
Section 1

Overview of the role, structure and governance arrangements of the Reserve Bank

Overview

The Reserve Bank is New Zealand's central bank and is constituted under the Reserve Bank of New Zealand Act 1989 (Reserve Bank Act).

As New Zealand's central bank, the Reserve Bank has primary responsibility for the promotion of a sound and efficient financial and monetary system. Its ultimate goal is to promote and maintain a financial and monetary system that enables New Zealanders and others to conduct their business and make financial decisions in the context of a financial system that is stable, reliable and efficient, using a currency that largely holds its value through time. This goal suggests a close inter-relationship between the promotion of price stability and financial stability.

The Bank seeks to meet the goal of a stable financial and monetary system in a number of ways:

- **Monetary policy.** The Bank conducts monetary policy with the aim of maintaining a stable level of prices.
- **Bank registration and supervision.** The Bank registers and supervises banks, and is responsible for responding to financial system distress, to promote a sound and efficient financial system.
- **Payment and settlement system.** The Bank operates the settlement system by which banks settle obligations between each other, and seeks to promote a robust and efficient payment system.
- **Management of foreign exchange reserves.** The Bank maintains foreign exchange reserves to enable it to intervene in the foreign exchange market should that be considered necessary.
- **Issuer of the currency.** The Bank is the sole issuer of currency in New Zealand.

The governance framework

In order to ensure that the Bank conducts its functions effectively, the Bank is subject to a comprehensive governance framework. This framework involves a number of elements, including:

- specification of the Bank's core objectives;
- assignment of responsibility for meeting those objectives;
- transparency of the Bank's objectives and performance;
- a structure for ensuring that the Bank's performance is closely monitored; and
- robust accountability arrangements.

These governance elements are discussed below.

Objectives

The Reserve Bank Act sets the objectives for the core functions of the Bank and thereby provides the basis for the Bank's accountability.

Price stability. The high level objective for the Bank's principal function – monetary policy – is set out in the Reserve Bank Act. Section 8 of the Act states that the Bank shall conduct monetary policy for the purpose of achieving and maintaining price stability. The Act requires a specific monetary policy target to be agreed between the Treasurer and Governor.

A sound and efficient financial system. The Act specifies that the Bank's powers to register and supervise banks must be exercised for the purposes of promoting the maintenance of a sound and efficient financial system and to avoid significant damage to the financial system resulting from the failure of a bank.

Assignment of responsibility for meeting objectives

In most aspects of the Bank's functions, authority for exercising the Bank's powers is assigned to the Governor.

In the area of monetary policy, the Governor has sole authority to make policy decisions. The Governor is also the sole decision-maker in respect of most of the Bank's other functions, such as in the area of bank registration and banking supervision, and in respect of the general administration of the Bank.

However, the Act does provide a number of checks and balances in the delegation of authority to the Governor, including:

- The clear specification of the monetary policy target, thereby reducing the scope for the Governor to take monetary policy in a direction that departs from the agreed objectives.
- Strong transparency requirements, allowing close public monitoring.
- Comprehensive performance monitoring and accountability arrangements. As noted below, the Board of directors of the Bank has responsibility for monitoring the performance of the Governor across all of the Bank's functions.

Transparency arrangements

Transparency strengthens the incentives for sound policy by enabling interested parties to assess for themselves the appropriateness of the objectives and the initiatives taken to meet those objectives. It is also a mechanism for conferring legitimacy on the Bank's powers, reinforcing the point that, with operational autonomy comes the responsibility to exercise those powers under the scrutiny of the public.

In the area of monetary policy, the objective of policy is publicly disclosed in the Policy Targets Agreement. Moreover, the Bank is required to issue at least every six months a Policy Statement that specifies the policies by which the Bank intends to achieve the policy target, states the reasons for adopting those policies and reviews and assesses monetary policy implementation.

In the area of bank registration and supervision, the Bank is required to publish a statement setting out the principles on which it acts in carrying out its registration and supervision functions.

In addition, the Bank must issue an annual report, together with externally-audited financial statements, setting out the Bank's actions for the year under review and its financial performance (against budget).

