B.29[03a]

In 2001 we reported on the Accident Compensation Corporation's (ACC) Investment Policies and Practices[1]. The article set out how much ACC invested, where the funds were invested, how investments were chosen, and how ACC managed the investments from an operational and governance perspective.

We concluded that ACC had an active approach to managing investment of its funds, compared to other funds held by the Crown. This active approach resulted in strong investment returns, but invariably presented greater risks that ACC had managed well.

This article reports on ACC's investment performance for the year ended 30 June 2002. It also discusses ACC's hedging policy and notes that ACC made a $100 million hedging gain in 2001-02, which largely offset a $142 million loss on New Zealand and offshore investments.

How Much Is Invested

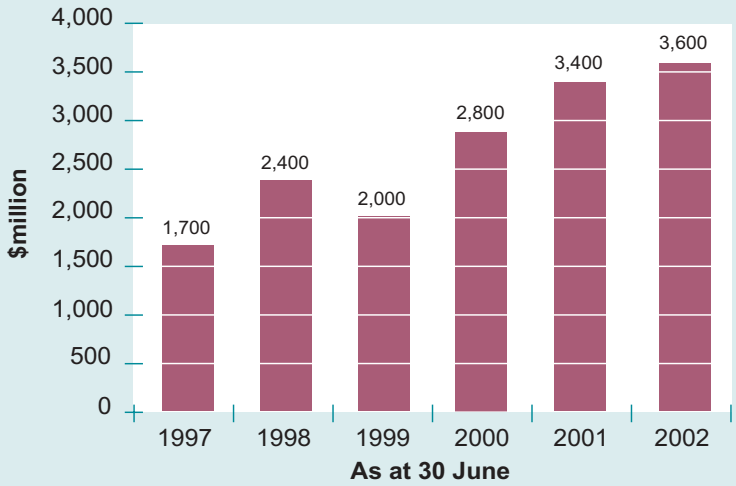
Current Investments

5.1 As at 30 June 2002, ACC had $3,600 million worth of investments and, during the year, earned $129 million of net investment income, comprising $176 million in interest and dividends, a $42 million net loss on debt and equity investments, and investment expenses of $5 million.

5.2 Figure 5.1 on the next page shows the growth in ACC's investments over the last six years.

1 *Central Government: Results of the 2000-01 Audits*, parliamentary paper B.29[01b], pages 47-61.

Figure 5.1
Total Investments 1997-2002



5.3 Figure 5.1 shows that investments have increased from $1,700 million at 30 June 1997 to $3,600 million at 30 June 2002. The decrease in 1999 was due to the closure of the Employers' Account for 12 months, as a result of the introduction of the Accident Insurance Act 1998. The Act stopped ACC from providing accident insurance in the workplace.

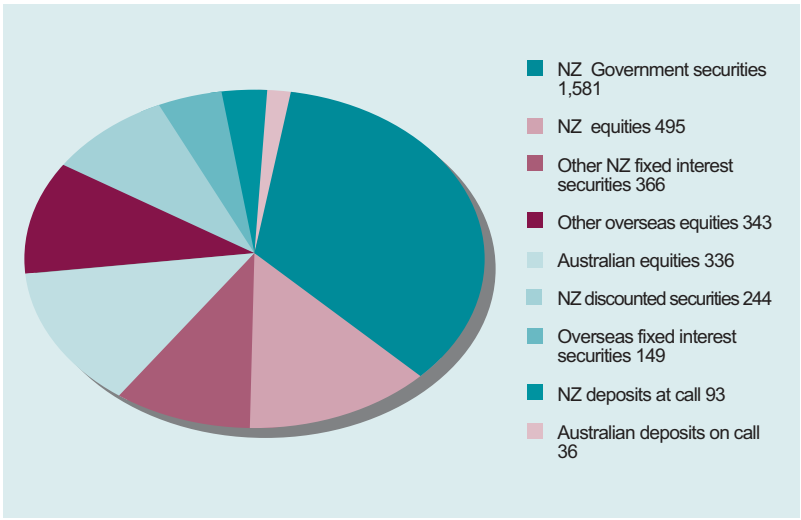
Future Growth

5.4 ACC investments are expected to increase significantly over the next 10 years – to more than $8,000 million. Broadly, this is because ACC now collects sufficient premiums each year to pay for all costs associated with injuries – regardless of whether the costs of the injury are incurred in the short or long term. This is known as a fully-funded regime.

