
Briefing on the Reserve Bank of New Zealand

August 2002

Contents

This paper has been prepared to brief the incoming Government on the role and functions of the Reserve Bank of New Zealand. The paper is also intended to be a useful briefing to other interested parties, including Members of Parliament and the new Governor of the Bank when he or she is appointed. It has the following structure:

- Executive Summary setting out the key points contained in the briefing paper.
- Section 1 of the paper provides an overview of the Reserve Bank's functions, governance and structure.
- Section 2 discusses the formulation and implementation of monetary policy.
- Section 3 discusses the Bank's responsibilities for promoting a sound and efficient financial system.
- Section 4 covers the other functions of the Reserve Bank.

Readers wanting more detailed information on particular issues covered in this paper are referred to the material available from the Bank, either on the Bank's web site (www.rbnz.govt.nz) or in hard copy from the Bank's Knowledge Centre.

Enquiries about the Briefing in the first instance should be referred to Paul Jackman, Corporate Affairs Manager at the Reserve Bank, telephone (04) 471 3671, or email jackmanp@rbnz.govt.nz.

Summary of key issues

This paper summarises the role and functions of the Reserve Bank and identifies a range of policy issues likely to be of interest to the Government and other parties. The key issues are highlighted in this Executive Summary.

Policy Targets Agreement. Before a new Governor is appointed, the Treasurer must agree a new Policy Targets Agreement (PTA) with that person. A PTA is negotiated between the Treasurer and the Governor-designate for the term of the new Governor. This paper outlines some of the considerations the parties may wish to take into account in framing the new PTA.

Financial system stability. The Reserve Bank has an important role to play in promoting a sound and efficient financial system. It does so in a number of ways, including the registration and supervision of banks, maintaining the capacity to respond to bank distress and failure events, and facilitating a robust payment system.

The paper identifies some banking supervision issues that will occupy the Bank's attention in the next year or two. These include the need for the Bank to decide the nature of the changes it may wish to introduce to the capital adequacy requirements applied to banks in light of proposed changes to the international capital standard. We will also develop the policy requiring some banks to incorporate locally rather than operate as branches of foreign banks. And we plan to further advance the policy issues relating to the options for responding to bank distress and failure events. These are matters that will be taken forward in consultation with the banking industry and other interested parties.

Financial sector integration with Australia. The Bank is also likely to become more involved in discussions with Australian financial sector regulatory agencies on issues relating to the progressive integration of the Australian and New Zealand financial sectors and the implications for the countries' respective regulatory frameworks. Substantive progress may depend on the broader question of the future evolution of the Closer Economic Relationship between Australia and New Zealand, which is ultimately a matter for the Australian and New Zealand governments to determine.

External assessment of the financial system. New Zealand is scheduled to undergo a financial sector assessment by the

International Monetary Fund in 2003. As is the case with most countries undergoing such assessments, it is likely that the assessment will reveal some areas of non-compliance with international standards and codes in the areas of financial sector regulation and supervision. In some cases, non-compliance reflects the fact that New Zealand's approach to promoting financial stability differs from that reflected in international standards and codes, but where our arrangements nonetheless produce sound outcomes. In other cases, the assessment may identify or highlight deficiencies and gaps in financial sector regulation, although in many cases these have already been identified by officials and are on the agenda for policy reform.

Proposed amendments to Reserve Bank of New Zealand Act. A Bill has been introduced to Parliament to amend the Reserve Bank Act. The proposed amendments relate to:

- The Bank's governance arrangements. The legislation will remove the Governor as chair of the Bank's Board of directors and provide for a non-executive chair. It will also remove the Deputy Governor from the Board and require the Board to issue an annual report on its assessment of the Bank's and Governor's performance.
- The Bill will clarify and strengthen some of the Bank's powers in relation to the use of the word "bank" and in relation to bank registration and supervision. It also formalises the Bank's powers to obtain information on the payment system.

Overseas Investment Commission. The Bank provides staff and resources to the Overseas Investment Commission (OIC) Secretariat and the Governor is an ex officio member of the OIC. It is only for historical reasons that the OIC is associated with the Bank. There is now no congruence between the responsibilities of the Bank and those of the OIC; the OIC's role does not fit with the Bank's core functions. Accordingly, we propose to initiate discussions with the Government with a view to fully separating the OIC from the Reserve Bank.

