio of around £1 million. At present, the working capital is £6 million. It is estimated that the average portfolio of investments during the period 1 February 1992 – 31 January 1993 will be £22 million. If the Director's proposal in document FUND/A.15/11 to levy a further £15 million to the HAVEN Major Claims Fund is approved, the IOPC Fund would after 1 February 1993 have a portfolio of investments of some £35 million.

7.4 In view of the high amount at present held by the IOPC Fund, the Director takes the view that the limit for investment in any one institution should be increased. He agrees with the External Auditor (paragraphs 6, 30 and 31 of his Report) that this limit should be based on two criteria, viz a fixed amount combined with a percentage of the total assets of the IOPC Fund. Allowing investments over £2 million with a given institution may offer the IOPC Fund the possibility of a higher yield, and would at the same time enable the Director to restrict investments to a limited number of institutions.

7.5 The Director submits for consideration by the Assembly whether the normal limit for investments in any one institution should be set at 35% of the IOPC Fund's total assets, provided however that investments with one institution should not normally exceed £6 million.

7.6 It should be noted that the level of investment in any given institution would depend on the Director's assessment of its financial standing.

7.7 The Director invites the Assembly to consider the following proposal for an amended text of Financial Regulation 7.1(c) (amendments underlined):

> "7.1(c) the maximum investment in any bank, building society or discount house shall not normally exceed [35%] of the IOPC Fund's total assets, subject to a maximum of [£6 million];"

8 Maximum Period of Investments

8.1 Under Financial Regulation 7.1(b), the term of the IOPC Fund's investments shall not exceed one year.

8.2 In view of the objectives of the IOPC Fund, viz to pay compensation to victims of oil pollution damage, the Director considers that the Fund should not make long term investments. There is in his view no need for the IOPC Fund to make investments for periods exceeding one year. For this reason, he proposes that the maximum period for the IOPC Fund's investments should be maintained at one year. This proposal is supported by the External Auditor (paragraphs 9 and 35 of his Report).

9 Use of Money Brokers

9.1 Money brokers act for major banks, discount houses, institutional investors, industrial companies, local authorities and building societies, placing deposits and arranging loans and specialist funding. No payment is made by the lender to the money broker, whose commission is paid by the borrower. The money brokers are regulated by the Bank of England Wholesale Markets Supervision Division. Major money brokers are constantly in touch with over 100 financial institutions at any given time. When the Director is unable to find a bank willing to borrow at a competitive rate of interest, a money broker may be able to put forward a suitable institution.

9.2 In view of the small size of its Secretariat, the IOPC Fund can only contact a limited number of institutions when investments are to be made. The Secretariat regularly takes quotations from a number of banks and discount houses approved by the Director for investment purposes. However, by using the services of money brokers, the Director can have access to a greater number of institutions, including building societies, and some of these may offer better rates than the institutions contacted by the IOPC Fund directly. The money broker used by the Director has on several occasions been able to arrange investments at better rates than those offered by the institutions contacted directly by the IOPC Fund. Investment with any institution proposed by the broker is only made after the institution has been approved by the Director.

9.3 The Director informed the Assembly at its 13th session that money brokers were used by the IOPC Fund (document FUND/A.12/16, paragraphs 12 and 13). Subject to instructions by the Assembly to the contrary, the Director intends to continue to use the services of money brokers, where appropriate.

10 Internal Procedures of the IOPC Fund relating to Investments

Criteria for Approval of Institutions

10.1 Under the Financial Regulations, investments of the IOPC Fund's assets may only be made with banks or building societies enjoying a high reputation and standing in the financial community or with discount houses which are members of the London Discount Market Association.

10.2 Investments are only made with institutions which have been approved for this purpose by the Director. Such approval is based on an examination carried out by the Finance Officer into the financial standing of the institution.

