
Briefing on the Reserve Bank of New Zealand

October 2005

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Introductory note

This paper has been prepared to brief the incoming Minister of Finance on the role and functions of the Reserve Bank of New Zealand. It highlights the key issues the Bank is facing at present, although the focus is largely descriptive, explaining the reasons why various functions are undertaken, the interactions between them, and the institutional arrangements under which the Bank's functions are governed, including the important roles played by the Minister, the Governor, and the Board of Directors.

The *Briefing* has the following structure:

- The Introduction and Executive Summary sets out the key points contained in the briefing paper.
- Section 1 provides an overview of the Reserve Bank's functions, governance, and structure.
- Section 2 outlines the framework within which monetary policy is conducted.
- Section 3 discusses the Bank's responsibilities for promoting a sound and efficient financial system.
- Section 4 covers the payment system and currency operations of the Reserve Bank.

This briefing was provided to the Minister of Finance on 20 October 2005.

Introduction and executive summary

As New Zealand's central bank, the Reserve Bank performs a number of functions, each of which contributes to the goal of promoting and maintaining a stable macroeconomic environment and a sound and efficient financial system. Doing so helps enable New Zealanders to conduct their business using a currency that largely holds its purchasing power through time, in an environment where avoidable swings in the macroeconomic environment are kept to a minimum, and using payment instruments and a financial system that are sound, efficient, and well regulated. Each of these interrelated dimensions of what the Bank does contributes to the overall environment that enables New Zealanders to make the most of our economic growth potential. The Reserve Bank has a considerable degree of operational autonomy in many of its areas of responsibility, balanced by clear and well-thought-out accountability mechanisms, and with important decision-making roles reserved for the Minister of Finance in a number of key areas.

By statute, the primary function of the Reserve Bank is to conduct monetary policy to maintain a stable general level of prices. Doing that in a way that avoids unnecessary fluctuations elsewhere in the economy, lays solid foundations that help firms and households to make good quality spending and saving decisions. The broad framework within which monetary policy is conducted is now well established. Under that framework, the Minister and Governor jointly agree an operational target for monetary policy (currently 1 to 3 per cent inflation on average over the medium term), and the Bank is then required to use the instruments of monetary policy to achieve such outcomes.

We are facing some particularly difficult monetary policy challenges right now. After several years of strong growth, accumulated pressures on resources have been quite intense, carrying core measures of inflation up to around 3 per cent. Although the pace of economic activity is now slowing, it is difficult yet to be confident that inflationary pressures will ease in the near term. The situation has been complicated by the sharp rise in world oil prices this year.

The persistent strength of domestic demand has been reflected in a variety of growing macroeconomic imbalances. Core inflation has risen and remains high. The

balance of payments current account deficit has widened substantially. House prices are reaching levels that appear to be inconsistent with longer-term fundamentals. And the exchange rate, in trade-weighted terms, is sitting only a little below record highs.

Against this background, a further slowing in the pace at which domestic demand is growing is a priority. Reflecting this assessment, the Bank has indicated that further increases in the Official Cash Rate (OCR) cannot be ruled out. Fiscal policy also has a role to play. While the Crown's own accounts are in a very healthy state at present, and could accommodate some further fiscal easing at some point, the economic imbalances outlined above mean that we would urge caution in considering any further easing of fiscal policy now.

The Reserve Bank's financial stability responsibilities range widely and have a number of interacting dimensions. The analysis that underpins our monetary policy also informs our financial stability activities, while the regular and intensive interactions with banks and financial institutions undertaken as part of the financial stability role benefit monetary policy as well. The Reserve Bank is responsible for the registration and supervision of banks, including preparing for the possible management of a bank failure or a financial crisis. For a small, highly indebted, relatively undiversified economy, in which most of the banks are owned by parents based in a single foreign country, crisis preparedness is of particular importance.

At present, the Bank faces several significant longer-term issues in the broad area of our financial stability responsibilities.

Earlier this year, consistent with the Government's commitment to a Single Economic Market with Australia, the Minister of Finance and the Australian Treasurer agreed to establish a Trans-Tasman Council on Banking Supervision. The initial work of the Council has focused on identifying possible measures that could ensure that the Australian regulatory agency (APRA) and the Reserve Bank can support each other in the performance of their regulatory responsibilities wherever possible. A report on this issue was provided to respective ministers in August 2005 and

recommends some legislative changes in both countries designed to help ensure that, wherever possible, actions are not taken by an agency in one country that would be detrimental to financial stability in the other.

The Reserve Bank has placed considerable emphasis in recent years on ensuring that the New Zealand operations of large foreign-owned banks would be able to be maintained and managed effectively in the event of a bank failure. Our policy of requiring large banks, and some smaller banks that take retail deposits in New Zealand, to incorporate locally was a first step in that direction. More recently, considerable emphasis has been placed on ensuring that appropriate contractual and operational arrangements are in place so that any outsourced business functionality (including that outsourced to overseas parent banks) is able to be effectively maintained and operated, including in the case of a bank failure. The more critical the functionality, the more robust those arrangements need to be. The Bank is in the process of finalising its policy, after extensive consultation with the industry. The policy will be implemented on a case-by-case basis, with transitional arrangements to be agreed with banks where the policy requires amendments to existing outsourcing arrangements.

The Reserve Bank is currently participating in a series of officials working groups that have been established to review the regulation of the non-bank financial sector and the allocation of roles amongst the financial sector regulatory agencies. The Reserve Bank has indicated that it believes there is a case for extending prudential supervision to some types of non-bank financial institutions and that we would be willing to take on additional responsibilities in this regard. These various streams of work are expected to reach conclusions and make recommendations to Ministers over the coming year.

The Reserve Bank has the sole right to issue bank notes and coins in New Zealand. We aim to ensure that the issuance of currency is conducted efficiently and robustly, effectively meeting the currency needs of the wider community. As part of maintaining a cost-effective currency issue, major changes are afoot in respect of 'silver' coins. During 2006 the five cent piece will be withdrawn from circulation and the metallic content of the 10, 20, and 50 cent coins will be altered and these coins will be reduced in size. The Bank has consulted widely on these initiatives, and will be working closely with affected parties, and through an extensive public awareness campaign, to ensure that the changeover is as smooth as possible.

Section 1

Functions and governance

Overview

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

As New Zealand's central bank, the Reserve Bank performs a number of functions, each of which contributes to the broadly defined goal of promoting monetary and financial stability. Doing so helps enable New Zealanders to conduct their business confident that they are using a currency that largely holds its value through time, and are using payments instruments and a financial system that are sound, efficient, and well regulated.

The Reserve Bank Act specifies that the primary function of the Reserve Bank is to conduct **monetary policy** to achieve and maintain a stable general level of prices; to maintain the purchasing power of New Zealand dollars, which are used for making payments and storing value. Closely linked to this role, the Reserve Bank is, by statute, the **sole issuer of currency** (bank notes and coins) in New Zealand and has a responsibility to maintain the integrity of that currency.

Banks are the key entities in the New Zealand financial system; they are the principal credit providers, deposit takers, and providers of payment services for households and the business community. The Reserve Bank is responsible for **the registration and prudential supervision of banks**, and does this, as specified in the Act, with a view to promoting a sound and efficient financial system. The Reserve Bank is also responsible for ensuring that it is well-positioned to respond to financial system distress, including the handling of bank failures and acting as Lender of Last Resort to the financial system. We aim to minimise the adverse impact of financial crises on the financial system and the wider New Zealand economy.