In practice, the Bank goes well beyond the requirements of the Act in its transparency. For example, it issues Monetary Policy Statements on a quarterly basis. In addition, the Bank produces a great deal of information for the public to explain its thinking on policy issues.

Performance monitoring

Under the Act, the Board has responsibility for monitoring the performance of the Bank and Governor across all the Bank's functions on a continuous basis. In addition to its monitoring function, the Board also has the authority to give advice to the Governor on matters relating to the conduct of the Bank's functions and administration of the Bank.

The Board comprises a majority of non-executive directors appointed by the Treasurer. Although the Board is currently chaired by the Governor, the monitoring function is undertaken by the non-executive directors.

As a result of the monetary policy review undertaken in late 2000/early 2001, legislation has been introduced to remove the Governor as chair of the Board and to provide for the chair to be appointed from among the non-executive directors. In addition, the legislation will remove the Deputy Governor from the Board and require the non-executive directors to issue an annual report setting out their assessment of the Bank's and Governor's performance.

The Bank and Governor are also subject to ongoing assessment by Parliament's Finance and Expenditure Committee. The Committee's capacity to scrutinise the Bank has recently been enhanced by the appointment of a part-time economist to advise the Committee. The Bank's performance is also kept under constant review through the financial markets, news media and private sector economists.

Accountability

A further element in the governance arrangements is the accountability for its policy decisions. Under the Act, the Board is required to advise the Treasurer if it is satisfied that, among other matters, the Bank has not adequately carried out its functions, the Governor has not adequately discharged the responsibilities of office or the Governor's performance in ensuring that the Bank meets the policy target in the PTA has been inadequate. In these circumstances, the Board may recommend to the Treasurer that the Governor be removed from office. Where the Treasurer is satisfied that the criteria set out in the Act for the removal of the Governor have been met, he or she may advise the Governor-General to remove the Governor, with or without a recommendation from the Board.

More generally, and of greater day-to-day relevance, the regular scrutiny from the public, news media, financial markets and others creates very strong incentives to clearly identify and explain the Bank's policy thinking and actions.

Financial and Risk Management

Responsibility for the Bank's financial management and use of resources rests with the Governor, with advice and oversight from the Board. An Audit Committee, comprising three non-executive members of the Board, monitors the accounting practices and policies and internal control systems of the Bank. The Committee also reviews the internal audit function and has direct access to the external auditor.

Funding structure

The Bank's main source of income is the return on investments funded by the issue of currency in circulation and by the Bank's equity. Currency in circulation effectively represents an interest-free loan from the public, the proceeds of which are invested in government bonds.

Under the Act, the Treasurer and Governor are required to enter into funding agreements to specify the amount of income of the Bank that may be used to meet the Bank's expenses in each financial year. The funding agreement must

be tabled in Parliament and does not become effective until ratified by a resolution of Parliament.

The Act makes provision for each funding agreement to apply for a period of five consecutive financial years. This contrasts with the arrangements for government departments, which are funded on an annual basis. The funding arrangements for the Bank are designed to strike an appropriate balance between the need for the Bank to retain a credible degree of operational independence, while also ensuring accountability.

The current funding agreement, signed in May 2000, covers the five years to 30 June 2005. The level of current year (2002/03) funding amounts to \$31 million. In addition, each year the Bank retains income earned from a range of sources.

The Act requires the Bank to calculate the amount of its income that exceeds the agreed level of operating expenditure in the funding agreement. The Treasurer, after consulting the Bank's Board, decides whether the surplus should be added to the Bank's reserves or paid to the government as a dividend. In addition, the Act provides that any expenditure savings made against the funding agreement levels must be added to the Bank's reserves, while any deficiencies must be deducted.

Expenditure performance

Total operating expenses for the 2001/02 year amounted to \$35.7 million, 4.6 per cent below the budgeted amount of \$37.4 million. Net expenditure under the funding agreement amounted to \$24.9 million, \$6.1 million below the limit of \$31 million.

Management of risks

As a government agency with major policy responsibilities and as a financial institution with a large balance sheet, the Bank faces a wide range of risks. The fundamental risk is associated with our policy responsibilities – the risk of making monetary or financial policy errors. We take these risks particularly seriously, given the potential for monetary policy to have detrimental effects on the economy and the importance of credibility to the effectiveness of a central bank.