10.3 In the case of banks and discount houses, the first condition for approval applied by the Director is that the institution should appear on the prevailing list of Authorised Institutions recognised by the Bank of England under the Banking Act 1987. The list, as well as any amendments thereto, is supplied to the IOPC Fund by the Bank of England. As far as banks are concerned, the second requirement is that the bank in question should enjoy a good credit rating by renowned debt-rating agencies such as Standard & Poor's Corporation, Moody's Investors Service and the International Banking Credit Analysis (IBCA). Where discount houses are concerned, however, it is sufficient that the discount house in question is a member of the London Discount Market Association. Discount houses are not normally rated by debt-rating agencies because their operations are short term and they are an integral part of the London Money Market System. Besides, the generally held view is that it is inconceivable that a discount house would not be automatically supported by the Bank of England in the unlikely event of financial difficulties.

10.4 As for building societies, it should first be noted that some of them have recently become banks under the Banking Act 1987 and would normally be credit-rated. If a building society is credit-rated, the Director would apply the same rating criteria as mentioned above regarding banks. In respect of building societies which are not credit rated, the Director makes an assessment on the basis of the published accounts and information supplied by the Building Societies Commission as to their financial standing.

10.5 In his Report (paragraph 29) the External Auditor discussed the meaning of the requirement laid down in the Financial Regulations that an institution, in order to be approved by the Director for investment purposes, should enjoy a "high reputation and standing in the financial community". In the view of the Director, it is not easy to lay down clear criteria in this regard. For example, the rating criteria applied by various credit-rating agencies differ, and discount houses and some building societies are not included in rating lists. The Director considers that each institution would have to be assessed individually in order to form an opinion as to whether the institution should be approved. Nevertheless, he agrees with the External Auditor that it would be useful to set out in an internal note the general criteria to be applied for the Director's approval of institutions for investment purposes.

10.6 So far, the approval by the Director of a particular institution for investment purposes has been documented in the relevant file. However, in his Report (paragraphs 11, 41 and 42) the External Auditor has recommended that the procedure for such approvals be formalised. The Director agrees with this recommendation and intends to discuss further with the External Auditor the formal procedures to be applied for this purpose.

<u>Procedure for Making Investments</u>

10.7 When an investment is to be made, the Director decides the period of investment and gives the Finance Officer instructions as to the institutions to be approached for quotations. For determining the term of the investment, the Director takes into account the need to maintain liquid funds and the projected cash flow requirements. He also considers the desirability to spread the risks between several institutions and the IOPC Fund's interest in obtaining a reasonable return on its investments. The Finance Officer makes the investments within the parameters of the Director's instructions.

10.8 The External Auditor has discussed (paragraphs 5 and 27 of his Report) whether a higher degree of separation of duties should be introduced in the IOPC Fund's investment procedures. In view of the small size of the Secretariat, the Director considers that it is not practical to introduce a higher degree of separation of duties for investment purposes than the separation already applied between the Director and the Finance Officer. The External Auditor has accepted that view.

10.9 In his Report (paragraphs 5 and 29), the External Auditor has expressed the view that the IOPC Fund could be at risk in the case of any prolonged absence of the Finance Officer, but that there would be limited scope for solving this problem in view of the small number of the IOPC Fund staff. The Director accepts that practical difficulties would arise in carrying out the IOPC Fund's investment activities if the Finance Officer were to be absent for a long period of time. Ideally, the IOPC Fund should have an officer who could replace the Finance Officer in case of prolonged absence. However, the Director takes the view that, in view of the small size of the Secretariat, there is no practical solution to this problem. The External Auditor has accepted the Director's position on this point. If this situation were to arise, it might in the Director's view be necessary to employ a replacement for the Finance Officer on a temporary basis.

10.10 In addition, the External Auditor has recommended (paragraphs 6, 28 and 29 of his Report) that the investment procedures applied within the Secretariat should be documented in the form of written guidance. The Director had not considered it necessary to document these procedures, since the procedures applied had been worked out by the Director and the Finance Officer who are actually carrying out the investments. However, the Director agrees with the External Auditor that it would be useful to document these procedures, in particular to facilitate the task of any successors of the present incumbents in dealing with the investments. For this reason, an internal note describing in some detail the procedures that are followed is being prepared, and this note will be made available to the External Auditor in due course.