The Reserve Bank operates the **interbank settlement system** which banks use to settle obligations between each other, and it also manages the terms on which liquidity is made available to enable those obligations to be settled (this is, in fact, the way in which monetary policy is implemented). The Reserve Bank also operates the Austraclear payments

and securities settlement system, and is actively involved in overseeing the development of robust and efficient **payments systems**.

The Reserve Bank manages a substantial pool of **foreign exchange reserves** to enable it to intervene in the foreign exchange market, to assist in maintaining a functioning foreign exchange market and ensuring that critical cross-border transactions can be made, should that be considered necessary.

Each of these interconnected roles is discussed in greater detail later in this document.

Governance and management

The Reserve Bank Act sets the powers and responsibilities of the various entities responsible for the conduct of the Bank's functions. There are some complex interactions, which were carefully considered in the design of the legislation, and which have, for the most part, worked successfully. The framework is designed to provide considerable day-to-day operational autonomy to the Bank, an important role for the Minister of Finance in some key decisions, and a robust accountability structure in which the Bank's Board, the Minister, and Parliament all have important formal roles. Transparency is an important feature of the overall framework.

Assignment of responsibility for meeting objectives

Under the Act, the Governor is the Bank's chief executive officer, appointed by the Minister of Finance on the recommendation of the Board of directors. This structure provides a form of 'double veto', in that both the Minister and the Board must have confidence in any person appointed as Governor. The Governor is appointed for a term of five years, but can be reappointed for further terms, each of up to five years.¹ Authority for exercising the powers assigned

¹ The Act also requires the appointment of a Deputy Governor as a Deputy Chief Executive. That appointment is made by the Board on the recommendation of the Governor.

to the Bank rests with the Governor, who is hence personally accountable for the conduct of the Bank's business. This makes the Bank different in an important respect from Crown entities (many of which also exercise operational autonomy in implementing areas of public policy). In most Crown entities authority rests with the Board of the entity, not with the chief executive officer.

In many of the Bank's areas of responsibility the Minister of Finance has an important involvement in the setting of key parameters. These include agreeing with the Governor on the monetary policy target, agreeing on changes to the scope of the supervisory regime (particularly those which require Orders-in-Council or legislative amendments), and approval of any decision to place a failing bank into statutory management or to give directions to a registered bank. The Act also reserves certain other directive powers to the Minister, including the ability to require the Bank to intervene in the foreign exchange market or to impose, for a limited period, an alternative monetary policy target. In these cases, transparent and pre-specified procedures are set out in the Act.

Performance monitoring and accountability

Under the Act, the Board has prime responsibility for monitoring the performance of the Bank and the Governor on a continuous basis. It is, in effect, the agent of the Minister of Finance. 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.

Under legislation passed in 2003, the Bank's Board consists of between five and seven non-executive directors appointed by the Minister of Finance for five-year terms, and the Governor. The Board is now chaired by one of the non-executive directors, elected by the Board from among their number each year. The Board is also now required to issue an annual report setting out its assessment of the Bank's and the Governor's performance. An Audit Committee, comprising four non-executive members of the Board, monitors the accounting practices, accounting policies, and internal control systems of the Bank. The Committee also

reviews the internal audit function and has direct access to the external auditor.

The Board plays an important ongoing monitoring role, offering advice to and asking questions of the Governor in the routine conduct of business, including, for example, after each Official Cash Rate (OCR) decision. Under more extreme circumstances, the Board is required to advise the Minister of Finance if it is satisfied that 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 carries out the Policy Targets Agreement has been inadequate. In these circumstances, the Board may recommend to the Minister of Finance that the Governor be removed from office. Where the Minister of Finance 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.

The Bank and the Governor are also subject to ongoing assessment by Parliament's Finance and Expenditure Committee. The Committee's capacity to scrutinise the Bank's monetary policy activities has been enhanced in recent years by the appointment of a part-time economist to advise the Committee. However, there is probably still scope for the Committee to undertake more intensive scrutiny of the Bank, both regarding the conduct of its functions and in respect of the Bank's use of resources.

Both the Reserve Bank Act and the State Sector Act also provide powers under which the executive can require a review or performance audit of the Bank and its functioning.

Transparency arrangements

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

The operational objective of monetary policy is publicly disclosed in the Policy Targets Agreement. Moreover, the Bank is required to issue at least every six months a *Monetary 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 practice, the Bank has for some years issued *Monetary Policy Statements* quarterly. These documents help provide a focus for the extensive market and media scrutiny of the Bank's monetary policy analysis and interest-rate setting.

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 function and in setting prudential requirements. In addition, the Bank consults extensively on material changes in its supervisory policy and practice. The new *Financial Stability Report* also helps expose our thinking on the nature of the risks facing the New Zealand financial system to ongoing scrutiny from interested parties.

The Bank's Annual Report, including externally audited financial statements, sets out the Bank's actions for the year under review and its financial performance (against budget).² The Bank is also required to provide a *Statement of Intent* before the start of each financial year. The *Statement of Intent* sets out the Bank's objectives for the next three years and the budget for the first year of that period. The Bank must have regard to any comments made by the Minister on the *Statement of Intent*.

Organisational structure

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 management structure is set out on the following page.

Many of the issues that the Bank deals with straddle a number of departments. Accordingly, the Bank makes extensive use

of committees comprising a range of senior staff in addition to those directly responsible for the decisions being made.

The main committees are:

- Governor's Committee, which meets weekly to consider the management and day-to-day operation of the Bank;
- Monetary Policy Committee (MPC), which meets weekly to advise the Governor on economic and financial developments;
- Official Cash Rate Advisory Group (OCRAG), which comprises a subset of MPC plus two part-time external advisers, and which has responsibility for advising the Governor on OCR decisions;
- Financial System Oversight Committee, which meets fortnightly to consider policy issues relating to the soundness and efficiency of the financial system;
- Asset and Liability Committee (ALCO), which meets monthly to review risks and risk management frameworks around the Bank's balance sheet and its operations in financial markets;
- Communications Committee, which meets weekly to consider communications issues; and
- Business Continuity Management Advisory Committee, which meets approximately monthly to review issues associated with the Bank's business continuity preparedness.

² The Auditor-General is responsible for the audit of the Reserve Bank's accounts.

