

**AMP CAPITAL INVESTORS LIMITED**

**ABN 59 001 777 591**

**DERIVATIVES RISK STATEMENT**

**(According to the Australian Prudential and Regulation Authority**

**Guidelines on Derivatives)**

**2008**

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**DERIVATIVE RISK STATEMENT**

**PART B**

**1. Responsible Party - AMP Capital Investors Limited**

AMP Capital Investors Limited (AMPCI), as investment manager, has prepared this Derivative Risk Statement (DRS) – Part B in accordance with the Australian Prudential and Regulation Authority (APRA) Superannuation Circular No II.D.7 Derivatives dated 17 February 1997 and the Derivatives Addendum dated October 1998.

**2. Objective of the DRS**

The objective of this DRS is to provide a brief description of the:

- policies that are in place for the use and control of derivatives; and
- processes and procedures that are in place for assessing compliance with those controls.

The policies and procedures described in the DRS form part of the overall investment operations in place at AMPCI that are designed to achieve the investment strategy being implemented for each fund or portfolio.

The DRS is reviewed and updated where necessary on an annual basis and approved by the AMPCI Board of Directors. The DRS is communicated internally to all persons who are responsible for managing, monitoring or implementing the investment processes of AMPCI.

### 3. Definition of derivatives

Derivatives have been defined by APRA as “a financial contract whose value depends on, or is derived from assets, liabilities or indices (the “underlying asset”).”

This definition includes futures, options, swaps, forwards, warrants and other related instruments. Derivatives do not include underwriting or sub-underwriting activity, partly paid shares or company issued options (where they arise incidentally to other investment activity and will not have a substantial impact upon the portfolio). However, AMP Capital Investors will manage these activities in accordance with the concepts of this DRS, to ensure that funds or portfolios do not accept inappropriate risk through the use of these tools.

### 4. Relationship to the investment strategy

The use of derivatives is subordinate to the investment strategy and has to be consistent with the investment objective of the fund or portfolio. Derivatives will only be used within the strategy of the fund or portfolio. Derivatives will not be used where their use will result in conflict with the strategy, objectives or constraints of a fund or portfolio. The overall investment strategy is defined and governed by:

- The relevant Investment Management Agreement (IMA) or Investment Mandates (IM) or Management Agreements (MA) or equivalent document established between the relevant client and AMPCI; and/or
- The relevant offer documentation including Information Memorandum (IME) and Product Disclosure Statements (PDS) that are provided to potential investors.

Unless specified otherwise in the investment strategy, AMPCI will not use derivatives to obtain exposure that is substantially different from that which could be obtained through physical securities. ***The investment strategy and any limits and controls specified in the IMA, IM, IME, MA, PDS or equivalent documents specified above shall take precedence over the disclosure of controls specified in this DRS.***

### ***Risk Tolerances***

The risk profile of each fund and portfolio is set out in the IMA or equivalent that is established for each fund and portfolio. The use of derivatives shall in no way compromise this.

### **5. Purpose of using derivatives**

Derivatives can be used for a variety of purposes. AMPCI permits the use of derivatives based on the following guiding principles:

- their use is within the strategy, objective and constraints set by the client;
- AMPCI does not allow for gearing of any fund or portfolio unless it is required as part of the investment strategy;
- there is always adequate underlying asset cover to meet any obligations arising from the use of derivatives;
- proper consideration is given to liquidity management having regard to the particular portfolio strategy; and
- derivatives are executed by staff that are qualified, knowledgeable and trained in the use of derivatives.

However, as noted, the use of derivatives must comply with the investment strategy, and where the investment strategy specifically states that derivatives may be used in other ways, e.g. to leverage returns, the specifics of that strategy will apply. Where concepts other than these guidelines apply, AMPCI maintains a list of such funds and portfolios.

The use of derivatives is considered an essential part of the prudent management of assets by AMPCI, with the prime objective being to enhance the total performance (including but not limited to return) of a particular fund and/or portfolio.

Derivative usage may include the following circumstances:

#### **a) Hedging**

Hedging to protect an asset or portfolio or fund against a fluctuation in market value, or to reduce the impact of such a fluctuation, including foreign

exchange hedging.

**b) Transaction efficiency and cost**

In achieving the objective of the investment strategy, AMPCI may find it effective to execute derivative transactions to achieve transactional efficiency through reduced transaction cost and/or obtaining prices that are better than the available in the physical or cash market.

**c) Investment tactical reasons**

In achieving the overall objectives of the investment strategy, AMPCI may execute derivative transactions due to investment tactical reasons. These reasons may include:

- reduction of volatility;
- controlling the impact of significant transactions on portfolio valuations;
- adjusting the yield curve;
- taking advantage of market imperfections;
- adjusting duration of fixed interest portfolios;
- adjusting asset exposure within established strategy; and
- managing credit risk.