Concept of "Reasonable Return"

10.11 The External Auditor has discussed the concept of "reasonable return" on the IOPC Fund's investments which is laid down in Internal Regulation 10.2 (paragraphs 8 and 33 of his Report).

10.12 The Director agrees with the External Auditor that it would be very difficult to define this concept. It is obvious that the IOPC Fund should not necessarily aim at obtaining the highest possible return, since there are many considerations which have to be taken into account when the IOPC Fund's investments are made. One criterion could be the average return from major banks in the United Kingdom. There are also other criteria, however, in particular the paramount requirement of not exposing the IOPC Fund's assets to undue risks and the IOPC Fund's cash flow requirements. The level of return often depends on the period of investment. As suggested by the External Auditor, the Director will mention in the internal note on investment procedures, which is being prepared, the various factors to be taken into account when investments are made.

Advice and Information from External Sources

10.13 In many organisations within the United Nations system, investment committees have been established to advise the Executive Head on investment matters. The Director considers that the IOPC Fund is too small an organisation for such a body to be set up. The External Auditor has accepted this view (paragraph 12, 43 to 45 of his Report).

10.14 In his Report (paragraphs 12 and 45) the External Auditor has encouraged the IOPC Fund to continue to seek independent advice on investment matters from external sources, such as debt-rating agencies. As the External Auditor has noted, the IOPC Fund already uses external sources for such purposes. Apart from the use of Ratings Handbooks, contacts are established between the Finance Officer and various debt-rating agencies, Barclays Bank Economics Department, the Nomura Research Institute and the Bank Relationships Consultancy. The Director intends to continue this activity and will consider whether it could be expanded without giving rise to undue cost.

10.15 The External Auditor has drawn attention to the fact that United Nations Consultative Committee on Administrative Questions provides United Nations bodies with valuable information on cash management and investments (paragraphs 13 and 47 of his Report). He has recommended that the IOPC Fund should explore the possibility of getting access to that information. The Director agrees with the External Auditor's recommendation and will explore the possibility of the IOPC Fund being associated with the Consultative Committee, even though the Fund does not belong to the United Nations system.

Crediting of Interest

10.16 The External Auditor has mentioned (paragraphs 13 and 46 of his Report) that bodies within the United Nations system generally specify where interest earned on investments should be credited and classified in the books of account and has recommended that this matter should be dealt with in the documented investment management procedures.

10.17 Financial Regulation 5 contains certain provisions concerning the crediting of interest to the General Fund and Major Claims Funds. Interest on the Provident Fund is calculated on the basis laid down by the Executive Committee at its 2nd session (document FUND/EXC.2/6, item 6). However, the Director will examine, in consultation with the External Auditor, whether more detailed provisions should be introduced in the Financial Regulations on this matter or whether this issue should be dealt with by the Director in internal instructions. He will report on this matter to the Assembly at its 16th session.

11 Investment of Assets of the Provident Fund

11.1 The IOPC Fund operates a Provident Fund instead of a pension scheme. Both staff members and the IOPC Fund shall contribute to the Provident Fund, on such terms and conditions as are approved by the Assembly (Staff Regulation 23(b)). The rates of contributions to the Provident Fund are currently 7.9% for staff members and 15.8% for the IOPC Fund, calculated on the basis of the pensionable remuneration of the staff member concerned. Under Staff Rule VIII.5(g), the auditing of the Provident Fund shall be carried out in conjunction with the annual auditing of the accounts of the IOPC Fund.

11.2 Since the establishment of the IOPC Fund, the Provident Fund has been merged with the General Fund, the Major Claims Funds and the Contributors' Account for investment purposes, in order to enable the Provident Fund to benefit from the higher interest rates which the investment of the IOPC Fund's assets can attract. The basis of calculation of interest on the Provident Fund is the one laid down by the Executive Committee at its 2nd session (document FUND/EXC.2/6, item 6).