Management Structure

as at 31 August 2005

Governors	Department/Heads	Functions	Internal Services	
Governor <i>Alan Bollard</i>	Assistant Governor/ Head of Economics <i>Grant Spencer</i>	Economics	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability <i>Adrian Orr</i>	Financial Stability	Market operations Foreign reserves management Financial system surveillance	
		Currency and Building Services <i>Brian Lang</i>	Currency operations	Property management Security
		Financial Services <i>Mike Wolyncewicz</i>	Settlement services Registry and depository services	Accounting services Treasury services
	Assistant Governor/ Head of Operations <i>Don Abel</i>	Knowledge Services <i>Yogesh Anand</i>		Library services Data services Computer services
		Human Resources <i>Tanya Harris</i>		Human resources strategy and services
		Communications <i>Mike Hannah</i>		Reputation management Communications
		Risk Assessment and Assurance <i>Steve Anderson</i>		Audit services Risk assessment and assurance

Board of Directors

Non-Executive

Dr Arthur Grimes	Chair RBNZ Board of Directors <i>Economic Consultant</i> First appointed 13 March 2002 – current term expires 12 March 2007
Alison Paterson QSO	Deputy Chair RBNZ Board of Directors and Chair RBNZ Board of Directors Audit Committee <i>Company Director</i> First appointed 1 February 1995 – current term expires 31 January 2010
Paul Baines	<i>Company Director</i> First appointed 1 July 1999 – current term expires 30 June 2009
Hugh Fletcher	<i>Company Director</i> First appointed 10 June 2002 – current term expires 9 June 2007
John Goulter DCNZM JP	<i>Company Director</i> First appointed 9 February 2000 – current term expires 8 February 2010
The Rt Hon Edmund Thomas DCNZM PC QC	<i>Retired Judge</i> First appointed 1 March 2003 – current term expires 29 February 2008
Dr Marilyn Waring	<i>University Professor</i> First appointed 4 February 2004 – current term expires 3 February 2009

Executive

Dr Alan Bollard	<i>Governor</i>
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Financial and risk management

Funding structure

The Reserve Bank is both a statutory agency and a financial institution. It receives no direct funding through the central government budgetary process. Instead, the Bank's main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the Government's equity contribution to the Reserve Bank. Currency in circulation is, in effect, an interest-free loan from the public, and the proceeds are invested by the Reserve Bank in government bonds. The Bank's equity was materially augmented last year, to enable the Bank to absorb the risks from any foreign exchange intervention undertaken at its discretion. (The policy change in this area is discussed in the next section.)

Under the Act, the Minister of Finance and the Governor are required to enter into funding agreements to specify the amount of the Bank's income that may be used to meet

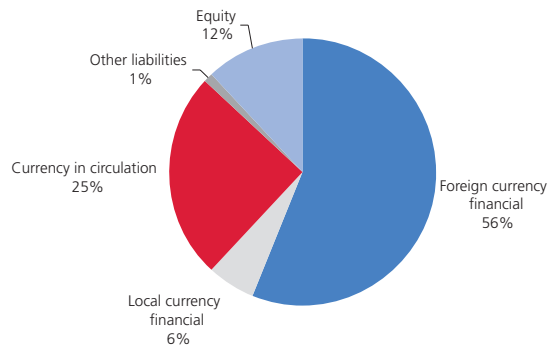
the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and does not become effective until ratified by a resolution of Parliament.

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 providing the Bank with a high degree of effective operational independence, while also ensuring accountability for the Bank's use of resources.

The current funding agreement, signed in April this year, and subsequently ratified by Parliament, covers the five years to 30 June 2010. For the current year (2005/06) approved funding amounts to \$39 million, rising to \$43 million in 2009/10. This represents a material increase in spending over the previous five-year period, reflecting various factors including, *inter alia*, the need to invest in the redevelopment

Summary Balance Sheet³

	2005 June (\$m)	2004 June (\$m)
Assets:		
Foreign Currency Financial	8,086	5,681
Local Currency Financial	4,866	4,777
Other Assets	44	39
Total Assets	12,996	10,497
Liabilities and Equity:		
Foreign Currency Financial	7,308	5,574
Local Currency Financial	790	1,382
Currency in Circulation	3,183	2,920
Other Liabilities	161	200
Equity	1,554	421
Total Liabilities and Equity	12,996	10,497



of systems, to strengthen our supervisory capability, and to ensure that robust business continuity arrangements remain in place. The Bank engages in a systematic annual internal budgeting process and is always looking for ways to achieve efficiency gains, which would enable our outcomes to be reached in a more cost-effective manner.

The Act requires the Bank to calculate both an actual realised net income, and a notional surplus income (loosely, the amount by which actual realised income exceeds the level of operating expenditure specified in the funding agreement). The Minister of Finance, after consulting the Bank's Board, decides whether the notional surplus income should be added to the Bank's reserves or paid to the Government. In addition, to encourage a prudent use of resources, 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.

Legislative amendments last year changed the basis of calculation of the Bank's net income to include only realised valuation gains and losses, excluding unrealised items. This change was designed to accommodate the Bank's new foreign exchange intervention policy (discussed in the following section), but has had some unanticipated effects. In particular, for an unchanged balance sheet structure, the

surplus available to be paid as dividend (or credited to the Bank's reserves) has become more volatile. We are exploring whether there might be better ways to ring-fence unrealised intervention gains and losses.

Total operating expenses for the 2004/05 year amounted to \$37.5 million, 3 per cent below the budgeted amount of \$38.4 million. Net expenditure under the funding agreement amounted to \$29.1 million, almost \$4 million below the limit of \$33.0 million.

Management of risks

As a government agency with major policy responsibilities and considerable discretionary power, and as a financial institution with a large balance sheet (\$13 billion of assets), the Reserve Bank faces a wide range of risks.

Risks associated with our policy responsibilities (policy mistakes or misjudgements) are perhaps the most important. Serious misjudgements could have far-reaching ramifications for the economy, and undermine our future effectiveness by undermining confidence in the institution.

We seek to manage the risks associated with monetary policy errors in a number of ways. We supplement economic forecasts with an active process of talking to the business community and monitoring the forecasts of other analysts. We also attempt to incorporate a broad diversity of views in the policy formulation process, both by involving a range of staff in advising the Governor and by engaging

³ 'Foreign Currency Financial' and 'Local Currency Financial' mean financial assets and liabilities denominated in either foreign currency (eg United States dollar bonds) or local currency (eg New Zealand government securities) respectively.

two part-time external advisers to supplement advice from staff. The Bank also periodically engages foreign central bankers and academics to provide peer reviews of our monetary policy process. In respect of our financial stability policy responsibilities, the Bank consults broadly, with other government agencies and with affected private sector institutions, before implementing changes to the policy framework. There is also liaison with overseas banking supervisors, particularly APRA.

The Bank also faces a number of financial risks. These mainly arise because of the Bank's operations in the domestic financial system and because of our holdings of foreign exchange reserves. 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 holdings of foreign currency reserves, including credit risk, interest rate risk, and exchange rate risk.
- 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 all of the transactions and processing areas of the Bank.

The Bank is a relatively small organisation (around 210 full-time equivalent staff) engaged in a wide range of activities. That exposes us to a constant risk around the loss of key highly-experienced staff and the associated institutional knowledge.

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. Consistent with this emphasis, we also place considerable emphasis on ensuring that we have procedures and systems in place to enable the Bank to maintain its core functionality in the event of physical crises, including localised loss of access to our building and wider regional disasters.

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

- The Risk Assessment and Assurance Department, responsible for general risk monitoring. The internal audit role and the Legal Counsel also reside in this department.
- The Risk Unit within the Bank's Financial Stability Department, which provides specialised advice on interest and exchange rate risk, credit risk, and liquidity risk, and the appropriate limits the Bank needs to have in place to ensure the prudent and effective conduct of its operations.

In addition, the Board and its Audit Committee contribute to the Bank's risk management processes and have an overview responsibility for the internal and external audit processes.

