



EARTHQUAKE COMMISSION
KŌMIHANA RŪWHENUA

**Statement of Investment
Policies, Standards and
Procedures - Interim**

**(For selling down of Fund post
Canterbury Earthquakes)**

SIPSP – Interim

(To be reviewed by December 2013)

Ref: 3.1.1 SIP

High Level Table of Contents

Introduction	1
Overview	1
Definitions of Key Terms	3
Chapter 1 – Investment Objectives, Philosophy and Principles	4
Overview	4
Investment Objectives	5
Statement of Investment Beliefs	6
Chapter 2 – EQC's General Investment Policies	8
Overview	8
Eligible Asset Classes and Investments	9
Approved Bank Accounts	10
Asset Allocation, Operational Ranges and Rebalancing	11
Measuring Investment Performance	12
Investment Management Structures and Mandates	13
Use of Other Derivative Financial Instruments	14
Credit Risks Management	15
Market Risks Management	16
Investment Redemptions and Liquidity	18
Appendix – Minister's Direction	19

Detailed Table of Contents

Introduction.....	1
Overview.....	1
Preamble.....	1
Governance.....	1
Earthquake Commission Act 1993.....	1
Ministerial Direction.....	1
obligations.....	1
Purpose.....	2
Audience.....	2
Contents.....	2
Definitions of Key Terms.....	3
Chapter 1 – Investment Objectives, Philosophy and Principles.....	4
Overview.....	4
Introduction.....	4
Contents.....	4
Investment Objectives.....	5
Introduction.....	5
Best practice.....	5
Safety and availability.....	5
Statement of Investment Beliefs.....	6
Philosophy.....	6
Strategic asset allocation.....	6
Higher returns = higher risk.....	6
Net of costs.....	6
Internal governance.....	7
External Resources.....	7
Chapter 2 – EQC's General Investment Policies.....	8
Overview.....	8
Introduction.....	8
Review.....	8
Trades in NZ Government Securities.....	8
Contents.....	8
Eligible Asset Classes and Investments.....	9
Introduction.....	9
NZ Fixed Interest.....	9
NZ Cash.....	9
Approved Bank Accounts.....	10
Introduction.....	10
Authorisation to hold and operate accounts.....	10
Delegation to others.....	10
Asset Allocation, Operational Ranges and Rebalancing.....	11
Asset allocation and operational ranges.....	11
Rebalancing.....	11
Measuring Investment Performance.....	12
Introduction.....	12
Benchmarks.....	12
Investment Management Structures and Mandates.....	13
Introduction.....	13
Management of NZ fixed interest and cash.....	13
Use of Other Derivative Financial Instruments.....	14
Introduction.....	14
Fixed Interest and Cash.....	14
Credit Risks Management.....	15
Introduction.....	15
NZ Fixed Interest.....	15
NZ Cash.....	15
Market Risks Management.....	16
Introduction.....	16
NZ Fixed Interest.....	16
NZ Cash.....	16
Introduction.....	17
Reporting by EQC Management.....	17
Investment Redemptions and Liquidity.....	18
Natural disaster liquidity.....	18
Other liquidity.....	18
Appendix – Minister's Direction.....	19

Introduction

Overview

Preamble The Board of EQC decided in December 2011 that, in light of the expected running down of the Natural Disaster Fund to meet Canterbury earthquake claims, the Fund should be viewed as having a short-term horizon. As a consequence, it was no longer appropriate to have a global equity exposure with its attendant volatility. This SIPSP (Interim) removes from the standard SIPSP the references to global equity investment and related issues of equity investment beliefs and procedures. It is to be reviewed by December 2013 to consider its ongoing applicability in the circumstances.

Global equity sales were to occur as a matter of priority in a phased process commencing and ending in the first half of 2012. During this process EQC was to remain style-neutral, while not having to adhere to the active-passive allocations specified in the previous SIPSP.

Sales were to occur in the following order:

Active managers:

The two 'style' managers (value and growth) in January-February.

The two 'market-oriented' managers (core) in March-April.

Passive manager:

The Common Trust Fund manager in April-May.

Governance The Earthquake Commission (EQC) is a Crown Entity acting under the Earthquake Commission Act 1993. Under this Act EQC has responsibility for the Natural Disaster Fund (the Fund).