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

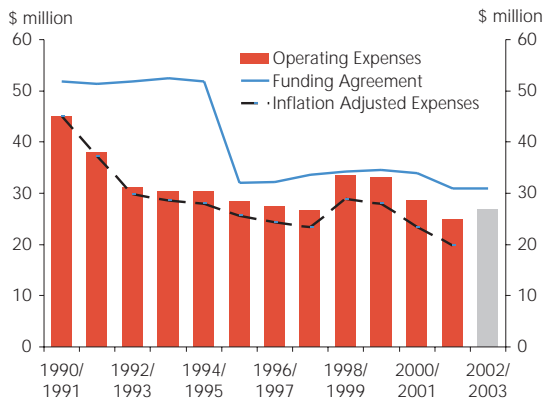


Figure 1 shows the Bank's expenditure between 1990/91 and 2001/02. Figures 2 and 3 show operating expenses by function and type for recent years.

Figure 2
Operating expenses by type

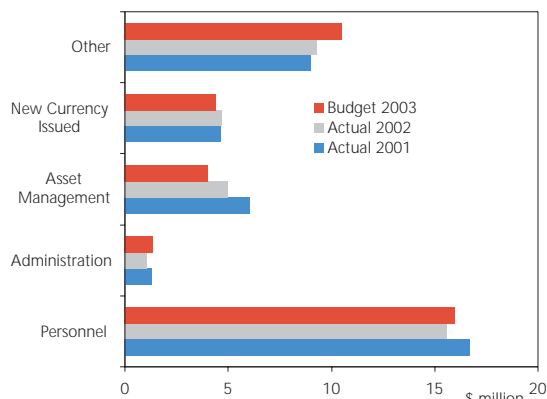
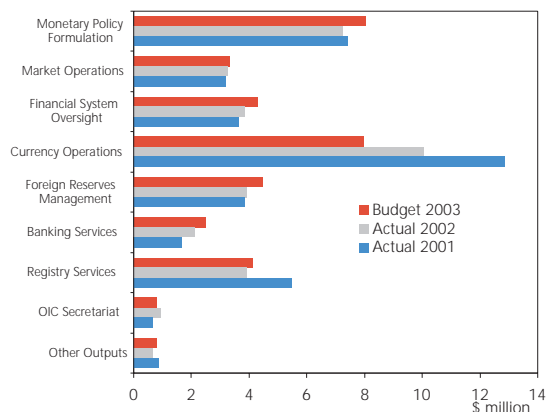


Figure 3
Operating expenses by function



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
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	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

Section 2

Monetary policy and the Policy Targets Agreement

Monetary policy is the most prominent of the Reserve Bank's core functions. Under section 8 of the Act, the Bank is required to "formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices".

Monetary policy has powerful and important effects on economic activity and key financial prices in the short to medium term. However, the statutory goal focuses on the medium to long term. Over those sorts of horizons it is now widely accepted that:

- monetary policy can only sustainably affect the inflation rate; and
- inflation itself typically has few benefits, has real economic and social costs, and should normally be avoided as far as possible.

Society typically – and rightly – places a high value on such economic outcomes as sustainable growth in real standards of living for New Zealanders, and the lowest sustainable rate of unemployment. Crucial as these goals are, they are largely beyond the ability of monetary policy to influence directly, other than over relatively short terms. It is now accepted fairly widely that any contribution monetary policy can make to achieving these goals is likely to be done by keeping inflation in check – making it one of those factors that neither shapes nor distorts the sorts of economic decisions we all have to make, as consumers, savers or investors. The Act embodies an expectation that, in keeping inflation in check, monetary policy should provide as stable as possible a backdrop against which the rest of economic life can proceed.

The Act sensibly does not define "stability in the general level of prices". Our understanding of economic issues changes through time, and the sorts of shocks the Bank is likely to face over several decades cannot be foreseen with any certainty. So the Act lays down the broad principles

against which monetary policy decisions are to be framed, but does not attempt to go further than that¹.

To provide more focus for the Bank's day-to-day monetary policy decisions, however, section 9 of the Act requires that:

The Minister [Treasurer] shall, before appointing, or reappointing, any person as Governor, fix, in agreement with that person, policy targets for the carrying out by the Bank of its primary function [monetary policy] during that person's term of office, or next term of office, as Governor.