Section 2

Monetary policy and the Policy Targets Agreement

Policy framework

Under the Reserve Bank Act, monetary policy is the Reserve Bank's "primary function". Section 8 of the Act specifies that 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".⁴

The Act 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 only the broad principles against which monetary policy decisions are to be framed. To provide more focus for the Bank's day-to-day monetary policy decisions, however, section 9 of the Act requires that:

*The Minister 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.*⁵

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

- 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 Minister of Finance.
- The involvement of both the Minister of Finance and the Governor in shaping the targets. The targets can neither be imposed by the Minister of Finance, nor be set unilaterally by the Governor.

⁴ Note that section 12 of the Act allows the Minister of Finance 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.

⁵ With the agreement of both parties, the Policy Targets Agreement can also be renegotiated during a Governor's term. To date, this has happened at each change of government (1990, 1996, and 1999).

- 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, say, the more general provisions of section 8) as the reference point in assessing the Governor's performance. And it is the pursuit of the policy targets that the Bank is required to report on in its *Monetary Policy Statements*.

The Act does not require that the parties to the Policy Targets Agreement define price stability. 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. The framework should leave the Governor sufficiently free to act sensibly and appropriately in the face of unexpected events. But it must also provide a reasonable degree of predictability for firms, households, and markets in more normal times, and provide some reasonably specific benchmarks that can form a starting point for assessing the Governor's performance.

The policy targets also need not be specified in terms of any of the various measures of inflation. However, in practice and for the whole period since the Act came into force in 1990, successive governors and 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.

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. However, over the succession of Policy Targets Agreements signed since 1990 – the current one is the seventh – changes have typically been incremental, rather than involving substantive changes in our understanding of how monetary policy should be directed to its goal. In particular, some of the changes to date have focused on ensuring that it is clear to all concerned – including the wider public – that price stability

is a means to an end, not an end in itself. Others have focused on articulating more clearly what had always been well-understood implicitly: that the pursuit of medium-term price stability can still involve important short-term trade-offs, especially as regards the variability of economic activity and interest and exchange rates. Financial markets take a very close interest in the Policy Targets Agreement, with a particular emphasis on actual, or possible, big changes.

The current Policy Targets Agreement (PTA), agreed at the time the Governor was appointed in September 2002, sets the policy target as being to keep future annual CPI inflation in a range of 1 to 3 per cent on average over the medium term. As all the PTAs have done, this agreement recognises that, for a variety of reasons, the actual annual rate of inflation will vary around the medium-term trend and will at times move beyond the 1 to 3 per cent medium term range. In this agreement, however, the wording is designed to emphasise that these outer edges are not to be seen as hard boundaries, and that moving beyond them does not impose automatic or immediate sanctions. Rather, the focus is on ensuring that when actual (or projected) inflation moves outside the range for whatever reason (and in some circumstances it will be highly desirable that inflation move outside the target range in the short term; a simple example is a material change in indirect tax rates) the Bank's focus, in judging the appropriate policy response, should remain consistent with the intended forward-looking and medium-term orientation of monetary policy. When inflation moves outside the target range (or is projected to do so) we need to explain clearly the reasons why such outcomes have occurred (or are projected to occur), and what steps the Bank plans to take to ensure that inflation outcomes remain consistent with the medium-term target. Such deviations clearly do not call for knee-jerk or short-term actions to return inflation to the target range as quickly as possible.

There is always scope to consider modifications to the details of these arrangements, but our judgement is that there are no pressing issues that require the Policy Targets Agreement to be revisited, or renegotiated, at present.

A well-designed Policy Targets Agreement helps to establish the framework within which the Reserve Bank will react to new information and emerging pressures on prices. A good

framework of that sort helps ensure that marked shorter-term fluctuations in the economy and in key financial market prices are kept to a minimum, and are avoided whenever possible. A bad framework, or a badly conducted monetary policy, can involve real economic costs, as signals to firms and households are distorted, and people have to devote real resources to countering the resulting volatility. In the medium to longer term, monetary policy can only directly influence the inflation rate. But stable prices provide a good backdrop that helps the private sector to make the most of New Zealand's growth opportunities. A wide variety of OECD countries have found in recent years that achieving and maintaining price stability contributes to greater macroeconomic stability, which, in turn, tends to improve, if only modestly, the average medium-term growth performance of the economy.

Challenges in managing monetary policy

In managing monetary policy, the challenges facing central banks, here and abroad, change through time. Many of the themes are global in nature, but others are more localised. Many central banks have been struggling in recent years to understand fully the reasons why the extent to which exchange rate changes affect domestic activity and prices seems to have diminished; and indeed, whether that change in behaviour will be permanent. Similarly, in many countries, including New Zealand, inflation has been more muted in recent years than the normal fundamental determinants would have suggested.

Authorities in many countries are grappling with the need to understand the strength and persistence of the boom in household credit and housing prices, and, in New Zealand, a further challenge is to understand just why, on average over many years, higher real interest rates have been needed, than in otherwise comparable countries to keep inflation around targeted levels. This year, markets and central bankers have struggled particularly to understand fully why global bond yields have remained so low, and to appreciate fully the implications of this development. Locally, the low international bond yields have made fixed rate mortgages

increasingly attractive at a time when our short-term policy rate, the OCR, has been relatively high. This has changed the way in which OCR decisions affect spending and saving decisions, and has been something we have had to factor into our projections and judgements.

New Zealand is facing some particularly difficult monetary policy challenges right now. After several years of strong growth, accumulated pressures on resources, and hence inflationary pressures, have been quite intense, carrying core measures of inflation up to around 3 per cent. Although the pace of economic activity is now slowing, it is difficult to yet be confident that inflationary pressures will ease in the near term. The situation has been complicated by the sharp rise in world oil prices this year. In the near-term, these price rises are likely to result in New Zealand's CPI inflation rate rising towards 4 per cent. Although higher oil prices will act as a drag on both New Zealand and international economic activity, the spike in the CPI inflation rate creates risks of a more sustained spill over into higher ongoing wage and price inflation.

The persistent strength of domestic demand has been reflected in a variety of growing macroeconomic imbalances. Core inflation has risen and remains high. In addition, the balance of payments current account deficit has widened substantially (at 8 per cent of GDP it is higher than in almost any other developed country, and well above the average for New Zealand, despite the current high terms of trade). After several years of very strong growth, prices for existing houses are reaching levels that appear to be inconsistent with longer-term fundamentals such as the cost of building new houses. And the exchange rate, in trade-weighted terms, is sitting only a little below record highs. The continued strong flow of retail investors into New Zealand dollar investments (attracted by the relatively high domestic interest rates needed to dampen domestic demand) is continuing despite a growing sense among analysts and commentators that the exchange rate is materially overvalued and that a substantial fall is both desirable and inevitable at some stage in the next couple of years.

Against this background, securing a material further slowing in the pace at which domestic demand is growing is a priority. Reflecting this assessment, the Bank has indicated that

further increases in the OCR cannot be ruled out (indeed, in recent weeks market participants and analysts have increasingly shifted to the view that further rises are likely and appropriate). Fiscal policy also has a role to play here. The government accounts are in a healthy state at present, and New Zealand's ratio of net public sector debt to GDP is among the lowest in the developed world. After several years in which fiscal policy, and in particular the surprisingly rapid growth in revenue, was playing a contractionary role in the economy, current fiscal policy is now projected to contribute to expanding demand this financial year and next. Although the Crown's own accounts are in a very healthy state at present, and could accommodate some further fiscal easing at some point, the economic imbalances outlined above mean that we would urge caution in considering any further easing of fiscal policy now. Fiscal restraint can contribute directly to easing demand pressures in a way that reduces the risk of a further rise in the exchange rate.