The investments of the Fund are governed by the:

- Earthquake Commission Act 1993
- Crown Entities Act 2004, and
- Ministerial Direction.

Earthquake Commission Act 1993

This Statement acknowledges and incorporates the specific financial goals and obligations of EQC as specified by the Earthquake Commission Act 1993 (the Act). In particular, Sections 5(1)(a) and (c) of the Act address two key financial goals for EQC:

To administer the insurance against natural disaster damage provided under this Act.

To administer the Fund and, as far as is reasonably practicable, to protect its value, including by the investment of money held in the Fund.

The Commission also recognises that the Minister of Finance previously had the power under Section 12 of the Act, and now has the power under Section 103 of the Crown Entities Act 2004 (and in accordance with Section 12 of the Act), to give directions for the investment of the Fund taking account of the Crown's wider financial interests.

Ministerial Direction obligations

EQC must invest the Fund on a prudent, commercial basis.

In doing so, EQC must manage and administer the Fund consistent with:

- best practice portfolio management

- maximising return without undue risk to the Fund as a whole, and
 - avoiding prejudice to New Zealand's reputation as a responsible member of the world community.
-

Purpose The purpose of this Statement of Investment Policies, Standards and Procedures (Interim) SIPSP is clearly to state the obligations and how EQC will meet the requirements of the governance bodies listed above. This SIPSP (Interim) differs from the standard SIPSP in that it is intended to cover the period of the running down of the Fund during the rebuild of the Canterbury region following the 2010-2011 series of earthquakes. Specifically, the Board of EQC decided that the global equities asset class would be sold from the Fund during the first half of 2012.

Audience The intended audience for this SIPSP includes:

- EQC Board
- EQC Chief Executive and staff
- Audit NZ, who audit EQC, and
- The Treasury.

Contents This document contains the following.

Topic	See Page
Definitions of Key Terms	3
Chapter 1 – Investment Objectives, Philosophy and Principles	4
Chapter 2 – EQC's General Investment Policies	8

Definitions of Key Terms

Terms

The following key terms are used in this document.

Term	Definition
Approved bank	A bank with which EQC is permitted to operate a bank account: <ul style="list-style-type: none"> • under section 158 of the Crown Entities Act 2004, or • in accordance with any Ministerial authorisation currently in force (see the 'Approved Bank Accounts' topic on page 10 of Chapter 2).
EQC	Earthquake Commission as defined by the Earthquake Commission Act 1993.
Minister	Minister Responsible for the Earthquake Commission.
Ministerial Direction	Direction given by the Minister in accordance with the Act and/or the Crown Entities Act 2004. This includes the direction given by the Minister pursuant to Section 12 of the Act that came into effect on 1 November 2001.
NZ Cash	Investments in short term investments (less than one year) including: <ul style="list-style-type: none"> • Treasury Bills, and • Bank 'Bills' (RCDs, Bank Bills, Term Deposits). NZ Cash as defined in this document excludes funds held on call or in the current account for working capital requirements.
NZ Fixed Interest	Investments in NZ Government Stock and NZ Inflation Indexed Bonds as issued by the New Zealand Government or Reserve Bank of New Zealand.
NZ Government Securities	Investments in any NZ Government issued securities, including: <ul style="list-style-type: none"> • NZ Government Stock • NZ Inflation Indexed Bonds, and • NZ Treasury Bills.
NZ Government Stock	Investments in NZ Government-issued Stocks and Bonds, but excluding NZ Government-issued Inflation Indexed Bonds.
NZX	New Zealand Stock Exchange.
NZX Indices	Market standard indices currently released by NZX. These were formerly released by CSFB and known as the CSFB Indices.

Chapter 1 – Investment Objectives, Philosophy and Principles

Overview

Introduction

Investment objectives listed in this topic are subject to Ministerial Direction.

EQC has developed the Statement of Investment Beliefs (described in this topic) to ensure investment values that relate to these objectives are:

- communicated
 - aligned, and
 - understood across EQC.
-

Contents

This chapter contains the following topic.