11.3 In reviewing the IOPC Fund's investment policy, the Director has come to the conclusion that the legal status of the assets of the Provident Fund is not clear. In his view, this is not satisfactory, since the interests of the staff members are of paramount importance as regards the Provident Fund. After discussion with the External Auditor (cf paragraphs 10 and 37 to 39 of his Report), the Director is at present taking legal advice on this issue in order to establish whether the procedure for management of the assets of the Provident Fund should be amended, for example, by creating a form of trust. He will submit this matter for consideration by the Assembly at its 16th session.

12 Action to be Taken by the Assembly

The Assembly is invited to:

(a) take note of the information contained in this document.

(b) give the Director such instructions regarding the IOPC Fund's investment policy and procedures as it deems appropriate;

(c) consider in particular:

- (i) the types of investments which the IOPC Fund should make (paragraph 4),
- (ii) which kinds of institutions should be used for investment purposes (paragraph 5),
- (iii) the extent to which investments should be made in currencies other than pounds sterling (paragraph 6),
- (iv) the maximum investment in any one institution (paragraph 7), and
- (v) the maximum period of investments (paragraph 8);

(d) consider the proposed amendments to Financial Regulations 7.1(a) and 7.1(c) (paragraphs 6.9 and 7.7, respectively);

(e) take note of the IOPC Fund's use of money brokers (paragraph 9);

(f) consider the internal procedures of the IOPC Fund relating to investments (paragraph 10); and

(g) give the Director such instructions concerning the investment of the assets of the Provident Fund as it considers appropriate (paragraph 11).

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ANNEX

INTERNATIONAL OIL POLLUTION COMPENSATION FUND

REPORT ON THE IOPC FUND'S INVESTMENT POLICY AND PROCEDURES

National Audit Office
September 1992

INTERNATIONAL OIL POLLUTION COMPENSATION FUND

REPORT ON THE FUND'S INVESTMENT POLICIES AND PROCEDURES

INTRODUCTION

Origin of Study

1. At its 14th session in October 1991, the IOPC Fund Assembly instructed the Director to examine, in consultation with the External Auditor, the Fund's investment policy. This request was in response to the events surrounding the collapse of the Bank of Credit and Commerce International (BCCI).

2. The Director of the IOPC Fund agreed to submit a report to the Assembly on the findings of the review at its 15th session to be held in October 1992.

Aims of Study

3. In discussion with the Director the External Auditor agreed that, as a basis for the review, he would:

- appraise the current policies governing investments, as set out in the existing Financial and Internal Regulations; and
- analyse the Fund's internal management procedures for placing investments.

SUMMARY AND MAIN CONCLUSIONS

4. The IOPC Fund's investments were valued at £4.49 million at 31 December 1991 and have increased significantly during 1992. They are expected to remain at a high level in the next few years at least. They comprise monies from the Contributors' Account, the General Fund, the Major Claims Funds, as well as the staff's Provident Fund (paragraphs 14 to 26).

On Investment Responsibilities

5. While the Director is responsible for the implementation of the Fund's investment policy, day-to-day responsibilities were largely focussed on one person, the Finance Officer. The prospects for establishing control through a wider separation of duties was limited due to the small number of IOPC Fund staff. In addition, the IOPC Fund had no written guidance governing investment procedures such that, in our view, the Fund could be at risk in any prolonged absence of the Finance Officer. I recognise, however, the limited scope for introducing a further separation of duties (paragraph 27).

On Investment Security

6. Although the Finance Officer clearly applied sound procedures to ensure that funds were securely invested, those procedures had not been recorded. I <u>recommend</u> that the IOPC Fund should document these investment management procedures, which should specify how to select institutions in which to invest. I also <u>recommend</u> that the Fund modify their current maximum of £2 million in any one

institution: I suggest a higher limit could be adopted, but subject to a percentage limit based on the total portfolio (paragraphs 28 to 31).