The Policy Targets Agreement framework is designed to provide for a number of things:

- Some guidance to the public and markets as to what outcomes the Reserve Bank's monetary policy decisions will be seeking to achieve. (The targets must be published.)
- Both stability and appropriate flexibility. The targets are set for the Governor's term of five years, but can be altered during that term by mutual agreement between the Governor and the Treasurer.
- The involvement of both the Treasurer and the Governor in shaping the targets. The targets are neither imposed by the Treasurer, nor able to be set unilaterally by an unelected official, the Governor.
- A framework for holding the Governor accountable for outcomes and for the conduct of policy. The Bank's Board is charged with using the policy targets, rather than the more general provisions of section 8, as the reference point in assessing the Governor's

¹ Note that section 12 of the Act does allow the Treasurer to establish temporarily (by Order in Council) an economic objective for monetary policy other than price stability. Any such alternative objective must be fully disclosed. These provisions have not been used since the Act was passed.

performance. It is also the pursuit of these outcomes on which the Bank is required to report in the *Monetary Policy Statements* required under section 15 of the Act.

The Act does not require that the parties to the Policy Targets Agreement define price stability, which would inevitably be a somewhat arcane exercise. What they are required to do is to set policy targets that are practical and workable in the circumstances, consistent with the economic objective of price stability. These policy targets for outcomes need not be specified in terms of inflation, however it is measured. However, since the Act was passed, the previous Governor and successive ministers have consistently found the expression of an inflation target range, expressed in terms of the CPI, to be the best focus for the Policy Targets Agreement. Although New Zealand was ahead of the world in introducing inflation targets in the late 1980s, this has now become a widespread – although not universal – approach to articulating the goals of monetary policy.

There is no single ideal formulation. In a world characterised by very substantial uncertainty, it is probably impossible to sensibly write down in advance all that each of the parties (the public and the markets, the Treasurer, the Governor, and the Bank's Board) would ideally like to know. There is a balance to be struck. The framework has to leave the Governor sufficiently free to act sensibly and appropriately in the face of the unexpected. But it must also provide a reasonable degree of certainty for firms, households, and markets in more normal times, and some reasonably specific benchmarks that can form a starting point for assessing the Governor's performance. The framework should not put the Governor in a position where inappropriately specified objectives create a perverse incentive for him/her to act against the best interests of the country simply to safeguard his/her own personal position. But equally the agreement should not be so loose that the Governor is to all intents and purposes setting his/her own objectives.

A well-designed Policy Targets Agreement is important to help establish the right framework within which the Reserve Bank will react to new information and emerging pressures on prices. Nonetheless, the best possible set of targets, and the best conduct of monetary policy within the confines of

those targets, is most unlikely to change very much the overall medium-term performance of the New Zealand economy. Saying that is simply to note again the point already made that, in the longer term, monetary policy can only sustainably influence the inflation rate.

A new Governor is to be appointed in the next few months. That will involve the Minister and the Governor-designate agreeing a new Policy Targets Agreement, to replace that signed with the previous Governor, Dr Brash, on 16 December 1999.

There is no presumption in the Act that successive Policy Targets Agreements will be the same or even highly similar. Indeed, one of the purposes of the Policy Targets Agreement device is to preserve flexibility, as understandings or attitudes evolve through time. The anchor in the framework is section 8 of the Act. So long as any Policy Targets Agreement is consistent with the economic objective of price stability, the parties are free to agree as they like.

Factors that the parties may wish to consider might include:

- The benefits of continuity. Continuity is never an absolute virtue, and flexibility is an intrinsic part of the framework, but it is desirable to provide as much certainty about the broad nature of the targets for monetary policy through time as possible. Ideally, if there were to be any changes to the Policy Targets Agreement, the changes should seek to strengthen public confidence in the broad framework for the conduct of monetary policy in New Zealand, and in the enduring nature of the commitment to the statutory goal of price stability.
- The actual conduct of monetary policy in New Zealand over the period since the Act was introduced. The recent independent review of monetary policy, conducted for the Government by Professor Lars Svensson, provides much valuable material in this regard.
- The experiences other countries have had with inflation targeting. Relevant considerations might include any insights from the different ways in which the various targets are expressed and monitored, and an assessment of how monetary policy is actually

conducted and articulated in response to the sorts of pressures and shocks those countries have actually faced. Is there any evidence, for example, that New Zealand's monetary policy has been inappropriately less flexible or more aggressive than that in other comparable countries?

- An assessment of the international literature and formal research in this area. Academic research can only go so far to help policy decision-makers – if only because there is rarely a unanimous voice – but is at least a valuable input to the periodic process of review.