Topic	See Page
Investment Objectives	5
Statement of Investment Beliefs	6

Investment Objectives

Introduction The current investment objectives that EQC needs to ensure are in this topic.

Best practice Maintain the safe-keeping of assets in accordance with best practice.

Safety and availability Ensure as far as possible at all times the safety and availability of the Fund. This is in order to meet all claims on EQC taking account of and in conjunction with other financial risk management alternatives available to EQC.

Statement of Investment Beliefs

Philosophy

EQC believes that successful investment organisations must develop and adopt a clear set of investment beliefs to ensure investment values are communicated, aligned and understood across an organisation.

Accordingly, EQC has developed this Statement of Investment Beliefs.

This is a philosophical statement that:

- guides EQC in its development of its investment organisation, investment policies and actions of the investment operations.
- guides management and administration of the assets of the Fund in a consistent manner that reflects the:
 - views of the Board
 - Statement of Intent, and
 - Ministerial Direction under which EQC operates.

The fundamental principles of this Statement of Investment Beliefs are described below.

Strategic asset allocation

The strategic asset allocation is the key investment decision.

The strategic asset allocation decision:

- lies at the core of the Fund's risk and return, and
- therefore provides the greatest impact to the Fund's future returns, as the majority of returns from a given asset class are typically driven by the underlying market exposure (beta).

Note: EQC has limited scope to alter strategic asset allocation, as Ministerial approval is required to amend policy to any substantive extent.

Higher returns = higher risk

Higher levels of return are typically associated with higher levels of risk.

Net of costs

Investment returns should be considered net of costs. Costs can erode real returns and remove the apparent risk premium in an investment.

Costs can be direct or indirect and may include:

- implementation delays
- transaction costs
- fees
- commissions
- market impact costs, and
- taxation (where it is deducted at source and is non-recoverable).

**Internal
governance**

An internal governance structure that promotes decisiveness, efficiency and accountability will help in the achievement of fund objectives.

**External
Resources**

EQC operates with a small investment team and therefore will need to utilise external advisors, custodians and investment managers as required.

One external investment advisor may not be able to meet all requirements and it may be beneficial to have peer reviews for major pieces of work. Use of external resources will also be used to build internal knowledge.

Chapter 2 – EQC's General Investment Policies

Overview

Introduction

The Board will invest the Fund subject to Ministerial Direction.

This topic describes EQC's general investment policies.

Review

All aspects of the investment process and functions are to be reviewed on a regular basis.

Trades in NZ Government Securities

To comply with the Ministerial Direction, all trades in New Zealand Government Securities must be transacted only through the NZ Debt Management Office.

Contents

This chapter contains the following topics.

Topic	See Page
Eligible Asset Classes and Investments	9
Approved Bank Accounts	10
Asset Allocation, Operational Ranges and Rebalancing	11
Measuring Investment Performance	12
Investment Management Structures and Mandates	13
Use of Other Derivative Financial Instruments	14
Credit Risks Management	15
Market Risks Management	16
Reporting Requirements	17
Investment Redemptions and Liquidity	18

Eligible Asset Classes and Investments

Introduction

The Fund shall be invested in the following asset classes:

- NZ Fixed Interest, and
- NZ Cash.

Eligible investments within these asset classes shall only include those listed in this topic.

NZ Fixed Interest

NZ fixed interest investments shall consist of securities issued or guaranteed by the NZ Government or the Reserve Bank.

Investment in index-linked securities and other non-standard debt instruments will require approval from the Board on a case by case basis. In any case the maximum invested in Inflation Indexed Bonds shall be 18% of the Fund.

NZ Cash

NZ cash investments shall consist of securities that have a maturity or redemption date of twelve months or less.

These securities must be:

- issued or guaranteed by the NZ Government or the Reserve Bank, or
- issued in NZ by approved banks.

Deposits, including Term Deposits (TDs) and accounts at approved banks may be utilised.

Continued on next page

Approved Bank Accounts

Introduction Section 158 of the Crown Entities Act 2004 permits all Crown Entities to operate certain types of bank accounts.

This includes an account with a bank that is registered under the Reserve Bank of New Zealand Act 1989, and has a short term credit rating of one of the following:

If rated by...	then a credit rating of...
Standard & Poor's (S&P) only	A-1 or higher.
Moody's only	Prime-1 or higher.
both S&P and Moody's	<ul style="list-style-type: none"> • A-1 or higher from S&P, and • Prime-1 or higher from Moody's.