If the Investment Manager (Team) proposes the use of a new derivative instrument or an existing instrument in a new market, such use would first have to be approved by the relevant Chief Investment Officer (CIO) or by a committee or individual(s) delegated by the relevant CIO. Approval considerations include the guiding principles specified in this DRS and the specific strategies or purpose of the particular portfolio involved. Where an instrument results in a use that differs from the Guidelines above, it will be approved by the relevant CIO.

All approvals for new instruments or derivatives that are in exception to the guiding principles are recorded manually or electronically. This record is reviewed periodically by the relevant CIOs.

In addition, the following operational aspects are considered while setting limits to derivative usage:

- ease or difficulty of measurement of potential derivative exposure;
- ease or difficulty in closing derivative position;
- market liquidity of the derivative; and
- counterparties to the derivative transaction.

To reiterate, the use of derivatives and the controls surrounding its use that are described in this DRS document are subordinate to the investment strategy and conditions specified in the IMA, IM, IME, MA, PDS or equivalent document established between the relevant client and AMPCI.

### ***Specific Limits***

#### **Fixed interest and cash portfolios**

Fixed interest portfolios are generally managed by way of reference to the duration of the portfolio. All positions, including derivative positions, must be managed in accordance with the duration requirements set out in the IMA or equivalent.

Gearing and cover requirements 2 and 5 specified in section 7 do not apply to fixed interest or cash portfolios.

#### **Foreign exchange portfolios**

Specific limits relevant to foreign exchange transactions are set out in Section 8. Section 7 does not apply in relation to foreign exchange positions.

#### **All other portfolios**

Unless specifically authorised by an IMA or equivalent, derivatives must not represent more than 50% by gross value – (i.e. no netting of sold and bought positions) of a particular portfolio or fund. In all cases any specific limits required by a client will override these general limits. Such client limits should be clearly set out in the IMA or equivalent.

In determining exposure, it is recognised that certain exposures may be obtained by way of a series of contracts (eg a 3 month futures contract each quarter to give effectively a one year exposure). This is considered to be a single exposure, as opposed to four separate exposures. It is expected AMP Capital Investors will exercise its professional judgement to determine effective exposure in such cases.

### **Property Business**

This Derivative Risk Management Statement equally applies to the Property business of AMPCI ("Property"), except for specific variations in respect of Section 7 and 8, where due to the nature of property investments, the nature of controls are as stated below:

The property business uses derivatives as an essential part of the proper management of assets managed by them, with the prime objective being to enhance the total performance (including but not limited to return) of a particular fund and/or portfolio. In no way should the use of derivatives compromise the strategy, objectives or constraints of a fund or portfolio.

In respect of Risk Analysis and Currency (Sections 7 and 8), Property performs activities according to the risk management policies and procedures of AMPCI. This document includes guidelines and controls that must be followed in respect of interest rate risk management, measurement methodology, risk parameters, operational controls, reporting and foreign exchange risk management.

Key controls that Property follows as part of the Policy are:

1. Segregation of duties is maintained in respect for functions of deal origination, deal confirmation and settlement. Property portfolio managers are responsible for deal origination and decisions making, while Finance and Investment Services (FIS) staff are responsible for deal confirmation and settlement and recording. Property portfolio managers and FIS have different management reporting lines within AMPCI.
2. The impact of interest rate exposure upon profitability of the property trusts is measured over a 10 year forecast period. Interest rate hedging is undertaken, and takes in to account current debt levels and contracted capital expenditure. A maximum hedge ratio limit is set to 100% of total projected debt in any forecast 6 monthly reporting period over a 5 year time horizon. The minimum limit is set to 50%, subject to the Earnings at Risk (EaR) limit.
3. Risk parameters and limits are set for each trust and adherence to these is

monitored every six months. EaR is set according to minimum acceptable risk threshold for each trust.

4. Foreign exchange hedging is undertaken in respect of forecast foreign exchange currency income net of foreign currency expenses and contracted capital expenditure (Translation Risk).
5. Foreign exchange hedging is undertaken in respect of the currency the fund is denominated in or the native currency value of foreign currency assets, subject to VaR limit. Hedging of foreign exchange exposure is always limited to 95% of forecast foreign exchange exposure, that is, no gearing is permitted.
6. Measurement of acceptable risk to fund net asset value, net income and cash flow is made with reference to the effect of financial market movements on the net tangible assets, revenue and expenditure and cash flows of the fund on a prospective basis at the time of transaction origination and reporting. This ensures that no individual investment, interest rate or currency exposure is looked at in isolation. In determining appropriate hedging in respect of the investment, interest or currency exposure, the management considers amongst other things, the volatility of the interest rate and currencies involved, the volatility of the cash flows generated by the investment, the cost of hedging, the size of the risk in the context of the total fund size.
7. All derivative transactions are recorded in the AMPCI systems, which are managed and controlled according to AMP IT security guidelines to maintain integrity of the information generated through the computer systems. Before approval is granted for trading in new derivative instruments, the relevant CIO or delegate is required to assess the adequacy of the supporting computer systems.