Implementing monetary policy

The main instrument used to implement monetary policy is the Official Cash Rate (OCR). The Bank sets the Official Cash Rate,⁶ which anchors the very short-term New Zealand interest rates. Anchoring the very short-term interest rate in turn influences other key interest rates and the exchange rate, and enables us to achieve effective influence over the inflation rate – although the lags can be quite long, and the linkages are inevitably imprecise. Policy actions taken today will not have their greatest effect on inflation until one to two years from now.

The OCR is reviewed every six weeks. Every three months we publish a *Monetary Policy Statement* containing a full assessment of the economic and inflation outlook. Approximately halfway between each *Monetary Policy Statement* there is a further review, and a brief public statement outlining the background to our interest rate decision. Our most recent assessment of economic conditions in New Zealand, and the latest decision on the level of the

⁶ Technically, the midpoint between the overnight interest rates at which the Reserve Bank lends to and borrows from its counterparties (typically, banks holding settlement accounts at the Reserve Bank).

Official Cash Rate, was published in the *Monetary Policy Statement* released on 15 September 2005.

In setting the OCR, the Bank has a well-established process in place to ensure that it is capturing all the relevant information and perspectives, and that it is interpreting that information to the best of our ability. Key elements of the process include:

- regular visits to a wide range of New Zealand businesses and labour market contacts;
- extensive internal analysis of key statistical and survey data; shorter-term analysis and longer-term research projects;
- the development and maintenance of a variety of analytical tools and “models” to help us make sense of the data;
- monitoring international economic developments and key forecasts of what is going on in the economies of our key trading partners;
- monitoring and comparing the analysis undertaken by the numerous other analysts and commentators looking at the New Zealand economy;
- closely monitoring how domestic and international financial markets are interpreting the data, and the risks around them.

All this information is brought together in a formalised internal process in which the economic outlook being provided to the Governor is reviewed and challenged. It is an open and contestable process, and benefits from the presence of two part-time external advisers, chosen for their ability to provide outside perspectives and to challenge the Bank staff’s own perspectives. Finally, the Governor makes the OCR decisions in consultation with a small group of senior staff and the external advisers. We believe that it is a robust approach, and stands scrutiny against the approaches used in other central banks. To this end, we have quite frequently opened the whole process to visiting senior academics and central bankers and have invited them to provide us with comments and suggestions on ways to improve the process.

We are continually aiming to improve our processes and our understanding of the way the New Zealand economy works.

Over the coming year, we have placed particular priority on beginning a process of redeveloping our formal model of the New Zealand economy, and on enriching our understanding of household sector savings and consumption behaviour.

Foreign exchange intervention for monetary policy purposes

Section 16 of the Act allows the Bank to operate in foreign exchange markets at its own discretion and risk. Any foreign exchange activities the Bank chooses to undertake must, however, be consistent with the Policy Targets Agreement.⁷

Since the exchange rate was floated in 1985, the Bank’s policy position had been that intervention would only be warranted in the case of a crisis, in which the liquidity of the foreign exchange market was disrupted. Substantial foreign exchange reserves are held to finance this sort of intervention, which is discussed further later in the document.

However, the Bank’s thinking has been evolving since the late 1990s. The floating exchange rate regime has been successful, and exchange rate movements have often provided a useful buffer to changing international circumstances. However, after an extensive review of the literature and of the experiences of other countries, most notably including Australia, the Bank has now concluded that there are times when it would be appropriate to intervene directly for the purpose of influencing the level of the exchange rate, to reduce cyclical exchange rate variability when the rate is exceptionally and unjustifiably high or low. In early 2004, the Minister of Finance endorsed this change in the Bank’s thinking on foreign exchange intervention. The new approach recognises that in some circumstances intervention can help to reduce the extent and duration of exchange rate misalignments.

Under this new approach, interventions (which can be expected to be infrequent) may occur if the exchange

⁷ The Act also makes provision to handle cases where a ministerial direction to intervene in exchange markets might not be consistent with the monetary policy goals contained in the Policy Targets Agreement.

rate is exceptionally high or low, and when, in the Bank's assessment, that level is clearly unjustified by economic fundamentals. Such interventions would be in support of our monetary policy role, and would be consistent with the requirement in the Policy Targets Agreement that the Bank should maintain price stability on average over the medium term, while seeking to avoid unnecessary volatility in, *inter alia*, the exchange rate.

The Bank will intervene only when it assesses that there is a material prospect of influencing the exchange rate, and in ways that seek to avoid giving rise to destabilising speculation. Foreign exchange interventions of this kind are likely to have only a limited effect on the exchange rate cycle – an effect that may be difficult to measure – and opportunities to have the desired effect may not always be available. However, we can envisage some circumstances in which intervention could interact with foreign exchange market dynamics to limit overshooting and/or to help trigger market-led realignments. Having the option of intervention available to use on rare occasions is, in our assessment, a prudent provision for a central bank. We have well-established internal procedures in place to help ensure rigorous evaluation of possible intervention opportunities.

Maintaining the option of intervening involves only very limited costs. The Reserve Bank needs to maintain a watching brief on markets to support its other functions and to maintain a dealing capability to facilitate crisis

interventions. Consistent with the Minister's endorsement of this new approach, the Bank's capital has been increased by \$1 billion, to enable the Bank to absorb the shorter-term fluctuations in the market value of any positions it takes in the course of intervention. This capital is, however, simply reinvested in government securities and so has no fiscal cost or impact on the Crown's gross debt.

Actual interventions in the foreign exchange market would, of course, involve financial risk. Experience in other countries, however, and especially in Australia, suggests that intervention along the lines outlined above can be expected to be profitable on average over time. This reflects, in part, the longer-term time horizons central banks are able to take.

The Bank has undertaken that accumulated open foreign exchange positions under this sort of intervention will be limited to an amount advised to the Minister of Finance. The Bank also has undertaken that any such intervention will not result in total gross reserves held by the Bank for crisis intervention purposes falling below the level approved by the Minister.

Interventions would not necessarily be disclosed at the time they were undertaken, but the financial impact of any intervention would be reflected in the Bank's published accounts (data are published monthly on our website). By 30 June 2005, the end of our most recent financial year, no intervention had taken place.

Section 3

Financial Stability

Overview

The Reserve Bank's second main area of responsibility is oversight of the New Zealand financial system. A well-performing financial system, which users have confidence in, is vital for the successful operation of a market economy. Financial institutions and markets provide the payments instruments that facilitate almost all economic exchange, help to mobilise resources (savings), and help ensure that those resources are allocated to their most valuable uses. Weaknesses in, or any material disruption to, these processes can be damaging to the stability and performance of the economy (among other aspects, it would also complicate the task of monetary policy).

All these issues are important for any country, but they present in a particularly stark fashion for New Zealand. New Zealand is a small, relatively undiversified, and heavily indebted economy. Our economy is heavily dependent on a continuing flow of international debt finance, much of which is intermediated through the banking system. Moreover, most of the banks in our financial system are owned by large overseas banks. That has some benefits, but the parentage is heavily concentrated in just one country (Australia), which means a high degree of exposure to shocks affecting the Australian economy and financial system. Bank failures do happen, and the high degree of foreign ownership of our banking system means that we have to think and plan particularly carefully for how the failure of a large financial institution might be managed in ways that would do least damage to the New Zealand economy and financial system.