Section 3

Financial system oversight

The other core function of the Reserve Bank is the promotion of financial stability. A sound and efficient financial system is vital to a healthy economy, given the role played by the financial system in receiving and intermediating savings, creating and allocating credit, and facilitating commercial transactions. A stable financial system is also important for effective monetary policy, given that monetary policy is implemented through financial markets. For these reasons, the Bank places a strong emphasis on the promotion of a financial system that is reliable, efficient and robust in the face of adverse events.

The Bank promotes financial stability in a number of ways, including:

- through the registration and supervision of banks;
- by providing inter-bank settlement facilities;
- by advising government on the operation of the financial system, including in respect of banking law issues; and
- by standing ready to respond to a bank distress or failure event.

This section of the briefing paper summarises the Bank's approach to these functions and associated policy issues.

Bank registration and supervision

Under Part V of the Reserve Bank Act, the Bank has responsibility for registering and supervising banks. The powers under Part V must be exercised for the purposes of:

- the maintenance of a sound and efficient financial system; or
- the avoidance of significant damage to the financial system that could result from the failure of a registered bank.

Unlike the supervisory regimes in many countries, banking supervision in New Zealand does not seek to protect depositors per se. Nor does it seek to protect individual banks or their shareholders from the consequences of poor risk

management or adverse events. Rather, it is focused on protecting the banking system as a whole by encouraging the effective identification, measurement, monitoring and control of risks within banks.

We do this in three inter-related ways:

- Promoting sound corporate governance and risk management in banks. We place considerable emphasis on the role of bank directors in overseeing, and taking ultimate responsibility for, the management of risks in their bank. Banks must disclose comprehensive financial and risk-related information on a quarterly basis. These disclosures must be signed by bank directors as being not false or misleading. Sound corporate governance is also fostered through a requirement for all banks incorporated in New Zealand to have a non-executive chairman and at least two independent, non-executive directors on their boards.
- Promoting robust market disciplines on the banking system. A fundamental element in this is the promotion of a highly competitive banking sector through contestable markets and through a competitively neutral system of financial sector regulation. The absence of deposit insurance or other support for individual banks also reinforces market disciplines. And the provision of comprehensive financial information to the markets via banks' disclosure statements enables market participants to monitor banks' financial performance and condition.
- Ensuring an appropriate degree of supervisory discipline over banks, but in ways that do not dilute the responsibility of banks' directors and managers for ensuring that their banks are well managed. If a financial institution wants to call itself a bank, it must be registered by the Reserve Bank before commencing operations. Only a small number of quantitative limits are imposed on banks, such as a minimum \$15 million of capital for a locally-

incorporated bank, minimum capital adequacy ratios and a limit on lending to connected parties. Unlike most banking supervisory authorities in other countries, the Bank does not normally conduct inspections of banks. However, we do monitor banks closely through their quarterly public disclosures and we meet with the senior management teams of all banks on an annual basis to discuss a range of risk-related and strategic issues.

Although most of our banking supervision role is focused on promoting sound risk management in the banking system, no banking system is immune to occasional episodes of financial distress or bank failure. The Bank maintains the capacity to respond to bank distress or failure events and is equipped with a wide range of statutory powers to handle a distress situation. These powers include the ability to:

- have the affairs of a bank investigated;
- give directions to a bank, with the prior consent of the Treasurer; and
- recommend to the Treasurer that a bank and its banking group be placed into statutory management.

The Bank also has the power under the Act to act as a lender of last resort to the banking system where it considers it necessary to do so to maintain the soundness of the financial system. There is considerable flexibility as to the terms on which the Bank may provide liquidity – such as whether it takes security, the interest rate charged for the funds and the repayment terms. These are matters that the Bank would determine on a case-by-case basis.

Although the banking system is currently in a strong position, the Bank is developing strategies for responding to bank distress and failure events. One of the options currently being explored is the possibility of using statutory management to temporarily close an insolvent bank and to use the funds of depositors and other creditors to absorb estimated losses, such that the bank's doors could be re-opened for business within a few days of closure. This option presumes that the losses in the bank have already eliminated all shareholders' funds and that there is no possibility of shareholder support.

The use of creditors' funds to absorb estimated losses offers a number of advantages over some of the other options available. It would enable depositors to access a major proportion of their deposits within just a few working days of the bank's closure. And it would minimise disruption to the rest of the financial system. It would also offer the possibility of managing a major bank failure in ways that minimise the cost to, and risks for, the taxpayer, thereby strengthening market disciplines on remaining banks.

Much work remains to be done before we can conclude whether it is a feasible option. We are working closely with banks to further develop the proposal and assess its feasibility. Our aim is to complete this work in the next 2 to 3 years.