Authorisation to hold and operate accounts

In addition, EQC is authorised to hold and operate accounts:

- with any bank outside New Zealand, or
- denominated in any foreign currency with a registered bank in New Zealand.

in line with its policies relating to the management of the Fund.

The same short term credit ratings that apply to New Zealand banks also apply to banks outside New Zealand.

Act reference: Authorisation to hold and operate accounts is given under Ministerial authorisation dated 27 July 2005, given under sections 158(2)(a)(i) and 158(2)(b)(i) of the Crown Entities Act 2004.

Delegation to others

EQC is authorised to delegate any of its functions or powers to (among others) an investment manager or managers or custodian or custodians.

Where EQC has appointed a custodian or custodians in relation to the Fund, and delegated to that custodian the power to operate bank accounts in relation to the Fund, the authorisations relating to operation of bank accounts referred to in the immediately preceding section will be applicable to the operation of bank accounts in relation to the Fund by that custodian.

Act reference: Delegation of functions or powers is given under Ministerial approval dated 18 July 2005, given under section 73(1)(d) of the Crown Entities Act 2004.

Asset Allocation, Operational Ranges and Rebalancing

Asset allocation and operational ranges

The Board, following its decision to remove global equities from the Fund, has decided that the following asset classes are eligible to be held in the Fund. The Ranges are the limits within which EQC Management intends to operate during the selling down of the Fund.

Asset Class	Ranges (% of portfolio)
NZ Fixed Interest	65-95%
NZ Cash	5-35%, or an absolute amount of \$1,000m

Rebalancing

Rebalancing is no longer operational given the need for liquidation and redemption of investments, particularly global equities, to meet Canterbury earthquake claims. EQC Management intends to operate within the ranges shown in the table above.

Measuring Investment Performance

Introduction The overall investment performance of the Fund shall be measured and compared to the performance of the Fund's aggregate weighted benchmarks.

Benchmarks For individual asset classes, the benchmarks against which performance will be measured are as follows:

Asset Class	Benchmark
NZ Inflation Indexed Bonds	NZX NZ Inflation Indexed Index.
NZ Government Stock	NZX NZ Government Stock Index.
NZ Cash	NZX 90-day Bank Bill Gross Return Index.

Investment Management Structures and Mandates

Introduction

EQC has ultimate responsibility for the management of all Fund assets.

EQC utilises the services of:

- external custodians to provide custody for all directly held assets.
-

Management of NZ fixed interest and cash

EQC Management is appointed to manage NZ Fixed Interest and Cash within authorised investment limits agreed by the Board from time to time.

EQC internally manages the cashflows, and resulting transactions between asset classes.

Additionally, EQC passively manages the domestic portfolio, including:

- NZ Government Stock
 - Inflation indexed bonds
 - Treasury bills, and
 - NZ registered bank Term Deposits (TDs).
-

Use of Other Derivative Financial Instruments

Introduction The policy on the use of other derivative financial instruments, including options and futures, is outlined in this topic.

Fixed Interest and Cash The Board will not use derivative securities in its fixed interest or cash portfolios.

Credit Risks Management

Introduction Credit risks associated with investments shall be managed within the constraints described in this topic.

NZ Fixed Interest All NZ Fixed Interest securities must be issued or guaranteed by the NZ Government or Reserve Bank.

NZ Cash **Approved bank ratings**
All NZ Cash securities must be issued or guaranteed by the NZ Government or Reserve Bank or issued in NZ by an approved bank with a short-term credit rating of one of the following:

If rated by...	then a credit rating of...
Standard & Poor's (S&P) only	A-1 or higher.
Moody's only	Prime-1 or higher.
both S&P and Moody's	<ul style="list-style-type: none"> • A-1 or higher from S&P, and • Prime-1 or higher from Moody's.

Exposure limited on individual banks

The manager shall ensure that no more than **25%** of the total market value of the NZ cash portfolio is invested in the securities of any one bank, subject to the overall limits that follow.