Banks have an especially important role. They are at the core of the payments system, through which tens of billions of dollars of transactions are made and settled each day, and in New Zealand (more so than in most countries) banks dominate the financial system. The Reserve Bank has responsibility for the registration and supervision of banks, and the Reserve Bank Act provides extensive powers for managing the failure of a bank. In recent years, much of our efforts have been devoted to ensuring that we are well positioned to handle the failure of a bank, and in particular to ensure that we have options available to allow the New

Zealand arm of a foreign-owned bank to remain operational in the event of a bank failure. Overseas experience shows that timely and effective resolution of bank failures can materially reduce the cost of a failure to the economy.

The main ways in which the Reserve Bank discharges its responsibilities in relation to the financial system are:

- through surveillance of, and as adviser to the Government on, the financial system as a whole;
- as supervisor of registered banks;
- as crisis manager, including as lender of last resort; and
- as overseer of the payments system.

The following provides an overview of these activities.

Financial sector surveillance and advice

The Bank is responsible for the monitoring and assessment of the New Zealand financial system as a whole, and for providing advice to the Minister of Finance in this area.

Overall, our assessment is that the New Zealand financial system currently is performing well. An in-depth review undertaken by the International Monetary Fund in late 2003, as part of its global review process, concluded that New Zealand has a well-functioning financial system, and well-developed financial markets. While noting the heavy dependence on foreign financing, that assessment noted that short-term risks to financial stability appeared low, given the favourable macroeconomic position, and sound and transparent financial policies. The assessment noted some weaknesses in the regulation of the non-bank sector of the financial system, and regarding provisions to counter money laundering.

In 2004, the Reserve Bank commenced publishing a half-yearly *Financial Stability Report*. Many central banks now publish such a report. The *Financial Stability Report* reviews macroeconomic developments and (im)balances from the standpoint of the potential impact on financial stability, as well as the main institutional sectors within

the financial system itself. The Report also keeps under review the markets, payments and settlement systems, and the regulatory and legal structures required to support the functioning of the financial system.

The Reserve Bank's most recent *Financial Stability Report* (published in May 2005) concluded that the main financial institutions are well placed should economic conditions become less favourable than they have been over the past two or three years. However, the Report also noted that risks in the fast-growing non-bank sector are greater. Currently non-bank deposit-takers face intensified competition for funding, and many operate in higher-risk lending markets than the registered banks do.

Section 33 of the Act requires the Bank, from time to time, to advise the Minister on matters relating to the operation of the financial system. Mostly this advice is provided in connection with the Reserve Bank's prudential supervision and payments system oversight roles, but it can (and from time to time does) extend wider than that.

Recently, the principal issues on which the Bank has been providing advice relate to the supervision of New Zealand banks that are Australian owned (including crisis preparedness), and the regulation of the non-bank financial sector. The Bank has also recently provided advice on arrangements that New Zealand will need to put in place to comply with international standards on countering money laundering and the financing of terrorism.

The Reserve Bank is currently participating in a series of officials working groups that have been established to review, and report to Ministers on, the regulation of the non-bank financial sector. The element of this review exercise with the most direct potential implications for the Reserve Bank concerns whether the supervision of some categories of non-bank financial institutions should be enhanced and whether that supervision should be undertaken by the Reserve Bank. This is part of a broader review of the allocation of roles amongst the financial sector regulatory agencies (currently the Reserve Bank, the Securities Commission, and the Ministry of Economic Development). Advice on these matters will take into account the regulatory approaches in other countries, including Australia. The Reserve Bank considers

that there is a case to be made for prudential supervision to be extended to a wider range of financial institutions. The Bank would be willing to take on additional responsibilities in that area, recognising the considerable synergies that exist between supervision and the Bank's wider financial and monetary stability responsibilities and also the benefits of having all prudential supervision done by a single regulatory body.

Supervision of registered banks

The Reserve Bank Act requires the Bank to:

- register banks; and
- undertake prudential supervision of registered banks

and to do so for the purposes of:

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

There are currently 16 banks registered in New Zealand, two of which are New Zealand owned.

The matters that the Reserve Bank is required to have regard to when considering applications for bank registration are prescribed in the Act, and include such considerations as the standing of the applicant; the suitability of the owners, directors, and senior managers; and the likely ability of the institution to conduct its business in a prudent manner.⁸

An applicant's 'incorporation and ownership structure' is another matter the Reserve Bank is required to have regard to. Banks can be registered either as New Zealand incorporated companies or as branches of overseas incorporated banks. The Reserve Bank's policy now is that large banks, or some small ones that take retail deposits in New Zealand, should be locally incorporated. This policy is designed to strengthen the local governance of such banks and enhance our ability to manage effectively the failure of such a bank, by ensuring that the assets and liabilities relevant to New Zealand depositors are clearly identifiable and subject to New

⁸ Note, however, that there are no types of business that only banks can undertake.

Zealand law. Westpac Banking Corporation, which to date has traded in New Zealand as a branch of the Australian-incorporated bank, is now about to begin the process of incorporating locally.

The Act allows the Bank to impose conditions of registration, and prescribes the matters that those conditions may relate to. The Bank has developed a core set of conditions that address a number of matters relating mainly to the governance and business of the bank, capital adequacy, and connected lending. Non-standard conditions may be applied where particular circumstances warrant them. Conditions of registration provide an important platform for the Reserve Bank to conduct its prudential supervision of registered banks.

The Reserve Bank has operational independence in registering and prudentially supervising registered banks, within the policy framework prescribed by the Act. The Act also sets some constraints and attaches accountabilities to that independence. In particular, the Act requires that the Bank publish the principles on which it acts in determining applications for registration, and in imposing, varying, or adding conditions of registration. Also, before imposing or varying a condition of registration, the Reserve Bank must give the registered bank reasonable opportunity to make submissions, and must have regard to those submissions.

Registered banks also are required to comply with requirements to publish regular (quarterly) disclosures on their financial and prudential positions, and to publish a credit rating. These disclosure requirements are an important component of the overall approach to banking supervision in New Zealand. They help to bolster market disciplines and the governance responsibilities of registered banks' directors. Each director of a registered bank is required to sign off each quarterly disclosure statement and additionally attest as to (a) whether the bank has been in compliance with its conditions of registration and (b) whether the director is satisfied that the registered bank has appropriate systems in place to monitor and control material risks, and that those systems are being properly applied.

The Reserve Bank monitors the publicly disclosed information (including for compliance with the disclosure and other

prudential requirements), and information available from other sources, eg, rating agency reports, the media, and market 'talk'. The Bank does not undertake regular formal inspections or reviews of banks on site, but does conduct a formal consultation with each bank's senior management annually.

Additionally, the Bank has powers under the Reserve Bank Act to require a registered bank, or banks, to provide additional information, or to commission an independent report on a matter that requires supervisory attention. Until recently these powers had been regarded as reserve powers. But, as part of a process to re-invigorate the Bank's supervisory role, they are now regarded as tools that can be appropriately used when there are prudential issues that warrant a formal approach, with clear statutory backing.

