EBS/06/169
Correction 1

January 4, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Semi-Annual Review of Investment Account Assets**

The attached corrections to EBS/06/169 (12/19/06) have been provided by the staff to amend a factual error:

Page 3, para. 7, last sentence:

> for "The transfers came from 15 central banks, including the 12 central banks in the euro area, as well as the central banks of Japan, the U.K., and the U.S., resulting in increased reserve tranche positions of the funding members."
>
> read "The transfers came from 15 member countries, including the 12 member countries in the euro area, as well as Japan, the U.K., and the U.S., resulting in increased reserve tranche positions of the funding members."

Questions may be referred to Mr. Ordoobadi, FIN (ext. 36935).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

Corrected: 1/3/07

Deposits and MTIs are held at the BIS, while State Street Bank acts as the custodian for all other securities managed by the external managers.

6. **The risk control measures described in previous papers have been implemented**.[1]

- **Interest rate risk** is the main risk to which the portfolio is exposed, as the incremental return of the IA will be derived largely from extending maturities. This risk is controlled by the duration of the 1–3 year benchmark index, which has in the past displayed risk characteristics consistent with the IA's investment objective. A 1–3 year benchmark is widely adopted by sovereign reserve asset managers and has consistently exhibited a low probability of loss over a one-year horizon.

- To control **currency risk**, the weight of each currency in the portfolio is adjusted through monthly rebalancing to reflect the weight of that currency in the SDR basket.

- **Liquidity risk** is judged to be small, given the low likelihood of an unanticipated call on the IA's assets, and further limited by the inherently liquid nature of the securities held in the portfolio.

- **Credit risk** is similarly limited in a portfolio that features BIS deposits, MTIs, the debt securities of highly rated international financial institutions, and the domestic government bonds of countries whose currencies are included in the SDR basket. Eligible securities are further limited to those rated at least A (or the equivalent) by a major credit rating agency.

- **Operational risk** arising from administrative errors or compliance failures is controlled by carefully structured due diligence reviews of external managers and custodians, the checks and balances provided by the reconciliation of portfolio valuation by managers and the custodian, stringent performance measurement and reporting requirements, and the internal controls on the Fund's operations.

III. Investment Account Funding and Portfolio Restructuring

7. **The IA was funded with a transfer from the General Resources Account of the IA of the equivalent of SDR 5.96 billion on June 20, 2006.** This transfer, which represented the amount of the Fund's General and Special Reserves, was made in the context of the Financial Transactions Plan for March–June 2006.[2] The transfers came from 15 member countries, including the 12 member countries in the euro area, as well as Japan, the U.K., and the U.S., resulting in increased reserve tranche positions of the funding members.

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[1] See EBS/06/57, paragraphs 16–22.

[2] *Enlargement and Extension of the Financial Transactions Plan for March–May 2006 to March–June 2006*, EBS/06/70, 05/22/06.

8. **Assets were initially placed in deposits with the BIS, pending the phased implementation over a period of four months of the 1–3 year benchmark that was endorsed by the Board.** The phasing plan, drawn up in consultation with the external managers, sought to balance the aim of lengthening the portfolio duration (in order to generate a return over the 3-month SDR interest rate) with the desire to limit the short-term exposure of the portfolio to large fluctuations in interest rates (see Annex).

- June 21: One quarter of the initial transfer from the General Resources Account to the IA was placed in MTIs; the remaining three quarters were placed in three BIS deposits with maturities structured to permit a phased transition to the 1–3 year benchmark;

- August 1: A further 25 percent of the IA portfolio was transferred from a maturing BIS deposit to a government bond portfolio managed by the World Bank;

- September 1: Proceeds from a maturing BIS deposit were invested in a combination of MTIs and government bond portfolios managed by two private external managers;

- October 2: The proceeds from the final maturing BIS deposit were partly invested in MTIs with the balance used to fund further the government bond portfolio managed by the World Bank.

The amounts transferred to the IA were fully invested in line with the 1–3 year benchmark by early October. The above transactions were conducted in parallel with portfolio restructuring and duration extension of trust account assets.[3]

9. **The IA portfolio is split evenly between eligible government bonds managed by external managers and MTIs issued by the BIS**. This structure is similar to that adopted for the investable assets of the trusts. Under this balanced allocation, both asset classes have similar durations, anchored to the strategic decision to adopt the 1–3 year benchmark index. Over the long run, the returns on such investments have proven to be closely correlated, but including both types of investments in a portfolio does provide some diversification benefits. MTIs have typically provided higher returns than government bonds of similar maturities, reflecting the higher underlying credit component, which is based on AA-rated financial assets. The yield differential was broadly in line with its historical average at the time of funding the IA.

Targeted Distribution of Assets among Investment Managers and the BIS

	In percent of Total
Bond Portfolio	50
JPM	8
UBS	8
World Bank	34
MTIs (BIS)	50
Total Investment Account	100

[3] See *Semi-Annual Review of Investment of PRGF-ESF, PRGF-HIPC, and MDRI Trust Assets* (EBS/06/168, December 19, 2006).