#### **6. Restrictions on the use of derivatives**

Derivative exposure combined with physical exposure should not result in a net exposure which is inconsistent with any fund's investment strategy.

Derivatives will not be used for speculation. Speculation means one of the following:

- the net exposure of the fund to an asset class exceeding the limits set out in the

fund's investment strategy;

- the fund or portfolio being outside the risk limits specified by the investment strategy;
- the fund holding uncovered derivatives outside the risk limits specified by the investment strategy; or
- in case of funds governed by the SIS Act, the fund's total portfolio being 'geared up' through derivatives in violation of limitations imposed by sections 67, 95 and 97 of the SIS Act on borrowings.

Deviations from the above restrictions may arise in the derivative positions held by AMPCI as a result of unforeseen market movements, investor contribution or withdrawal, or variation of investment parameters; however these deviations will be reported to management by the Mandate Monitoring Team and the Investment Management Team will take measures to rectify the position as soon as possible.

The Risk and Compliance Team is responsible for monitoring adherence to relevant Financial Services Legislation, Regulations, Regulatory Policy and Circulars. The contractual obligations with clients are also reflected in the mandate rules and constraints, which are monitored by the Mandate Monitoring Team.

## **7. Risk Analysis**

As in any investment decision, the use of derivatives results in various inherent risks. AMPCI has processes in place to identify, assess, remedy, monitor and manage these risks. These processes form part of the overall operation and risk management structures at AMPCI. The organisational and operational structure is also designed to ensure separation of dealing, administration and management of derivatives. This includes:

- a third party custodian and investment administrator who is independent of AMPCI, except for property assets; and
- an Investment Control Team that is separate from the Investment Management Team. This team is responsible for performing mandate monitoring and investment analytic functions, including performance attribution checks.

The major risks associated with the use of derivatives, and the relevant controls AMPCI has in place to ensure that these risks are within the relevant risk tolerance established for each fund and portfolio, are set out in the following paragraphs.

**a) Market Risk**

Market risk is one of the key risks that impact the use of derivatives and the one that can be quantifiable for risk management.

Market risk represents the risk of adverse movements in markets (including asset prices, volatility, changes in yield curve, implied option volatility or other market variables) for the derivative or underlying asset, reference rate or index to which the derivative relates. In particular, derivatives give rise to the risk that the derivative(s) used may not move identically to the underlying asset(s) value (basis risk).

Exposure to options or option related derivatives is calculated on a delta weighted basis.

The control of market risk primarily involves the use of investment strategy that includes setting up of strategic ranges for each fund and portfolio, which control the exposure to any asset class.

AMPCI manages market risks through controls in the areas of gearing and cover requirements, exposures to asset ranges and stress testing. These are described in more details below.

Gearing and Cover requirements

1. In the case of derivative positions that are held to achieve exposure, cover consists of assets that in AMPCIs professional judgement are equivalent to cash and can be converted to cash within the settlement period. The assets must be sufficient to meet all potential obligations arising from the underlying asset exposure represented by the derivative position. Synthetic cash, created by selling derivatives, may be used as part of cover. Net derivative positions may be considered where appropriate.

2. In the case of bought call option positions, no cover is required if the delta adjusted value of such options is less than 10% of the portfolio, as there is no obligation to exercise the option. Positions in excess of 10% of the portfolio require appropriate cover at the delta adjusted value. (except for fixed interest or cash portfolios)
3. Partly paid shares are not considered derivatives but nevertheless there is a potential obligation and Investment managers are expected to ensure there is appropriate cover dependent upon the exact terms and the period until payment.
4. With company issued options, as there is no obligation to exercise these and as they are often issued for no consideration, cover is not normally required. However, it is expected that if they exceed 10% of the portfolio, appropriate cover will be provided.
5. In certain circumstances AMPCI may use sold put options to acquire exposures. Where these are in readily tradeable securities and do not amount to more than 5% of the portfolio in total, cover will be calculated on a delta adjusted basis within a particular portfolio. In other cases cover will be calculated with a delta of 1 (except for fixed interest or cash portfolios).
6. Internal cash overdrafts (i.e. where there is “borrowing” within portfolios of the same fund) may exist provided they are covered by synthetic cash. For separately managed portfolios (i.e. excluding AMP Trusts and AMP Life Limited), these are a maximum of 5% of the fund or portfolio unless otherwise set out in the relevant IMA or equivalent.
7. Fixed interest portfolios and cash portfolios are managed generally by way of reference to the “duration” of the portfolio. In considering whether positions are covered, consideration is given to whether the resultant duration falls within the duration band established within the IMA or equivalent. In the absence of any specified duration band, the relevant index plus or minus one year shall be considered.
8. In case of doubt in respect of determination of appropriate cover, the CIO or

delegated committee or person shall make the determination.