Figure 1
Operating expenses under the funding agreement

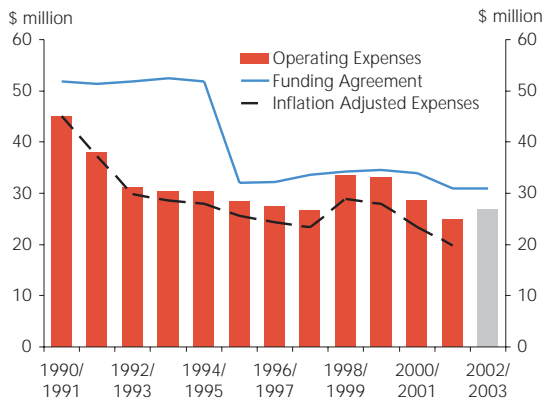


Figure 1 shows the Bank's expenditure between 1990/91 and 2001/02. Figures 2 and 3 show operating expenses by function and type for recent years.

Figure 2
Operating expenses by type

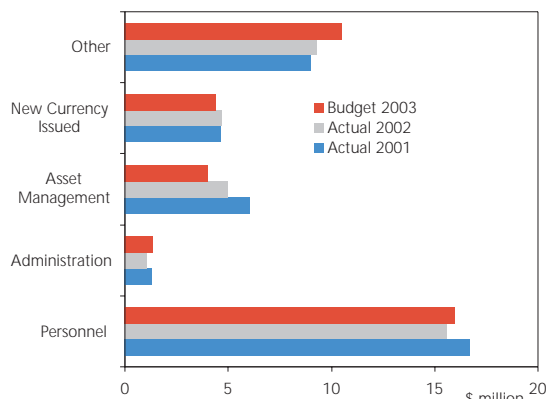
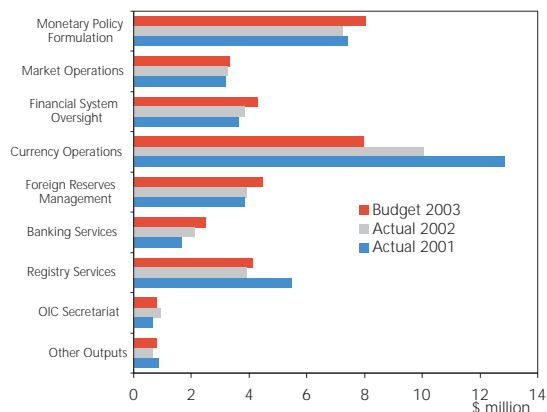


Figure 3
Operating expenses by function



In addition to the reputation risks and potential costs to the economy associated with our policy functions, the Bank also faces a number of financial risks. These mainly arise because of the Bank's dealings with registered banks and because of the size and nature of the Bank's balance sheet.

The risks include:

- Credit risks and market risks associated with our day-to-day dealings with financial institutions in the process of managing liquidity in the financial system.
- Risks associated with our holding of foreign currency reserves, including credit risk, interest rate risk and exchange rate risk. As part of the management of reserves, the Bank takes active positions in international interest rate and foreign exchange markets. These activities are undertaken within tight risk constraints and have been moderately profitable, but do expose the Bank to potentially substantial financial risks.
- Risks associated with the processing and storage of currency, including the risks of theft;
- The risks associated with facilitating large value securities transactions via Austraclear.
- Operational risks in a range of areas in the Bank.

The Bank also faces risks associated with being a small organisation, such as the loss of key staff and associated corporate memory.

In order to ensure that all of the Bank's risks are well identified, monitored and managed, the Bank has developed a strong risk management culture and a number of management systems and internal controls based on best international practice and honed through experience.

We seek to manage the risks associated with monetary policy errors by supplementing economic forecasts with an active process of talking to the business community. We also involve a broad diversity of view in the policy formulation process, both through the involvement of a range of staff in advising the Governor and by engaging two part-time external advisers to supplement advice from staff. The Bank also periodically engages foreign central bankers to provide peer reviews of our monetary policy process.