The manager may invest the NZ cash portfolio in the securities of any bank subject to the following limits:

Up to 25% of the total market value of the NZ cash portfolio in any bank rated by...	then a credit rating of...
S&P only	A-1+ or higher.
Moody's only	Prime-1 or higher.
both S&P and Moody's	<ul style="list-style-type: none"> • A-1+ or higher from S&P, and • Prime-1 or higher from Moody's.

Up to 15% of the total market value of the NZ cash portfolio in any bank rated by...	then a credit rating of...
S&P only	A-1 or higher.
Moody's only	Prime-1 or higher.
both S&P and Moody's	<ul style="list-style-type: none"> • A-1 or higher from S&P, and • Prime-1 or higher from Moody's.

Market Risks Management

Introduction Market risks associated with investment of the Fund shall be managed as follows.

NZ Fixed Interest The manager will allow the duration of the NZ Government Stock portfolio to become shorter than the duration of the benchmark over time, as Treasury issues longer-dated stock. This is in light of the manager being required to sell down the Government Stock portfolio in the course of meeting earthquake claims. The manager will engage with Treasury in regards to the maturity dates of the bonds it wishes to redeem.

NZ Cash The manager shall ensure that the duration of the NZ Cash portfolio shall not exceed 90 days.

Reporting Requirements

Introduction Reporting on the investment performance of the Fund and of individual asset classes shall be as follows.

Reporting by EQC Management EQC Management shall provide:

- monthly reports to the Board, and
- quarterly reports to the Board.

Monthly reports

These are monthly reports on portfolio performance and characteristics, including an explanation of the factors affecting the portfolio.

Quarterly reports

These are comprehensive quarterly reports that incorporate:

- performance summary and explanation

Investment Redemptions and Liquidity

Natural disaster liquidity In the event of a natural disaster requiring liquidation and/or redemption of investments, decisions on sell-down of investments and currency risk management shall be made in consultation with the Minister of Finance.

In respect of investment redemptions of New Zealand government securities, the Commission will maintain its present policy arrangements with the Treasury in respect of redeeming the Commission's holdings of Treasury bills and New Zealand government bonds, including inflation indexed bonds.

Other liquidity Liquidity for day to day working capital is to be maintained separate from the Fund in on call or cheque accounts with approved banks.

All other liquidity is to be maintained in the fund as Approved Bank deposits or NZ Government Treasury Bills, taking account of reinsurance and other financial resource arrangements.

Appendix – Minister’s Direction

Direction to the Earthquake Commission pursuant to Section 12 of the Earthquake Commission Act 1993.

- i. This direction comes into effect on 1 November 2001 and as of that date the direction dated 2 June 1998 is hereby revoked.
- ii. The Earthquake Commission (the Commission) shall invest the Natural Disaster Fund (the Fund) in:
 - a. NZ Government securities comprising Treasury bills and/or Government stock and/or Inflation-Indexed Bonds tradeable only through the NZ Debt Management Office;
 - b. global equities; and
 - c. New Zealand bank bills.
- iii. The Commission shall invest the Fund with the objectives of:
 - a. achieving an average rate of return of at least 1% per annum over the Crown's cost of borrowing over a rolling ten year period (where the Crown's cost of borrowing is measured by the change in the CSFB New Zealand Government Stock Gross Index);
 - b. subjecting the Fund to no more than 1 chance in 4 that over any 10 year period the annual rate of return will be less than the Crown's cost of borrowing; and
 - c. ensuring that there is no more than 1 chance in 30 of the Fund incurring an investment of less than negative 2% in any one financial year.
- iv. The Commission must invest the Fund on a prudent, commercial basis, and in doing so, must manage and administer the Fund in a manner consistent with:
 - a. best practice portfolio management;
 - b. maximising return without undue risk to the Fund as a whole; and
 - c. avoiding prejudice to New Zealand's reputation as a responsible member of the world community.
- v. The Commission must prepare, and adhere to, a statement of investment policies, standards, and procedures for the Fund that is consistent with paragraph iv of this direction.
- vi. The Commission must review those investment policies, standards, and procedures for the Fund at least annually.
- vii. A statement of investment policies, standards, and procedures must cover (but is not limited to):
 - a. the classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes;
 - b. the determination of benchmarks or standards against which the performance of the Fund as a whole, and classes of investments, will be assessed;
 - c. standards for reporting the investment performance of the Fund;
 - d. ethical investment for avoiding prejudice to New Zealand's reputation as a responsible member of the world community;
 - e. the balance between risk and return in the overall Fund portfolio;
 - f. the fund management structure;
 - g. the use of options, futures, and other derivative financial instruments;
 - h. the management of credit, liquidity, operational, currency, market, and other financial risks;
 - i. the retention, exercise, or delegation of voting rights acquired through investments;
 - j. the method of, and basis for, valuation of investments that are not regularly traded at a public exchange; and
 - k. prohibited or restricted investments or any investment constraints or limits.