On Investments in Foreign Currencies

7. I recommend that the Fund's Financial Regulations set out the circumstances in which holdings of foreign currencies are permitted (paragraph 32).

On Return on Investments

8. I recognise that the IOPC Fund consider a wide range of criteria in determining a "reasonable return", and that these factors are difficult to define. I suggest that, in any documented investment management procedures, the Fund underline the need to consider all such factors (paragraph 33).

On Liquidity

9. I support the IOPC Fund's limit of one year for term investments as sufficient to maintain liquidity while securing a fair rate of return (paragraphs 34 to 36).

On Investment Stewardship and the Provident Fund

10. My staff reviewed the investment procedures for the IOPC Fund's Provident Fund, in the light of recent events in the news about pension funds. They noted that the policy of pooling all funds, including the staff's Provident Fund, is intended to maximise the rate of return. However, my staff were concerned that funds relating to staff entitlements are invested jointly with funds which relate to the IOPC Fund's mainstream activities; and that stewardship of the Provident Fund was wholly controlled by the Fund, without staff representation. The IOPC Fund share these concerns, and the Director has sought a legal opinion to clarify his stewardship responsibilities for the Provident Fund. I welcome this initiative (paragraphs 37 to 39).

On Comparison with United Nations Bodies

11. Based on my review of current best practice in the major United Nations organisations, I was pleased to note that the Fund's Director adopts the UN practice of approving banks and building societies with which funds may be invested. I recommend, however, that the practice be formalised to improve the transparency of this procedure (paragraphs 40 to 42).

12. I recognise that, as the IOPC Fund is a relatively small organisation, it would not be practicable to establish an investment committee, as is common practice in the UN and elsewhere. I was pleased to note, however, that the IOPC Fund secure the benefits of independent review and guidance in other ways (paragraphs 43 to 45).

13. UN bodies generally specify where interest should be credited and how it should be accounted for. I recommend that the IOPC Fund's documented investment management procedures take account of this. I also noted that the UN's Consultative Committee on Administrative Questions provides UN bodies with valuable

information on cash management and investments, and I recommend that the IOPC Fund explore the possibility of accessing that information (paragraphs 46 and 47).

DETAILED FINDINGS

Present Investment Policies and Procedures

Background

14. IOPC Fund investments embrace income for the General Fund, the Major Claims Funds, Provident Fund and Contributors' Account. As at 31 December 1991, the Fund had investments totalling some £4.49 million (1990: £7.54 million), invested in seven institutions, four of which were branches of overseas (ie non UK) based banks.

15. The Fund's investment portfolio has increased during 1992 and is expected to increase further over the next few years, as the financial effects of the Haven incident become more evident. Total liabilities arising from the incident have been estimated at £45 million. Contributions levied for 1992 across all funds amount to £26 million.

Investment Responsibilities

16. Overall responsibility for setting the Fund's investment policies rests with the IOPC Fund Assembly, which formally approves the investment regulations in which the principles of investment are laid down. Generally, in setting the investment policies, the Assembly acts on advice and information presented to it by the Director.

17. From time to time, either at the Assembly's request or on his own initiative, the Director carries out a review of the investment policies and reports on this to the Assembly. The Director last reported in 1990, when the Assembly approved an amendment to the regulations, allowing the Director to invest with building societies, in addition to banks and discount houses.

18. The Director is responsible for the implementation of the investment policy, and approves the institutions, rate, period of investment and amount to be invested. Each year, he submits to the Assembly an investment report detailing amounts invested with the various institutions over the preceding twelve months. In this way, the Assembly performs an "arms length" monitoring of the Fund's investments.

Main Investment Principles

19. The principles guiding the IOPC Fund's investment policy are set out in Internal Regulation 10.2 and in Financial Regulation 7.1. There are four main principles: security of assets; maintenance of liquidity; avoidance of undue currency risk; and securing a reasonable rate of return.