Financial and economic instability can arise from many different sources and in many different ways, particularly for a small and open economy such as ours. We have therefore created a new team in the Bank to monitor and analyse the broader financial system and capital markets to enhance our capacity to detect and respond to possible financial and economic vulnerability.

We are currently satisfied that the New Zealand economy and financial system are well placed to absorb adverse shocks, given the quality of the banks operating in New Zealand, quality of risk management in the banking and corporate sectors and the absence of any generalised asset price bubbles in New Zealand at present. Sound economic policies and policy transparency are also important factors reducing the risks of significant instability arising from adverse shocks. However, the economy and financial system are not immune to potential instability and there are points of vulnerability that need to be monitored carefully. These include the high level of external debt, the dependency on foreign capital inflows, and the high level of household debt relative to disposable income.

Current issues in banking supervision

Internationally, the standard practice for banking supervision has been progressively codified by the Basel Committee on Banking Supervision. This committee, which formally reports to the Governors of the G10 central banks, has developed

the international supervisory framework in a number of areas, including codification of the responsibilities of home country and host country supervisors and the development of a Capital Accord, which sets out a basis for setting minimum capital requirements for banks.

In recent years, the Committee has actively sought to further extend and update this framework. Two important pieces of work that have emerged are a set of Core Principles for Effective Banking Supervision, and a set of proposed revisions to the Capital Accord.

The Core Principles are an attempt to set out minimum standards for banking supervision which should be aimed for by all countries. The intent of the Principles has our support. However, some of the Principles do cause difficulties for New Zealand, for two main reasons.

First, our fundamental objectives differ from those in many other countries. Our purpose in conducting bank supervision is to maintain the soundness and efficiency of the financial system. As noted above, we do not specifically seek to protect depositors or banks and we have no deposit insurance scheme.

Second, we have made a deliberate decision to harness market forces and strong internal governance incentives as the primary means of encouraging banks to conduct their affairs prudently. This contrasts with the approach in many other countries, which tends to rely on relatively detailed supervisory rules and intensive monitoring by supervisors. Accordingly, New Zealand does not comply with the Core Principles in detail in the same way as many other countries, but we are satisfied that our current framework is appropriate for New Zealand and delivers sound outcomes.

The other major international initiative is the proposed reform of the international Capital Accord (which sets minimum capital adequacy standards for banks). The proposed revision to the Capital Accord seeks to address the deficiencies in the current Accord and involves the use of three "pillars":

- The setting of minimum capital requirements. The Basel Committee is proposing a more sophisticated set of rules for measuring the risks of banks' assets and off-balance sheet exposures, including allowing banks to use their own data for measuring risks and allocating capital.

- The supervisory validation of the models for measurement of capital adequacy, including through on-site examinations of banks.

- Market discipline, through enhanced public disclosure of banks' capital and financial information.

The new framework is still in the process of public consultation and is unlikely to be implemented by the major economies until 2006 or later. The Bank has yet to conclude a view on how it would implement the proposed changes. Subject to consultation with banks and others, our preliminary inclination is to avoid the complexities and heavy supervisory oversight involved in some aspects of the proposed changes, but to implement the more standardised capital measurement option included in the proposals. We wish to avoid a system that would involve the Bank taking ultimate responsibility for the appropriateness of banks' capital adequacy models with the attendant risk of diminishing market disciplines on banks and exacerbating moral hazard.

Another banking supervision issue is the decision to require some overseas banks operating, or proposing to operate, in New Zealand to be locally incorporated. The banks in this category are banks whose size in New Zealand makes them systemically important, and banks with substantial retail deposits whose disclosure practices are materially less satisfactory than those imposed under the Reserve Bank Act or are from countries that confer a preference on home country depositors. This policy change reflects a desire to be able to identify the assets of a bank's New Zealand business with as much certainty as possible, and to help ensure a close connection between the assets available in a crisis and those published in the bank's disclosure statements. The policy also helps to ensure that significant banks operating in New Zealand have strong local corporate governance arrangements.

Currently, two banks are affected by this policy and we are in the process of discussing the implications of the policy with them. Legislation may be required to effect some elements of the local incorporation policy.

Current issues in the payment system

A reliable, efficient and stable payment system is vital to the functioning of a modern economy and to the stability of the financial system. Some years ago we set out some basic objectives for the payment system, the most important of which were:

- that risks in the payment system should be reduced to acceptable levels, and managed appropriately;
- that any material risks should be underpinned by back-up or failure-to-settle arrangements which are legally, financially and operationally robust; and
- that the legal status of payments should be certain at all times.