The Reserve Bank Act provides for a range of direct intervention powers. Use of these powers is confined to serious situations, including, but not limited to, where a bank has failed. Use of these intervention powers requires the involvement of the Minister. Specifically, the Reserve Bank can:

- with the consent of the Minister, give directions to a registered bank;
- recommend to the Minister that a bank (by Order in Council) be placed in statutory management; and
- recommend to the Minister that a registered bank's registration be cancelled.

The Act sets out extensive provisions governing the wide-ranging role of a statutory manager of a failed registered bank. A statutory manager has all the powers of a corporation and of a liquidator, but is subject to any directions issued by the Reserve Bank.

Banking supervision policy developments

Trans-Tasman banking supervision

In January 2004, the Minister of Finance and the Australian Treasurer announced a policy aim of achieving greater mutual recognition and harmonisation in prudential regulation of

the Australian and New Zealand banking systems. Key considerations here were that 85 per cent of the assets of the New Zealand banking system are now (following the takeover of the National Bank of New Zealand by the ANZ Banking Group) on the balance sheets of banks owned by Australian parent banks, and the Government's wider (trans-Tasman) Single Economic Market goal.

New Zealand and Australian officials reported jointly to Ministers in July 2004 on two possible approaches to further the goal of greater mutual recognition and harmonisation in banking supervision:

- making the Australian Prudential Regulation Authority (APRA) responsible for the prudential supervision of New Zealand banks that are branches or subsidiaries of banks headquartered in Australia (favoured by Australian officials);
- adopting enhanced 'home-host' arrangements between the Reserve Bank of New Zealand and APRA to achieve maximum co-ordination and mutual recognition of the requirements and practices of each (favoured by New Zealand officials).

The Government decided that enhanced home-host supervision was the preferred model, but that other options for closer integration could be further explored. To provide a basis for this, Cabinet requested a further report from officials on the performance and regulation of major financial institutions in New Zealand, and on whether a joint trans-Tasman regulator would be appropriate. This report was provided in January 2005. It concluded that the New Zealand financial system, and financial regulation, are working well, though with some deficiencies in the regulation of non-bank financial institutions.

Officials did not consider that moving to a joint trans-Tasman regulator for prudential regulation and supervision was desirable at this time, as the benefits were likely to be small and the costs potentially high. However, officials considered that formalising, through a joint trans-Tasman committee, the policy harmonisation, information sharing and coordination work already being undertaken and strengthened by the Reserve Bank and APRA would ensure

that the momentum towards a more seamless regulatory environment would be maintained where appropriate.

At their annual bilateral meeting in early 2005, the Minister of Finance and the Australian Treasurer agreed to the formation of a Trans-Tasman Council on Banking Supervision. The Council's Terms of Reference require it to:

- enhance cooperation on the supervision of trans-Tasman banks and information sharing between respective supervisors;
- promote and review regularly trans-Tasman crisis preparedness relating to events that involve banks in both countries;
- guide the development of policy advice to governments, underpinned by the principles of policy harmonisation, mutual recognition, and trans-Tasman coordination; and
- report to Ministers on legislative changes that may be required to ensure APRA and the RBNZ can support each other in the performance of their regulatory responsibilities at least regulatory cost.

The initial work of the Council has focused on the last of the Terms of Reference, and a report on this was provided to respective Ministers in August. The report recommends legislative changes in both countries that would require each regulator to act to support the other in fulfilling its statutory objectives and, wherever possible, to avoid actions that are likely to have a detrimental effect on financial system stability in the other country. The latter would include actions that interfere with or prevent the provision of outsourced services to a related party in the other country.

In addition to these developments, the Reserve Bank and APRA have taken a number of steps during the year to improve coordination within the enhanced home-host framework. In March 2005, terms of engagement were agreed in respect of the implementation of the new Basel II Capital Accord (see below). The aim is to ensure that the approaches used to set capital adequacy requirements in each jurisdiction optimise the use of supervisory resources and reduce compliance costs, and are harmonised and mutually consistent to the extent possible. Agreement

has also been reached on issues such as how to improve information sharing, achieve more mutual involvement in supervisory visits and actions, and cooperation on staff training. These initiatives are already leading to significant benefits. Further work to enhance the arrangements for crisis coordination is also planned.

Outsourcing

The Reserve Bank Amendment Act 2003 added outsourcing of business functions to the matters the Reserve Bank is required to have regard to in determining whether to register a bank, and in its prudential supervision of registered banks. Our thinking in this area has been particularly influenced by the desire to ensure that the New Zealand subsidiaries of foreign-owned banks are able to maintain operational functionality in the event of a banking crisis.

Internationally there has been a trend by banks to outsource technology and information processing functions. There has been a corresponding trend for bank supervisors to establish standards that banks should meet, when outsourcing such functions, to protect national interests. These include requirements that outsourcing arrangements should be established in a way that ensures that business continuity capabilities are not weakened, including if a service provider becomes unable to perform on its service obligations. APRA has such a policy for Australian banks.

The Reserve Bank is finalising the outsourcing policy to be applied to New Zealand banks, taking account of comments received on a proposed policy that was published for consultation in late 2004. The underlying principle is that any services outsourced by a registered bank must be supported by legal and operational arrangements that robustly protect the bank's ability to maintain business functionality, including in the case of a bank (or service provider) failing. The more critical the functionality, the more robust those arrangements need to be.

Different banks are differently placed in terms of their initial level of compliance with the outsourcing policy. Accordingly, the policy will be implemented on a case-by-case basis, with transitional arrangements to be agreed with banks where

the policy requires amendments to existing outsourcing arrangements.

Capital adequacy requirements

To operate prudently, registered banks must be adequately capitalised in relation to the nature and extent of the business being conducted. The Reserve Bank has set a minimum capital adequacy requirement for each of the New Zealand banks that operates in New Zealand as a locally incorporated company. (Overseas banks that operate in New Zealand as a branch of the overseas bank are required to comply with home supervisor capital adequacy requirements.) These capital adequacy requirements are based on minimum international standards prescribed by the Basel Committee on Banking Supervision.

The Basel Committee in mid-2004 issued a new framework for establishing minimum capital adequacy requirements for banks. The new framework is often referred to as 'Basel II'. The framework includes a number of different options, including a 'standardised' approach which is similar to that already in place, and advanced 'internal ratings-based approaches'. The latter allow minimum capital requirements to be determined by banks using internal risk management procedures, subject to supervisory review of those procedures.

The Reserve Bank has indicated New Zealand- incorporated banks will be able to adopt internal ratings-based approaches, but will have to be accredited by the Reserve Bank for this purpose. This is in line with the approach that APRA has indicated it intends to adopt for Australian banks. The transition to Basel II, including the accreditation process and a 'parallel running period', during which banks using internal ratings will also have to meet existing requirements, will precede the introduction of the new requirement in early 2008.

Banking system crisis management

The Reserve Bank Act prescribes that one of the purposes for which the prudential supervision powers are to be exercised is to "avoid significant damage to the financial system that could result from the failure of a registered bank". This obligation relates both to the steps that can be taken in

advance to avoid significant damage should a bank fail, and use of crisis management powers such as statutory management of a bank that has failed.