Current Investment Procedures

20. The Finance Officer advises the Director on institutions in which to invest, the period, rate and amount to be invested, and

makes the investment. In consultation with the Director, the Finance Officer will, on a daily basis, assess the amounts available for investment based on his projections of future cash flow and any investments maturing. He obtains bids from institutions on current rates and terms available. Final selection is usually made on the most favourable quote with due regard to the period of investment, future cash flow and spread of risk.

21. The IOPC Fund employ stringent procedures in choosing those institutions in which to place deposits. They will only invest with Banks authorised under the Banking Act 1987 (and subsequent amendments) and appearing on the Bank of England list. But this is not the only criterion; even before the BCCI collapse, the IOPC Fund were sufficiently cautious not to rely solely on the Bank of England listing. In particular, the Fund also review guidance issued by generally accepted authorities in bank rating to identify institutions which meet appropriate rating standards, using, for example, the publications of Moodys and Standard and Poors, two ratings agencies (Annex A).

22. Using the ratings guidance, the IOPC Fund will typically select only those institutions which have a credit rating of AAA or AA long term, or an A1+ short term rating. Although these ratings are at the top end of the ratings scale, they generally provide a reasonable choice of institutions in which the Fund can invest.

23. The IOPC Fund have also invested with Building Societies since 1991, following an amendment to the Financial Regulations in 1990. They consider only those building societies which, as Members of the Building Societies' Association, enjoy as high a reputation and standing in the Financial community as those banks listed by the Bank of England as authorised deposit takers.

24. The IOPC Fund are aware that ratings information and comparative data on the financial stability of building societies are difficult to find. The standard credit ratings applied to banks do not apply to building societies. The IOPC Fund therefore place a measure of reliance on a listing provided by the Building Societies Association, which details the assets and liabilities of each Society. Risk is minimised by reference to that list; and assurance taken from provisions set out in the Building Societies' Act 1986; and past experiences, which suggest that the industry would not allow a Society "in financial difficulty" to collapse.

25. The Finance Officer identifies banks and building societies which meet the Fund's review criteria and submits them to the Director for approval. Additions to, or deletions from, those approved institutions are discussed with the Director, and the Finance Officer will not make an investment with any institution not approved by the Director.

26. The Fund have adopted a cautious approach to investment in foreign currencies. In accordance with the Financial Regulations, such investments are made only where there is a perceived short term need to settle payments (claims) in a foreign currency. Where the need arises, the Fund will open a deposit account in the currency required with one of the institutions approved by the Director. The IOPC Fund do not speculate in foreign currencies.

Review of the Investment Policies and Procedures

Investment Responsibilities

27. My staff reviewed the present arrangements for dividing responsibility for the Fund's investment management. I recognise the difficulties of establishing clear separation of duties in a very small organisation such as the IOPC Fund. Ideally there should, for example, be a separation between the decisions as to what investments should be made, and the putting into effect of those decisions. However, such clear segregation may not be practical, and could not be made without employing an additional staff member to share the investment and finance responsibilities. Under the existing arrangements, the Director exercises a close supervisory role by reviewing papers after the event and by signing letters of confirmation. In these circumstances my staff were satisfied that the Director exercises sufficient independent check to ensure reasonable security of the Fund's assets.

Investment Security

28. Internal Regulation 10.2 requires the assets of the Fund to be secure. Minimising investment risk involves strong internal control procedures over the selection of institutions in which to invest; and a need to spread investments widely. However, although the criteria for selection and spread of investments are well understood by the Finance Officer, these have not been recorded.

29. I suggest that the Fund should establish written guidance to assist practical interpretation of the Internal Regulation; provide a basis for regular review of procedures; and provide back-up support when the Finance Officer is absent. Such guidance could indicate, for example, the critieria for determing the institutions in which the Fund might invest. This would help clarify the Financial Regulations (7.1(b)) which define secure investment institutions as "banks or building societies enjoying a high reputation and standing in the financial community".