These goals continue to underpin our work in this area. Much has already been achieved. We have introduced a real-time gross settlement system, which was a major contribution to risk reduction. And legislation has been enacted to provide for netting arrangements in the financial sector which can be used to reduce remaining risks.

The main area of risk which has not yet been dealt with is foreign exchange settlement risk between financial institutions. This arises as a result of timing differences between the paying and receiving of foreign currency transactions, due to time zone and settlement system differences, and can pose substantial risks to banks actively engaged in foreign currency markets. An international effort is now under way to address foreign exchange settlement risk, through the formation of CLS Bank, being sponsored by several of the world's leading commercial banks. It will link the real time settlement systems of a number of major central banks and will allow simultaneous settlement of both legs of foreign exchange transactions for participating currencies.

The CLS system is expected to be operational within the next year for seven currencies. In order to facilitate the access of the New Zealand dollar to CLS Bank, various Acts may need to be amended to remove existing uncertainty over the legal status of payments made to CLS Bank in a winding up or statutory management situation. The Bank proposes to

recommend that amending legislation be introduced into Parliament in the next 12 months if possible.

Financial sector integration with Australia

The Bank is likely to become more involved in discussions with financial sector regulatory agencies in Australia on the issue of possible closer integration between the Australian and New Zealand financial systems. The two financial systems are already integrated in important respects, particularly in view of the extent of Australian bank participation in New Zealand. It seems likely that the two countries' financial systems will become more closely integrated in the years to come. As a result of closer integration between the two financial systems, there are arguments to suggest a closer degree of harmonisation in the financial regulatory and statutory frameworks of the two countries.

It is very early days in the discussions on these issues and the future direction may be significantly influenced by the Australian and New Zealand governments' policies on the future direction of the Closer Economic Relationship between the two countries. Nonetheless, this is an issue that is unlikely to go away, and would benefit from ongoing discussions between the relevant government agencies in the two countries. The Bank therefore proposes to continue its discussions in this area, in close liaison with the Ministry of Economic Development and Treasury.

Financial crime and money laundering developments

The Reserve Bank maintains an interest in promoting structures to combat financial crime and money laundering, as part of its systemic soundness objective under Part V of the Act. We work with other government agencies in the inter-departmental FATF (Financial Action Task Force) Working Group. This group serves as a vehicle to coordinate New Zealand's response to international initiatives to combat money laundering and terrorist financing, and participation in relevant international groups. In particular, we seek to ensure that New Zealand complies with international

standards on countering money laundering and the financing of terrorism in those areas that involve the banking system. A Reserve Bank staff member represents New Zealand on the FATF steering committee.

We also contribute to New Zealand's efforts to encourage good governance in the South Pacific region, promoting anti-money laundering/financial crime measures. We have longstanding relationships with the six central banks in the South Pacific, and provide occasional assistance to various authorities in the region on policies and practices for countering financial crimes.

The Bank also has responsibility for administering the financial aspects of the United Nations' sanctions regulations. In this capacity, there are occasions when the Bank may seek the Minister's agreement to implement modifications to the regulations or exemptions from the sanctions.

Proposed amendments to the Reserve Bank Act

Legislation has been introduced to amend Parts IV and V of the Reserve Bank Act – the parts that govern the bank name protection provisions and banking registration and supervision responsibilities. The amendments will clarify and strengthen the Bank's powers in relation to protection of the use of the word "bank" and in relation to the registration and supervision of banks. In addition, a proposed new Part VB of the Act will clarify and make explicit the Reserve Bank's responsibility in relation to the payment system in New Zealand.

External assessment of New Zealand's financial system

New Zealand is scheduled to undergo a financial sector assessment by the International Monetary Fund (IMF) in 2003. The assessment is under the IMF's and World Bank's Financial Sector Assessment Programme (FSAP), a programme initiated as a result of the financial instability arising in the Asian Crisis of 1998-99. Under this programme, every member country of the IMF is expected to undergo a financial sector assessment every 5 to 7 years, to assess the potential

vulnerabilities in the country's financial system and to assess the quality of financial sector regulation against international standards and codes. The FSAP will include an assessment of a wide range of issues, including banking supervision, securities market regulation, supervision of life insurance, transparency of financial sector regulation and the payment system. It will also include stress tests of the financial system to identify areas of potential vulnerability to adverse economic events, such as a sharp depreciation in the exchange rate, a large increase in interest rates, a sudden fall in real incomes and a collapse in asset prices.