#### Exposure Management

9. In using derivatives, the exposure created is considered on the basis of a delta weighted effective exposure, after incorporating all derivatives. Net exposure is restricted within the strategic ranges or limits set out in the IMA or equivalent.
10. Unless set out in the PDS or specifically agreed by the client, in the case of derivative positions acquired to remove exposure, cover consists of assets which, in AMPCI professional judgement, are considered a reasonable hedge. Net derivative positions can be considered where appropriate.
11. Short positions may arise if more of an asset is sold, using derivatives, than is physically owned. Short positions may be acquired in terms of point 10 above, if it is considered a reasonable hedge, or within sub Portfolios of an overall Portfolio where the total position is not short, or if it is allowed in the specific Strategy of that Portfolio or Fund.

#### Stress Testing

12. Regular stress testing is undertaken to determine the impact of adverse market moves on the value of portfolios and the impact of any derivative positions. Such testing is undertaken to determine if the resultant structure of the fund or portfolio remains within its strategic ranges, or results in gearing. Unless set out in a PDS or specifically agreed by the client, positions that result in gearing or a breach of ranges as a result of this testing are reviewed by senior management.
13. The monitoring, reporting and stress testing is carried out by personnel who are independent of the investment management function.

#### **b) Liquidity Risk**

Liquidity risk exists in two forms:

- a) the risk that a particular position cannot be unwound;
- b) the risk that the fund or portfolio will not be able to meet its obligations resulting from its derivatives activities.

AMPCI gives consideration to liquidity of the portfolio as part of its investment strategy decisions. These considerations include derivative transactions. AMPCI's consideration to derivative liquidity risk also includes the following controls.

1. All new types of derivative instruments need to be analysed and approved by the CIO or a CIO delegated committee or person. The analysis includes assessing the market depth of the instrument to be traded.
2. Derivative exposures are monitored by the Investment management team as part of the portfolio management process. All derivative trading will be subject to appropriate levels of overview by the Chief Investment Officer and senior Investment managers.
3. A daily portfolio liquidity report that includes exposures to derivative transactions is used by Investment managers to ensure that liquidity of the portfolio is adequately considered. This is also monitored to ensure that cover requirements for use of derivatives are satisfied.

**c) Counterparty (Credit) Risk**

This refers to the risk that the other party to the derivative transaction may not honour their obligations.

Management of counterparty risk at AMPCI includes the implementation of the following controls:

1. Each client of AMPCI may establish their risk tolerance to credit risk, as set out in the IMA or equivalent. AMPCI monitors adherence to the set risk tolerance through mandate constraints that are considered as part of investment decisions.

2. The Mandate Monitoring Team independently monitors adherence with credit constraints as set out in the IMA or equivalent.
3. Derivative transactions for exchange traded derivatives are only conducted through recognised exchanges. AMPCI periodically assesses the credit risk of the major 'clearers' it uses to facilitate these transactions.
4. In respect of 'over the counter' derivatives, AMPCI ensures that there are appropriate agreements in place with each counterparty (e.g. an International Swaps and Derivatives Association recommended agreement). Appropriateness is considered based on financial strength and reputation of the counterparty, having regard to the nature of the IMA or equivalent.
5. The AMPCI Legal team is responsible for reviewing the adequacy of legal agreements with respect to derivatives and that counterparties are able to enter such transactions.
6. Documentation such as transaction agreements and settlement details are securely held independent of the front office.

**d) Operational Risk**

According to Basel II international standard, operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

In the use of derivatives, operational risks assume significance because of the complex nature of their payment structures and calculation of their values. AMPCI values derivatives based on current industry standards. Valuation is based on independent sources of data, including counterparty confirmations.

A key control at AMPCI in the area of operational risk is the separation of duties to ensure that there is independence in monitoring and reporting on the use of derivatives, so as to reduce the potential for errors or fraud, and allows adequate cross checking and verification.

Management of operational risk at AMPCI includes the implementation of the following controls:

### **People & Responsibilities**

1. Compliance monitoring and other custodial responsibilities (including settlement) are performed and managed independently of those persons charged with managing funds. These functions have different and independent lines of reporting, including to the Board (or its delegated sub Committee), as appropriate.
2. Separation of duties within AMPCI is exercised at several levels and there are clearly nominated officers within each team responsible for each activity:
  - AMPCI has established delegations of authority limits for various levels of management with respect to deal origination ;
  - IMAs or equivalent prescribing overall risk and exposure are set by the particular client concerned and agreed through the Client Service Manager;
  - The Mandate Monitoring Team independently monitors adherence with the IMAs or equivalent and reports to Senior Management, including Client Service and Product technical teams;
  - The Performance analytics team is responsible for investment attribution checks; and
  - The AMPCI Risk and Compliance team oversees the management of operational risk and regulatory compliance.
3. Investment management and the Product technical teams are accountable to ensure that prudent portfolio/fund investment profiles exist and that they comply with all Constitution / Trust Deed and contractual requirements.
4. Client Service Manager (team) discuss and agree with the clients the risks associated with a fund or portfolio. The team also informs the relevant Investment management team of their obligations arising from the fund or portfolio profile.
5. Investment Manager (team) are accountable for the day to day risk management

of their portfolios. They are required to manage those portfolios in accordance with IMA or equivalent and the AMPCI operating procedures. They are required to monitor any breaches and take appropriate remedial action as soon as possible.

6. The accounting and settlement functions are segregated from the investment and dealing functions. The records of derivative trades are thus independently reconciled to the records of the counterparty.

### **Processes**

1. Controls are in place to confirm that all funds and portfolios remain within their portfolio profiles, whilst delivering results consistent with stated objectives in the investment strategy. This occurs through regular monitoring and reporting with:
  - Investment Managers being responsible for the day to day management and adherence to IMAs or equivalent;
  - Mandate Monitoring Team and investment analytics team responsible for monitoring and reporting to the Senior Management;
  - Product Technical Managers (team) and Risk & Compliance responsible for analysing exceptions reported; and
  - Client service managers (team) responsible for communicating mandate related information between the client and the relevant teams within AMPCI.
2. All portfolio management activities are performed in accordance with a formally documented set of delegation of authorities approved by the appropriate AMPCI Board or Board sub committee. The Mandate Monitoring Team monitors exceptions to the delegations and reports to the Senior Management for implementation of necessary corrective action.
3. Transactions are evidenced with relevant documentation in accordance with market practices before recording of these in AMPCI transaction recording and reporting system.
4. All derivative legal agreements, including custodial agreements, are reviewed by the AMPCI Legal team.

5. The Client service or Product Technical Team provides clients with information on their investments, including on the use of derivatives.
6. Portfolios are regularly marked to market on both a market value and a delta adjusted exposure basis, based on independently sourced data and according to AMPCI policy and procedures. Any departure from this because of a lack of independent data is noted. AMPCI Risk & Compliance team is required to assess the risks in such a situation and agree on suitable alternate compensating controls.
7. A review of funds and portfolios performance against mandates is completed monthly by the Mandate Monitoring Team. The team also monitors portfolio exposures and reports on its findings to the Investment and Product technical teams. A summary report is also provided to Senior Management on all compliance issues including derivatives compliance.
8. The relevant Chief Investment Officer and the delegated sector managers are responsible for ensuring that Investment Manager (team) operate within these constraints and oversee any remedial action required in the event of a breach.
9. All counterparties are requested to provide deal confirmations and settlement details to AMPCI's investment administrator, BNP Paribas Fund Services Australasia Pty Limited ('BNPP') Derivatives Operations Team (or equivalent). BNPP is independent of AMP Capital Investors, further enhancing separation of duties.

## **Systems**

1. All derivative transactions are recorded in AMPCI systems and are regularly audited by internal and external auditors to ensure controls are in place to provide comfort over integrity of the information generated through the computer systems.
2. Before approval is granted for trading in new derivative instruments, the relevant CIO or delegate is required to assess the adequacy of the supporting operating

systems.

3. Procedures are in place to ensure that all transactions are recorded in the transaction processing systems of AMPCI as soon as the deal has been confirmed to enable continued monitoring of derivatives in accordance with this DRS.

## 8. Currency

Foreign currency exposure will naturally arise from investment in overseas assets. As part of normal portfolio risk management, currency hedging may be used by AMPCI. Currency Profiles are established to ensure there is a clear understanding of the objectives, authorities and controls on such activity.

It is acknowledged that hedging activity will primarily be by way of forward contracts, but options and other derivatives may also be used. In all cases the guiding principles specified in this DRS are considered. However, “cover” may not be in strict accordance with the definitions in section 7a - Market Risk, as by definition the assets backing the foreign currency may be in shares, property etc, as opposed to “cash or cash equivalent”, while the backing for the AUD (or base currency) hedge will be the foreign currency.

In addition, the use of different currencies within blocs, or the hedging of a basket of currencies back to AUD (or base currency), as opposed to exact currency mixes, means that negative currency positions may arise. (i.e. over hedging)

Management of currency risk at AMPCI includes the implementation of the following controls:

1. The overriding principle in all cases is that there should be no gearing - the total net currency position of the portfolio must not exceed the market value of the assets - and any activity must be within the IMA or equivalent.
2. Negative currency positions that may arise are monitored and AMPCI will use its professional judgement to ensure that resultant structure is appropriate.