30. Regulation 7.1(c), sets a maximum investment in any one institution at £2 million. Taking account of the experiences of the Western Isles local authority in the wake of the BCCI fraud, (Second Report of the Treasury and Civil Service Select Committee), we concluded that the best option would be to combine a percentage limit on the total portfolio with a raised value limit, where the lower of the two alternative figures is applied.

31. In practice this would mean that at times when fewer and smaller oil pollution incidents have resulted in a low level of claims, and fewer cash assets, the maximum value of investments with one institution would not exceed the percentage limit specified in the Regulations; and for periods when major incidents have resulted in a high level of claims, and more cash assets, the absolute value limit would take precedence over the percentage limit. The combination of these two criteria would ensure that the Fund's exposure with any one institution would be carefully restricted, without unduly diminishing the prospect of securing a reasonable rate of return.

Investment in Foreign Currencies

32. I share the IOPC Fund's view that to meet needs arising from specific incidents, the Regulations should continue to permit investments in foreign currencies, so that claims arising out of those incidents may be readily met. I consider that the circumstances of such holdings should be defined in the Fund's Financial Regulations.

Return on Investments

33. Internal Regulation 10.2 specifies that a "reasonable return" should be sought on investments placed. As the IOPC Fund recognise, this does not necessarily imply that the return should be the highest available, and the Fund are careful to take account of other important criteria such as the average return from UK banks, the degree of risk, and the period of investment. I recognise that the full range of criteria is difficult to define, but I suggest that the Fund underline the need to consider all factors in any documented investment management procedures.

Liquidity

34. Internal Regulation 10.2 states that "all necessary steps should be taken to ensure the maintenance of sufficient liquid funds for the operation of the IOPC Fund". Financial Regulation 7.1(b) further states that assets placed on term deposit or used to purchase bank bills shall be on a term which "in neither case exceeds one year".

35. The principle of liquidity suggests that funds should not be tied up in any long term investments where there is likely to be a clear, short term need to meet claims expenditure. In this regard, I consider the maximum period of investment of one year to be appropriate.

36. The IOPC Fund regularly compare the rates available for deposits and bank bills. We note that so far, investments have only been made in the form of deposits, largely due to their more favourable rates.

Investment Stewardship and the Provident Fund

37. The current policy of pooling monies available for investment from the General Fund, Provident Fund, Contributors' Account and any Major Claims Fund is designed to attract a higher rate of return. Although interest earned on the Provident Fund and Contributors' Account is governed by Staff Rule VIII.5(b)(iii) and Internal Regulation 3.11, the security and stewardship responsibility for the Provident Fund assets is legally uncertain.

38. The Provident Fund was established as a separate Fund under Financial Regulation 5.3, in accordance with Staff Regulation 23. The IOPC Fund recognise that they have a duty of care to the Provident Fund members but it is unclear whether the Provident Fund can be regarded as a separate legal entity and consequently whether its assets are fully protected against claims arising from IOPC Fund's mainstream activities. The Director shares my concern regarding his stewardship responsibility for the Provident Fund and

has sought a legal opinion to clarify this role and the status of the Fund. I welcome this initiative.

39. Subject to the outcome of the legal opinion, and in recognition of the interests of staff in the Provident Fund, I suggest that the IOPC Fund may wish to consider establishing separate arrangements for managing Provident Fund Investments. They may wish to consider, for example, the establishment of a Board of Trustees to represent the IOPC Fund staff's interests in the oversight of the Funds. And should legal opinion or other considerations determine that the Provident Fund is inseparable from the IOPC Fund's mainstream funds, IOPCF may wish to consider insuring against any losses to the Provident Fund arising from claims and liabilities accruing to the IOPC Fund.

Comparison with UN Organizations

40. My staff compared the IOPC Fund's Internal and Financial Regulations with those of the World Health Organization, the International Labour Organisation, the United Nations, and other UN Agencies. They found differences in the regulations covering three areas: custody of assets; investment committees; and investment accounting.