The FSAP assessment of New Zealand is scheduled for the middle of 2003. The Reserve Bank is the coordinating agency and is working with the Treasury, the Ministry of Economic Development, the Securities Commission and other relevant agencies in preparing for the FSAP.

As is the case with many other countries undergoing an FSAP assessment, it is likely that the assessment of New Zealand will reveal some areas of non-compliance with international standards and codes in the areas of financial sector regulation and supervision. In some cases, these departures reflect well thought through policy decisions, where the frameworks adopted have produced a sound outcome for the New Zealand financial system. In other cases, the FSAP may identify or highlight deficiencies and gaps in financial sector regulation and supervision, although some of these are already on the agenda for policy reform.

The areas that may be identified in the FSAP as departures from international practice are likely to include:

- the absence of on-site examination of banks' financial records, systems and procedures;
- the relatively light-handed regulation of banks' risk positions;
- the absence of deposit insurance;
- the relatively undeveloped nature of insurance regulation and supervision;
- the lack of a licensing procedure for non-bank financial institutions; and
- some departures of securities market regulation from international norms.

The overall assessment of the New Zealand approach to financial sector regulation and supervision will depend on whether the external assessors take a mechanistic “tick the boxes” approach or whether they look beyond the issue of strict compliance with international standards and codes to the underlying substance of our regulatory framework. The former approach could lead to a relatively harsh assessment of the regulatory framework. The latter approach would acknowledge that New Zealand has adopted some different techniques but that, in the banking supervision area at least, the policy framework more than adequately delivers the desired results in terms of a sound and efficient financial system.

Another issue that may arise in the FSAP assessment is whether the existing allocation of responsibility for financial sector regulation and supervision in New Zealand is the most appropriate model. The existing framework involves a division of responsibility between the Reserve Bank (banking

supervision, payment system and general oversight of the financial system), Securities Commission (securities market regulation) and Ministry of Economic Development (securities market policy and insurance regulation). This contrasts with the more formally aggregated approach adopted in some countries, including the United Kingdom, Australia and Japan, where financial regulation and supervision of a range of financial institutions have been located in one agency.

We are currently satisfied that the existing model works well for New Zealand. Coordination between the relevant agencies is facilitated by regular meetings of a committee of the regulatory agencies. This committee provides a framework for exchanging views on policy issues and coordinating approaches to regulation where appropriate, without the need for a more formal “mega-regulator” structure. Nonetheless, this is an issue that will doubtless be subject to assessment in the FSAP process.

Section 4

Other functions and activities

Foreign reserves management

The Reserve Bank Act enables the Treasurer to direct the Bank to intervene in the foreign exchange market and requires the Bank to hold foreign exchange reserves to provide the capacity to implement such a directive. The target level of reserves is set by the Treasurer in consultation with the Bank. The current target level is NZ\$4.5 billion.

Foreign currency reserves are held to enable the Bank to intervene in the foreign exchange market in particular circumstances. Since the New Zealand dollar was floated in 1985, the Bank has generally limited its intervention objective to countering extreme disorderly conditions in the currency market. Although intervention has been considered on occasions since 1985, the Bank has not yet found it necessary to intervene.

The foreign reserves held by the Bank are financed by foreign currency borrowing undertaken by the Treasury's Debt Management Office. This has some important risk minimisation advantages in relation to the Crown's finances, by matching the maturity and currency of assets and liabilities, thereby minimising the risks associated with interest rate and exchange rate movements.

Although holding foreign currency reserves provides a benefit in the form of a degree of "risk insurance" against disorderly market conditions, it also entails costs. The costs arise because the government can typically only borrow at higher interest rates than we can expect to earn by investing in highly liquid, highly rated foreign government bonds. The cost fluctuates from year-to-year, but the annual cost to the Crown of maintaining New Zealand's current intervention capacity has averaged between NZ\$5 and 10 million in recent years. These costs have been falling as a result of looking for smarter ways to fund and hold reserves.

The Bank has two reserves-related reviews underway at present. The first review relates to the objectives of and circumstances in which the Bank would consider intervening in the foreign exchange market. Over recent years we have been reviewing the case for widening the circumstances in

which we would intervene in currency markets such as to ease exchange rate pressures in situations where the currency appears to have substantially over-shot (at either end of the cycle). Overseas experience suggests that, at the margin, sterilised intervention might be able to affect the exchange rate slightly, and internationally intervention has often had positive results. Notwithstanding these points, a key issue to be considered is whether the possible benefits of widening the intervention policy would outweigh the risks, given New Zealand's record of having had a clean float since 1985.