Where the Funds are Invested

5.5 Figure 5.2 below sets out where ACC has invested its funds.

Figure 5.2
Investment Portfolio as at 30 June 2002 ($million)



5.6 Compared to other institutions, ACC invests a larger portion of its funds in New Zealand investment markets. We explained the reasons for this in our 2001 article (see Footnote 1 on page 51).

Investment Returns for 2001-02

5.7 The net investment returns of $129 million were $121 million below the budgeted returns of $250 million. The main reason for the lower-than-expected returns was the decline in world equity markets during the year.

5.8 Although below budget, the overall return was good considering the decline in world equity markets. A number of factors contributed to the result, including:

- that ACC invested a relatively large percentage of its funds in New Zealand investment markets;
- the resilience of the Australian equity markets; and
- a $100 million hedging gain (see paragraphs 5.14-5.22).

Returns Against Benchmark

5.9 In our 2001 report we stated that, because investment markets are volatile and unpredictable, ACC's practice is not to set a specific monetary level of return on investments. Rather, relative performance is measured by reference to a recognised market benchmark. We also set out how market benchmarks work.[2]

5.10 Figure 5.3 on the next page sets out the investment returns, measured against the relevant benchmarks, for 2001-02. The returns have generally exceeded benchmark rates.

5.11 ACC's target was to achieve at least benchmark rates of return for 2001-02 and for the average of the previous three years. Returns exceeded targets for eight out of 10 benchmarks for 2001-02, and for six out of eight benchmarks for the average of the last three years.

2 Ibid., page 54.

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Figure 5.3
Returns from Investments

Category of Investment	2001-02			Average 1999-2000 to 2001-02		
	Return %	Bench-mark %		Return %	Bench-mark %	
NZ Cash Portfolio	5.71	5.46	✔	6.06	5.90	✔
NZ Equity Portfolio	4.37	2.73	✔	11.05	2.93	✔
Australian Equity Portfolio	1.66	(2.67)	✔	n/a	n/a	✔
Reserves Cash	5.43	5.40	✔	5.87	5.85	✔
NZ Bonds	7.81	7.32	✔	7.68	6.71	✔
NZ Listed Property	18.37	14.38	✔	n/a	n/a	
NZ Index Linked Bond Portfolio	8.10	8.16	✗	7.86	8.05	✗
Offshore Bonds	6.24	10.59	✗	6.78	8.63	✗
Offshore Equity – Developed	(19.53)	(22.24)	✔	(3.76)	(7.41)	✔
Offshore Equity – Emerging	(10.61)	(16.60)	✔	1.26	(3.53)	✔

✔ = Actual return has met or exceeded ACC's benchmark rate of return.

✗ = Actual return was less than ACC's benchmark rate of return.

n/a = not applicable.

The source for the data is ACC's 2001-02 Annual Report.

Equity Investments

5.12 Of note are ACC's returns on both New Zealand and offshore equity investments. In 2001-02 the New Zealand equity portfolio returned 4.37% compared with a benchmark return of 2.73%. Moreover, the average return for the last three years was 11.05% compared to a three-year benchmark return of 2.93%. These are good returns, and support ACC's confidence in outperforming the New Zealand equity market benchmark.

5.13 Secondly, both the Offshore Equity – Developed and Offshore Equity – Emerging portfolios suffered negative returns of -19.53% and -10.61%, respectively. The result was not unexpected, given the decline in world equity markets during the 2001-02 year, but it is pleasing to note that ACC's losses were below those reflected in the relevant benchmarks. It was able to "limit the damage".

2001-02 Hedging

The Results of Hedging

5.14 There are good reasons for ACC entering into foreign exchange contracts. First, hedging asset values allows ACC to invest funds offshore without taking any significant exposure to movements in foreign exchange rates. Any foreign exchange losses on the value of offshore investment assets will tend to be covered by gains in the associated exchange hedges.