3. AMPCI monitors the effectiveness of all foreign exchange hedging in relation to the investment strategy.
4. AMP Capital Investors reports appropriately on all foreign exchange hedging positions.

## 9. Personnel Management

AMPCI recognises that due to the complexity and risk involved in dealing with derivatives, sufficient skills and knowledge are required to transact in derivative instruments.

AMPCI ensures that staff with appropriate skills and professional expertise are responsible for managing portfolios that include the use of derivatives. Personnel are also required to participate in ongoing training and knowledge update programs and briefings. This statement is also made available to all AMPCI staff.

Management of personnel risk at AMPCI includes the implementation of the following controls, along with people controls described under operational risk:

1. Staff expertise is considered by the relevant CIO or by a committee or individual delegated by the CIO, before approval is given to trade in new instruments.
2. All personnel responsible for the trading and administrative support of derivative securities are required to have appropriate educational qualifications and practical experience. These personnel are also required to complete ongoing professional training relating to new instruments and the law pertaining to trading and market practices, including matters related to this Statement. This is ensured by the responsible line managers.
3. The remuneration system for AMPCI staff is such that while there are performance incentives, this is capped so that there is no incentive for excessive risk taking.
4. There is proper separation of duties and staff reporting lines- refer section 7 Operational Risk.

## 10. Assessment of Controls

In addition to the review of the controls and procedures outlined in this DRS as part of the normal management functions of the personnel involved, the following assessments are conducted:

1. The CIO or by a committee or individual delegated by the CIO may request an assessment of derivative controls from time to time based on changes in the business environment, regulatory changes, organisational changes.
2. As determined appropriate from time to time there may be assessments by the Internal Audit function which operates independently of the business.
3. The Mandate Monitoring Team regularly monitors the adherence to derivative mandates and constraints and provides reports to various management levels.
4. The DRS is annually reviewed and approved by all the CIOs or by a committee or individual delegated by the CIOs.
5. The DRS is also approved by the AMPCI Audit Committee annually after considering the sufficiency, the compliance of business activity and report from the Risk & Compliance Team.
6. An Audit Committee with majority of non-executive members oversees the maintenance of adequate and an effective internal control environment.
7. The AMPCI Business Risk and Compliance Committee considers mandate breaches and provides oversight over performance of rectification actions.

## 11. External Audit

The DRS is subject to an annual external audit. The scope of the audit requires the auditors to assess and report on whether the major procedures described in this DRS have been followed and that any changes have been approved. The audit is to be conducted in accordance with Australian Auditing Standards.

## 12. Reporting

### *Internal Reporting to Board of Directors - Significant Exposures*

AMPCI provides such reports as are necessary to the Board of Directors of AMP Capital Investors and other Boards in the AMP Limited Group (or their delegated sub committees) to enable them to perform their responsibilities. Reporting with respect to compliance matters is performed with consideration to materiality and the nature of the compliance breach.

### *Reporting to Clients*

AMPCI provides such reporting to clients as is agreed and is necessary for the client to fulfil their obligations. This involves supplying a copy of this DRS, together with any subsequent changes.

On an ongoing basis AMPCI provides regular and appropriate reporting on asset exposures including the impact of derivatives, as agreed with the client. AMPCI also report on matters when, in its professional judgement, there is a significant occurrence or event in relation to the use of derivatives.

It is recognised that daily movements in markets may create compliance breaches which are beyond the control of AMPCI, and which the controls and systems are designed to identify and correct. Provided that such breaches are not material, corrected as soon as practicable and do not represent a fundamental breach in controls, such breaches will not be specifically identified or referred to in any reporting.

## 13. External Investment Managers

AMPCI may appoint external fund managers as part of its or the clients investment or product strategy. These fund managers may operate outside Australia and may not be subject to Australian regulations relating to preparation and disclosure of derivative risk management statements. AMPCI performs the following control activities to ensure reasonable derivative risk management checks are in place within

the operations of these fund managers:

1. All external fund managers, including those domiciled overseas are appointed after a due diligence process. The due diligence process includes an evaluation of the capabilities of the fund manager and a more specific evaluation of the operational and risk management capabilities. This includes a review of the risk management practices and controls, including their use and control of derivatives.
2. All external fund managers, including those located in overseas are periodically reviewed by an AMPCI appointed external investment consultants. AMPCI procedures specify the trigger points for initiating these reviews.
3. Periodic reports from external fund managers are sought and reviewed as required for assessing the operation of derivative controls. The determination of review intervals is in accordance with AMPCI procedures and is dependant upon the domicile, local regulations and investment management agreement in place with the external fund manager.
4. BNPP monitors and reports compliance and breaches to derivative mandates established with external fund managers. During setting up of the mandates with external fund managers, AMPCI considers the guiding principles of this DRS and the overall investment strategy of the fund.