- viii. The Commission must consult with the Minister of Finance (the Minister) if it intends to modify the statement of investment policies, standards, and procedures to any substantive degree.
- ix. The Commission must consult with the Minister if it intends to modify the portfolio composition from the following:
 - a. NZ Government securities;
 - b. up to a maximum of 35% of the market value of the Fund in global equities; and
 - c. up to a maximum of \$250 million of New Zealand bank bills.
- x. The Commission must consult the Minister if it forms the intention to cover its pre-disaster currency exposures and may not proceed with the implementation of a hedging strategy without the consent of the Minister being first had and obtained.
- xi. In the event of a major natural disaster likely to involve claims on the Commission in excess of \$250 million the Commission must consult with the Minister before liquidating any part of the investment portfolio of the Fund apart from the holdings of New Zealand bank bills.
- xii. If the Commission considers at any time that any provision in this direction is inconsistent with another provision in this direction or any other direction under Section 12 of the Earthquake Commission Act 1993 or any provision under that Act it shall advise the Minister of that inconsistency.



Hon Dr Michael Cullen
Minister of Finance

30 October 2001



Office of Hon Bill English

MP for Clutha-Southland
Deputy Prime Minister

Minister of Finance
Minister for Infrastructure

14 SEP 2011

EARTHQUAKE COMMISSION

16 SEP 2011

WELLINGTON

Mr Michael Wintringham
Chair
The Earthquake Commission
PO Box 790
Wellington 6140

Dear Mr Wintringham

Pursuant to section 12 of the Earthquake Commission Act 1993 I now issue a new Ministerial direction to The Earthquake Commission. The direction takes effect from Thursday 15 September 2011, and expires on 14 September 2014. I intend to publish the direction in the Gazette and present a copy of it to the House of Representatives as soon as practicable.

Yours sincerely

Hon Bill English
Minister of Finance

COMMERCIAL-IN-CONFIDENCE

Direction to the Earthquake Commission pursuant to Section 12 of the Earthquake Commission Act 1993

1. This direction comes into effect on 15 September 2011.
2. As of 15 September 2011, paragraph 2 of the direction dated 30 October 2001 is revoked and replaced with the following:
 2. The Earthquake Commission (the Commission) shall invest the Natural Disaster Fund (the Fund) in:
 1. NZ Government securities comprising Treasury bills and/or Government stock and/or Inflation-Indexed Bonds tradeable only through the NZ Debt Management Office;
 2. global equities; and
 3. New Zealand bank securities, including New Zealand bank bills and deposits, held only in Banks which are registered under the Reserve Bank of New Zealand Act and which have a short term credit rating of A-1 or higher; Prime 1 or higher; and if rated by both Moody's and Standard and Poors, ratings from both which equal or exceed the foregoing ratings. Funds invested in New Zealand bank securities shall be held across a number of banks.
3. As of 15 September 2011 paragraph 9 of the direction dated 30 October 2001 is revoked and replaced with the following:
 9. The Commission must consult with the Minister if it intends to modify the portfolio composition from the following:
 1. NZ Government securities;
 2. up to a maximum of 35% of the market value of the Fund in global equities; and
 3. up to a maximum of \$2,000 million of New Zealand bank securities.
4. All other parts of the direction dated 30 October 2001 are unchanged and remain in effect.
5. This direction is in effect from 15 September 2011 to 14 September 2014. As of 15 September 2014 this direction is revoked.



Hon Simon William English
Minister of Finance

13 September 2011