The Bank has two units with specific responsibilities in relation to monitoring and managing risk. These are:

- The Bank's Risk Assessment and Assurance Department, responsible for risk monitoring. The internal audit role also resides in this department.
- A Risk Unit within the Bank's Financial Markets Department, which provides specialised advice on interest rate risk, credit risk and liquidity risk limits.

In addition, the Board of Director's Audit Committee contributes to the Bank's risk management processes and has overview responsibility for the internal and external audit processes.

Organisational structure

Under the Act, the Governor is the Bank's chief executive officer, appointed by the Treasurer on the recommendation of the Board of directors. The Treasurer is unable to appoint a Governor without a recommendation from the Board. This structure provides a form of "double veto", thereby strengthening the credibility of the Bank's operational independence.

The Governor is appointed for a term of five years, with facility for a renewal of term by the same process as for the original appointment.

The Act requires the appointment of a Deputy Governor as a Deputy Chief Executive, where the appointment is made by the Board on the recommendation of the Governor for a term of five years, with a facility for renewal of term. The Act enables, but does not require, a second Deputy Governor to be appointed. At present, the Bank has only one Deputy Governor, Roderick Carr, who is currently Acting Governor.

The Bank's functions are generally conducted within departments, although a number of functions are managed across different departments, either by way of committee or through cross-department project management. The organisation chart is set out opposite:

In recognition that many of the issues the Bank deals with straddle a number of departments, the Bank makes extensive use of committees, the membership of which includes senior

staff in addition to those directly responsible for the decisions being made. The main committees are:

- the Monetary Policy Committee (MPC) which meets weekly to advise the Governor on economic and financial developments;
- the OCR Advisory Group, which comprises a subset of MPC plus two part-time external advisers, and which has responsibility for advising the Governor on monetary policy decisions;
- the Financial System Oversight Committee, which meets monthly to consider policy issues relating to the financial system's soundness and efficiency;
- the Risk Management Committee, which meets monthly to consider risk management frameworks for the Bank's activities;
- the Reserves Oversight Committee, which meets quarterly to consider the Bank's foreign reserves activity;
- the Governor's Committee, which meets weekly to consider the management and day-to-day operation of the Bank; and
- the Communications Committee, which meets weekly to consider communications issues and the management of reputational risk.

Reserve Bank Structure

as at 30 June 2002

| | Departments/ Managers | Functions | Internal services |
|--|---|--|--|
| Deputy Governor Rod Carr (Deputy Chief Executive and Acting Governor) | Economics Department David Archer (Assistant Governor and Acting Deputy Governor) | Monetary Policy Formulation | |
| | Financial Markets Department Michael Reddell | Market Operations Foreign reserves management | |
| | Banking System Department Peter Ledingham | Financial system oversight | |
| | Corporate Affairs Department Paul Jackman | | Reputational risk management Communications Board secretariat Governors' support |
| | Currency and Building Services Brian Lang | Currency operations | Property management Security |
| | Financial Services Group Mike Wolyncewicz | Settlement services Registry and depository services | Accounting services Treasury services |
| | Human Resources Team Tanya Harris | | Human resources strategy and services |
| | Knowledge Services Group Yogesh Anand | | Library services Data services Computer services |
| | Risk Assessment and Assurance Department Steve Anderson | | Audit services Risk assessment and assurance |
| ----- | ----- | ----- | ----- |
| | Overseas Investment Commission Secretariat Steve Dawe | Overseas Investment Commission | |

Board of Directors

Executive Director

Roderick Carr Acting Governor, Acting Chair of the Board

Non-Executive Directors

Bill Wilson, Company Director, Chair of Reserve Bank Non-Executive Directors' Committee

First appointed 1 February 1990 – current term expires 31 January 2003

Paul Baines, Company Director

First appointed 1 July 1999 – current term expires 30 June 2004

Hugh Fletcher, Company Director

First appointed 10 June 2002 – current term expires 9 June 2007

John Goulter, Managing Director

First appointed 9 February 2000 – current term expires 8 February 2005

Arthur Grimes, Economic Consultant

First appointed 1 March 2002 – current term expires 28 February 2007

Alison Paterson, Chartered Accountant

First appointed 1 February 1995 – current term expires 31 January 2005

Hon Ruth Richardson, Company Director

First appointed 4 February 1999 – current term expires 3 February 2004