Custody of Funds

41. Most of the UN bodies reviewed required their Director/ Director-General to designate the bank or banks in which the organisation's funds should be kept. Although the Director does, at present, approve the banks, discount houses and building societies with which the IOPC Fund may invest, I suggest that the existing procedures be established on a more formal basis.

42. Once the formal procedures have been established, adding a new institution would have to be justified and approved by the Director; similarly, there would have to be a formal procedure for carrying out a periodic review of the qualifying institutions and deleting, where necessary, any institution about which new information had come to light which cast doubt on its financial stability.

Investment Committees

43. Several of the organisations we examined required their Director/Director-General to set up an investment committee; and to consider that committee's advice when making investments. Clearly this arrangement has the advantage of broadening the range of experience brought to bear on investment decisions, and subjecting the decision making process to a degree of independent review.

44. The IOPC Fund consider that, while these additional benefits are desirable, it would not be practicable to adopt similar arrangements, essentially because of its small size; and the associated problems with ensuring that meetings of the committee coincide with investment timings.

45. I accept the IOPC Fund's view that an investment committee would not be practicable, and welcome the contacts the Fund have established to secure independent advice in other ways. The Treasury and Civil Service Committee was critical of local

authorities' reluctance to use the help of financial experts. Thus I would encourage the IOPC Fund to continue to seek independent advice where necessary from external sources (for example, to provide credit rating information). However, as the Committee pointed out, such advice should not come from brokers, who are not regarded as sufficiently independent and whose role should be confined to effecting transactions between borrower and lender.

Accounting for Investments

46. UN bodies generally specify where the income from interest should be credited, and how it should be classified in the books of account. I suggest that the IOPC Fund do likewise, and consider setting out the basic accounting principles in the Financial Regulations, supported by more detailed accounting guidance in the Fund's Administrative Instructions.

47. The Consultative Committee on Administrative Questions (CCAQ) of the United Nations provides its members with information on cash management, deposit and investment arrangements and bank ratings available for investment purposes. Access to such information would benefit the IOPC Fund by allowing them to compare their practices and policies with those of UN organisations. Although the IOPC Fund is not a member of CCAQ, it may be in a position to apply for observer status and I recommend that they explore that possibility, primarily as a means of accessing CCAQ's channel of information on international banking.

ACKNOWLEDGMENTS

48. I should like to thank the Director, Mr M Jacobsson and the Finance Officer, Mr S Nte, for their co-operation and kind assistance in helping to produce this report.

John Bourn

Sir John Bourn
Comptroller and Auditor General, United Kingdom
External Auditor

17th September 1992

Annex A

SOURCES REVIEWED

1. On the UK Legislative Framework for Banking

Banking Act 1987	HMSO
Building Societies Act 1986	HMSO

2. On the Legislative Requirements in the UN System

Financial Regulations and Rules of the United Nations	UN
Financial Rules of the United Nations Industrial Development Organization	UNIDO
Financial Regulations and Rules of the International Labour Organisation	ILO
Financial Regulations and Rules of the World Health Organization	WHO
Financial Regulations of the United Nations Food and Agriculture Organization	FAO
Financial Regulations and Rules of the International Maritime Organization	IMO

3. On Bank and Building Society Ratings

Global Ratings	MOODY 1991
Ratings Handbook	STANDARD & POOR 1992
Buildings Societies Association Building Society Branch and Staff Numbers	BSA
Handbook of the Consultative Committee on Administrative and Budgetary Questions	CCAQ

4. On Bank and Building Society Supervision

Treasury and Civil Service Committee Reports on Banking Supervision and BCCI	HMSO	Cmd 26 & 177
Registry of Friendly Socieities: Grays Building Society	HMSO	Cmd 7557
Registry of Friendly Societies: New Cross Building Society	HMSO	Cmd 9033
Building Societies Commission: Selected Annual Reports	HMSO	

5. On Investment Management in the Public Sector

Public Finance and Accountancy	CIPFA

6. On the Audit of Investments and Banking

Auditing and Reporting 1990/91	ICAEW