#### **14. Date of Approval of Part B DRS**

This DRS have been authorised through a resolution of the AMP Capital Investors Board on 3 March 2008

## 15. Glossary

### **Asset class exposure:**

The proportion of an entity's investment portfolio that is invested in a particular asset class (for example, Australian equities or property).

### **Basis risk:**

The risk that a derivative position will not move in line with a physical position. For example, a portfolio of Australian equities may not move in line with the Share Price Index (SPI) future which is based on the All Ordinaries Index because of the different weighting of various shares.

### **CIO (Chief Investment Officer):**

AMPCI business broadly consists of Infrastructure, Property and Listed Assets-Equity-Bonds and Private Capital. Each of these businesses have CIOs within their business. References to CIOs in the DRS refer to the CIO of the relevant business.

### **Collective investment:**

A class of investments where investors' subscriptions are typically pooled and managed by an investment manager. Examples would include unit trusts, PSTs, and life insurance company pooled funds.

### **Counterparty:**

The other party with whom a

derivatives contract is made.

### **Counterparty risk:**

The risk that a counterparty will fail to perform contractual obligations (i.e. default) under a contract. This is also sometimes referred to as 'credit risk'.

### **Cover:**

i. In the case of derivative positions to achieve exposure - cover consists of assets that in the responsible party's professional judgment are equivalent to cash and can be converted to cash within the settlement period. They must be sufficient to meet all potential obligations arising from the underlying asset exposure represented by the derivative position. Short dated fixed interest securities may well be equivalent to cash but equities are not. Synthetic cash (e.g. derived by selling 10 year bond futures against the physical bonds) is also acceptable. Net derivative positions can be considered where relevant.

ii. In the case of derivative positions to remove exposure - cover consists of assets for which in the responsible party's professional judgment the derivative(s) are considered a reasonable hedge. Net derivative positions can be considered where relevant.

### **Delta:**

The expected expansion or contraction in an option premium given a change

in the value of the underlying security.

**Delta weighted basis:**

An options position equal to the market value of the underlying security multiplied by the delta.

**Derivative exposure:**

The effective proportion of an entity's investment portfolio that is invested in derivatives. For example, with a futures contract, the exposure is not the amount of margin calls (or deposits) paid but the full value of the contract.

**Discretionary individual portfolio:**

A portfolio over which an investor gives a manager or broker authority to effect transactions without prior reference to or approval from that client.

**Exchange traded derivatives:**

Exchange traded derivatives are usually traded on organised exchanges - principally the Sydney Futures Exchange and the Australian Options Market in Australia. They are typically standardised as to expiry, contract size and delivery terms.

**Excluded funds:**

Are defined in the Superannuation Industry (Supervision) Act 1993 as

superannuation funds with fewer than 5 members.

**Exotics:**

Are defined broadly as complex variations of standard derivatives.

**Forwards:**

Are legally binding agreements to buy or sell a commodity, currency or security at a fixed time in the future at a price agreed upon today.

**Futures:**

Are legally binding agreements to buy or sell a commodity or security at a fixed time in the future at a price agreed upon today (i.e. the same as a forward contract). For example, on the Sydney Futures Exchange the delivery period, quantity and quality of a futures contract is standardised and specified, while the price is set at the time the contract is opened and negotiated by competitive outcry between buyers and sellers on the trading floor or on the Exchange's computerised overnight market. At the opening of a position an initial margin or deposit is required (usually less than 5% of the value of the contract). In addition margins are required to be paid (or received) daily reflecting the profit or loss each day.

**Gearing / leveraging:**

Occurs where the level of market exposure of derivatives exceed the market value of the fund or portfolio. It can also mean a portfolio is borrowing money in order to increase exposure through the use of derivative to the underlying asset class beyond its net asset value.

**Investment Management Agreement – Investment Mandate**

The schedule or document that records the agreed investment parameters between the client and AMPCI.

**Legal risk:**

The risk that an entity may not have the legal power to enter into a derivatives contract (and is therefore not bound to perform the contractual obligations).

**Liquidity risk:**

An entity faces two types of liquidity risk in its derivatives activities: one related to specific products or markets and the other to the general funding of the entity's derivatives activities. The former is the risk that an entity may not be able to, or cannot easily, unwind or offset a particular position at or near the previous market price because of inadequate market depth or because of disruptions in the market place. The latter is the risk that the entity will not

be able to finance its derivatives activities (for example, meeting margin calls on futures contracts).

**Margins:**

'Security' deposits required for exchange traded derivatives to ensure that if the market moves against the derivatives holder during the day, extra backing is provided against potential losses.

**Market exposure (exposure):**

Market exposure (or exposure) is a financial term which measures the proportion of money invested in the same industry sector

**Marked to market:**

Recording the price or value of security, portfolio, or account to reflect its current market value.

**Market risk:**

The risk to an institution's financial condition resulting from adverse movements in (stock, bond, currency, etc.) market prices.