More recently, we have begun an extensive review of the target level of foreign reserves. The review was initiated in recognition that the level of target reserves has remained largely unchanged since 1988, despite substantial growth in foreign exchange turnover, in the size of the economy and in New Zealand's external debt since then.

Reserve Bank registry and Austraclear operations

Section 35 of the Reserve Bank Act enables the Bank to provide securities registry services under terms and conditions agreed between the Bank and the person for whom they are supplied. The Bank provides these services as part of its role of promoting a sound and efficient financial system. The services provided can be divided into two categories:

- registrar and paying agent (registry) services; and
- securities clearing and settlement (Austraclear) services.

Registry services

Registry services are a specialist administrative function undertaken for organisations that borrow money by issuing debt securities. The Reserve Bank's registry service has competed with other providers of registry services since 1989 and has been offered to issuers meeting criteria relating to ownership, status and credit rating.

Effective from 15 May 2000, the Bank out-sourced the registry services function. However, the Bank still remains responsible for the services carried out on its behalf.

The Bank has indicated its intention ultimately to exit the business of providing registry services. We will work with issuers with a view to achieving this end within the next one to two years.

Austraclear clearing and settlement system

This system is an electronic securities clearing and settlement service provided on a subscription basis to both investors and financial service providers. The Austraclear system has been in operation for 12 years.

The provision of depository services is not a core central bank function. The Bank intends to continue to provide depository services using the Austraclear system until such time as an alternative system becomes available. The Bank would welcome the development and operation of a new depository system by a third party. Until such time as an acceptable alternative system becomes available, the Bank will continue to ensure the Austraclear system is supported.

Settlement Services

Section 32 of the Act allows the Bank to provide settlement account services for financial institutions on such terms and conditions as may be determined by agreement. Presently there are 12 institutions with exchange settlement accounts. While all 12 institutions are registered banks, the Bank has a policy which allows non-bank financial institutions to obtain an exchange settlement account.

Currency issue and management

Section 25 of the Reserve Bank Act gives the Reserve Bank the sole right to issue legal tender bank notes and coins in New Zealand, including determining their design and composition.

The Bank considers that one of its key roles is to ensure that New Zealand's notes and coins are meeting the needs of the

public as effectively as possible. To this extent we are continually monitoring usage and overseas trends in such areas as counterfeit avoidance and note durability.

Over the coming months the Bank will be reviewing coin usage. Any review will involve extensive consultation with interested parties.

The Bank is also working on the five dollar note, with a view to improving its durability.

International liaison

An important aspect of the Bank's functions is its relationships with a wide range of overseas central banks, international financial institutions and international forums. The Bank derives significant benefit from its international relationships, including improved access to information and research, greater participation in international policy formulation, and an enhanced capacity to exchange views and experience on policy issues. We also see our involvement as contributing to New Zealand's wider international relationships, particularly in the Asia-Pacific region.

We maintain close working relationships with a number of central banks and active participation in a number of Asia-Pacific regional groups, including:

- the APEC Finance Ministers' process (Asia Pacific Economic Co-operation forum for finance ministries and central banks);
- EMEAP (Executives' Meeting of East Asia and Pacific central banks and supervisory agencies);
- SEANZA (South East Asia New Zealand Australia central banks and supervisory agency forum); and
- The Manila Framework Group (a group of central banks and finance ministries in the Asia-Pacific region).

Government cash and debt management

The Reserve Bank undertakes a number of functions for the Treasury. These include selling treasury bills and government bonds at competitive tenders, on a timetable and to amounts determined by the Treasury's Debt Management Office, under approvals from the Treasurer.

Undertaking these functions and the management of day-to-day government cashflows through open market operations assists the Bank to stay closely attuned to developments in domestic financial markets.

Overseas Investment Commission

The Reserve Bank provides the Secretariat for the Overseas Investment Commission (OIC). The Governor of the Reserve Bank, or such officer the Governor may nominate, is an *ex-officio* member of the Commission. It is only for historical reasons that the OIC is associated with the Bank. There is now no congruence between the responsibilities of the Bank and those of the OIC; the OIC's role does not fit with the Bank's core functions. Accordingly, we propose to initiate discussions with the Government with a view to fully separating the OIC from the Reserve Bank.