5.15 Secondly, ACC's obligations to claimants are paid in New Zealand dollars, but the majority of its investments are in overseas currencies. Accordingly, there is the risk that the value of ACC's offshore investments will vary depending on the fluctuation of the New Zealand dollar relative to its New Zealand dollar liabilities. Foreign exchange contracts provide ACC with the opportunity to reduce or eliminate exchange rate variances by allowing it to convert foreign currency gains into New Zealand dollars at a pre-determined rate.

5.16 Included in the $42 million realised and unrealised debt and equity loss, was a currency hedging gain of about $100 million. This means the actual losses suffered were $142 million, with the final result being improved by the $100 million hedging gain.

5.17 ACC "hedges" the majority (see paragraph 5.20) of its foreign currency assets. It does this through a series of forward foreign exchange contracts (usually monthly or three-monthly contracts) under which ACC agrees to buy or sell a quantity of foreign currency at a fixed rate for delivery at an agreed date. The forward rate of exchange is set at the time of the agreement.

5.18 Depending on the movement in the New Zealand dollar exchange rate in comparison with the agreed contract exchange rate, a gain or loss on the contract arises.

5.19 For example, on 1 May 2003, a person enters a forward foreign exchange contract whereby they agree to buy $US100 on 30 June 2003 at a fixed rate of US$0.60 = NZ$1 – a total of NZ$167. However, at the date of settlement on 30 June, the actual exchange rate was US$0.50 = NZ$1. Thus, if the person had left buying the US$100 until then, it would have cost NZ$200. The person can be said to have made an exchange rate gain of the difference, i.e. NZ$200 – NZ$167 = NZ$33 (disregarding the cost of the contract).

5.20 In 2001-02, ACC made about $100 million on these contracts. As at 30 June 2002, ACC had forward foreign exchange contracts for about $678 million – about 78% of total offshore investments of $865 million.

5.21 The exchange rate gains generated by ACC occurred because the ACC's investment team took a view that the New Zealand dollar would not fall as rapidly over the long-term as was implied by forward foreign exchange markets. This view accounts for ACC hedging a relatively high percentage of its offshore assets. So far, that view has proved correct. However, should it be incorrect, then there is a risk that ACC will experience exchange rate losses.

5.22 ACC would expect to lose money on hedging if the New Zealand dollar fell by more than 3% over a year against a basket of foreign currencies dominated by the United States dollar, Euro, British pound, Japanese yen, and Australian dollar.

Managing Risk

5.23 We have previously warned of the dangers associated with government organisations entering forward foreign exchange contracts and have said that, where these contracts exist, it is critical that the relevant Boards have policies in place to minimise their long-term foreign exchange risks.[3] In particular, when managing foreign exchange risks, Boards need to:

- Set out their objectives as to what they are aiming to manage, and why.
- Ensure that policies and procedures are sufficiently detailed to give effect to the objectives.
- Require that they receive sufficient information to enable them to understand clearly and fully the exposure that their entity has to foreign exchange risk. This information should include known and anticipated changes in business conditions and the effect that these could have on the entity's exposure.
- Require that, where the policies are not being complied with, the Board be advised immediately of the extent of the exposure as well as an action plan to ensure a return to compliance.
- Provide for a suitably qualified external party to periodically review the policies. This review should include a comparison with other participants in their industry, as well as current trends in foreign exchange management. Any changes to the policies should be subject to detailed analysis in the light of any known or anticipated changes in business conditions.

3 *How Are State-Owned Enterprises Managing Foreign Exchange Risk?*, parliamentary paper B.29[99a], pages 89-104.

5.24 The dangers of taking forward foreign exchange contracts are more particular to organisations hedging future export receipts or import-related costs. In those circumstances, there will often be a much higher degree of uncertainty as to what the underlying foreign exchange exposure will be, and how it might correlate to other factors such as commodity prices. Indeed, not entering foreign exchange contracts may be the more risky position when foreign assets are involved.

5.25 While acknowledging this distinction, it is important that all organisations undertaking hedging operations, including ACC, have sound policies and procedures in place to limit the adverse consequences that may arise from hedging. We are satisfied that ACC has such policies and procedures.