**Net exposure:**

The total of physical exposure and derivative exposure.

**Net position:**

The difference of all purchase and sales of derivatives.

**Net short position:**

The Net Position where the derivative positions are new sales.

**Operations risk:**

The risk that deficiencies in information systems or internal controls will result in unexpected loss. This risk is associated with human error, system failures and inadequate procedures and controls. This risk can be exacerbated in the case of certain derivatives because of the complex nature of their payment structures and calculation of their values.

**Options:**

Provide investors with the right but not the obligation to buy or sell a commodity, currency, security or futures contract. Buying options provides a means of obtaining insurance against risk in the underlying markets while still providing the investor the option of benefiting from favourable price movements. The fee for this flexibility or 'option' is a premium (likened to a once only insurance premium). Apart from their flexibility, the primary advantage of purchasing options is that they allow investors to take advantage of many different market scenarios and implement strategies whereby any potential losses are limited and are

clearly defined at the outset.

**Call option:**

Gives the holder the right but not the obligation to buy a specified commodity, currency, security or futures contract at a designated price on or before a specified date in the future.

**Put option:**

Gives the holder the right but not the obligation to sell a specified commodity, currency, security or futures contract at a designated price, on or before a specified date in the future.

**Over-the-counter (OTC) derivatives:**

Are derivatives not listed on any security exchange. OTC contracts (e.g. between banks and corporations) are custom tailored to an institution's needs and often specify commodities, instruments and/or maturities that are not offered on any exchange. Main OTC derivatives include swaps, forwards and options, which are based upon interest rates, currencies, equities or commodities.

**Physical exposure:**

Is the proportion of an entity's investment portfolio which is invested in 'physical' or actual securities, as distinct from derivative securities. For

example, equities would be regarded as physical exposure whereas equity derivatives would be regarded as derivative exposure.

**Roles:**

**Client Service Manager (Team):** responsible for communication with the client in respect of agreed mandates and communicating these mandates internally with the Mandate monitoring and the Fund / Portfolio management teams and the Product technical manager, as required.

**Product Technical Manager (Team):** responsible for monitoring compliance to client and product mandates, including derivative constraints. Also responsible for communicating AMPCI mandates to external fund managers.

**Mandate Monitoring Manager (Team):** responsible for leading the mandate monitoring team that is responsible for implementing client, product and fund/portfolio driven mandates and constraints, including derivative constraints in the mandate monitoring processes and systems. Also, the team is responsible for exception reporting of actual performance against these mandates and constraints to the Client service managers, Product technical

managers and Fund/Portfolio managers and the Risk and Compliance team.

**Investment Manager (Team):** Fund / Portfolio Manager (Team) responsible for implementing investment strategies agreed between the client and AMPCI and/or product investment strategies. This includes decisions relating to derivative transactions.

Also, the managers are responsible for carrying out pre trade compliance checks and checks on the use of derivatives based on the client agreements and the DRS.

**Investment Dealers** are responsible for executing the decisions made by the Investment Manager, including executing derivative transactions with the broker / exchange.

**Sensitivity analysis:**

Is the financial modelling technique of determining how changes in selected variables impact on overall results. For example, sensitivity analysis may be used to estimate the impact of falls in the \$A compared to the \$US on a portfolio's investment returns. Stress testing is the related modelling technique which shows the entity's capacity to cope with a series of hypothetical adverse scenarios.

**Share ratio futures:**

Are futures contracts based on the relative movements between the price of a specified share (e.g. BHP) and the All Ordinaries Index.

**Swaps:**

Are agreements between two parties to exchange (swap) their respective obligations (loan repayments or interest payments) so that they can manage their cash flows more effectively. In Australia, there are two main categories of swaps - interest rate swaps and currency swaps. Interest rate swaps are the largest of the two categories and there is no exchange of principal but rather only the stream of periodic interest payments are 'swapped' and settlement is the net difference between the two interest rate costs. Traditionally, interest rate swaps involve an exchange of fixed interest payments for floating rate payments and vice versa.

**Synthetic exposure (Synthetic cash):**

An arrangement whereby a derivative is aggregated with cash to arrive at an equivalent exposure to the physical situation (for example, combining a ten year bond future with cash, giving equivalent exposure to holding a ten year bond).

**Underlying asset:**

The asset on which the derivative contract is based. For example a BHP call option is based on BHP shares. The underlying of a derivative is an asset, basket of assets, index, or even another derivative, such that the cash flows of the (former) derivative depend on the value of this underlying

**Valuation risk:**

The risk that the valuation system incorrectly calculates a price for a derivative or its equivalent exposure.

**Warrants:**

Are the same as call options (see options) but tend to be long dated

**Yield Curve**

The yield curve is the relation between the interest rate (or cost of borrowing) and the time to maturity of the debt for a given borrower in a given currency.