In recent years, the Reserve Bank has devoted considerable effort to this area of responsibility. Particular emphasis has been placed on the complex issues associated with handling the New Zealand operations of a foreign bank. This has been an important element in the motivation for the local incorporation policy discussed earlier, and for the proposed outsourcing policy. We have also been investigating options for managing a bank failure that might allow a quick resumption of a failed bank's core functionality, in a way that might allow depositors continued access to the bulk of their funds, and enable businesses dependent on working capital credit lines to continue to maintain their flow of payments, without requiring the injection of large amounts of public funds. We have been working with banks exploring the feasibility of such options, and aiming to better understand the constraints and limitations that any such solution might face.

In most countries, there is a deposit insurance mechanism, which provides for an immediate payout of small deposit balances (ie, up to a capped dollar amount). These schemes generally are limited in their aims, focusing on protecting the value and liquidity of small depositors' funds. However, provision of insurance for these deposits cannot mitigate a sharp contraction of liquidity in wholesale markets, and would not do anything to provide for the continuing functioning of the institution. For these reasons, deposit insurance schemes tend to have only limited application in large bank failures and would not be a substitute for the policy initiatives the Reserve Bank has been undertaking in recent years. Nonetheless, New Zealand and Australia are the only two OECD economies without such a scheme, and the issue is currently under consideration in Australia.

The Reserve Bank Act provides that the Reserve Bank shall, if the Bank considers it necessary for the purpose of maintaining the soundness of the financial system, act as lender of last resort to the financial system. The Bank has been doing considerable work to develop its thinking on how to apply this important role in practice. One of the reasons central banks exist is to ensure that there is an elastic supply

of liquidity available in the face of unexpected changes in demand, such as in the event of a major uncertainty-causing shock. Without that flexibility, such shocks could pose threats both to macroeconomic and financial system stability.

In the course of its routine liquidity management operations, the Reserve Bank provides funds on demand to banks (and other counterparties), but does so against good quality collateral. Loans of last resort however, would involve providing funds against lower quality collateral, or on an unsecured basis. Before making loans of last resort, the Bank would have to have good grounds for judging the illiquid institution(s) not to be insolvent. This means that there is a close connection between the lender of last resort function and the prudential supervision function.

The Bank is also continuing to improve our internal preparedness to handle a major bank failure. We are strengthening internal awareness of the key steps that might need to be taken, and ensuring that the provisions and constraints of relevant pieces of legislation are well-understood. We are planning to conduct scripted exercises to better test our preparedness, and will be looking to work closely with APRA to strengthen our ability to handle the trans-Tasman dimensions of any crisis.

Payments system oversight

The Reserve Bank is both a provider of core payment and settlement systems, and the general overseer of New Zealand payments systems. Our operational role as provider of Austraclear and the Exchange Settlement Account System (ESAS) is dealt with later in this document.⁹

The Reserve Bank's payment system oversight role is prescribed in parts 5B and 5C of the Reserve Bank Act. Part 5B establishes the Reserve Bank's power to require payment systems to provide the Bank with information. The Reserve

⁹ Other than those provided by the Reserve Bank, the main payment system is Interchange and Settlement Limited (ISL), which handles the daily inter-bank interchange of cheque, ATM, and internet and desktop banking payments. Interchange of EFTPOS and credit card payments occurs through separate systems. These payment systems are owned by the banks. The New Zealand banks that deal in foreign exchange also use the international Continuous Linked Settlement (CLS) system.

Bank can address any issues identified by publishing its analysis, and by consulting with payment system providers and (supervised) registered bank users of those payment systems. The main areas of current policy interest relate to governance of the bank-owned payment systems, business continuity arrangements for critical payment functions, and the rules for handling a failure to settle by a participant. The Reserve Bank has recently published a Statement of Principles to explain, and put more structure around the Reserve Bank's payment system oversight activities. There is considerable ongoing work in this area.

Part 5C of the Act establishes the ability for payment systems to apply to be 'designated' payment systems (designation is by Order in Council, on the advice of the Minister, given in accordance with a recommendation by the Reserve Bank). The effect of designating a payment system is to make the rules of that payment system, in respect of finality of payment, valid and enforceable under New Zealand law despite any enactment or rule of law to the contrary. Currently, two systems are designated. One is our own ESAS system. The second is the international Continuous Linked Settlement (CLS) system for the simultaneous and irrevocable settlement of the two legs of foreign exchange transactions. The Reserve Bank was actively involved in securing the adoption of the New Zealand dollar as one of the CLS settlement currencies late last year. This system has materially reduced the degree of risk associated with the settlement of foreign exchange transactions (by far the largest portion of the transactions settled by the banking system each day).

Financial market operations

Domestic markets

As noted in Section 2, as a technical matter, implementing monetary policy involves the Bank standing willing to borrow and lend from counterparties overnight at interest rates either side of the Official Cash Rate. In addition, the Reserve Bank supports the effective management of financial system liquidity by undertaking daily open market operations to smooth the fluctuations in aggregate liquidity arising mainly from the Government's own financial transactions. We are

currently reviewing the nature and required frequency of these open market operations.

The Bank also conducts the regular tenders of government bonds and Treasury bills, under an agency arrangement with The Treasury's Debt Management Office. And in July this year, the Bank introduced a bond lending facility. Under this facility, the Bank can lend bonds to the market out of its own portfolio to alleviate occasional pressures that arise when scarcity of particular bonds in the market cause payment and settlement stresses.

Undertaking these various activities, and the day-to-day engagement they provide us with key financial institutions, assists the Bank to stay closely attuned to developments in domestic financial markets. That enhances our ability to do the monetary policy and prudential supervision roles well.

Foreign reserves for crisis intervention

The Reserve Bank holds the bulk of New Zealand's foreign exchange reserves (others are held by The Treasury's Debt Management Office). Under section 24 of the Act, the Minister of Finance periodically determines, in consultation with the Bank, the level of foreign reserves to be held by the Bank. The Reserve Bank holds highly liquid foreign reserves primarily to facilitate intervention in the foreign exchange market, on the rare occasions when conditions of extreme disorder prevail in the foreign exchange market. The focus of any such intervention would be to help restore liquidity to the market and ensure that essential business was able to be conducted. Holding foreign reserves, and maintaining the requisite systems and trading skills, is akin to maintaining an insurance policy – it has value even if a claim is never made. Managing foreign reserves and closely monitoring the New Zealand dollar foreign exchange market provides us with a degree of ongoing active engagement with domestic and international markets that helps inform both our bank supervisory and monetary policy responsibilities.¹⁰

¹⁰ To help further strengthen our monitoring and dealing capability, the Reserve Bank recently reached an agreement with The Treasury's Debt Management Office to become a major provider of foreign exchange transactions services to them.

For most of the period since the New Zealand dollar was floated in 1985, the Bank has limited its intervention objective to countering extremely disorderly conditions in the currency markets. Although intervention has been considered on occasions since 1985, it has not yet been found necessary to intervene. The possibility of intervention to counter extreme disorder remains an important part of the Reserve Bank's planning, including shaping the emphasis we place on ensuring that our assets are held in highly liquid form. As presently structured, any such intervention would be subject to ministerial directive.¹¹

After an extensive review, the first undertaken since the late 1980s, the target level of foreign reserves approved by the Minister was increased last year.¹² In New Zealand dollar terms, the Bank's reserves will increase gradually, by a total of around \$1.9 billion, over the period to mid-2008. The target level of reserves is set solely on the basis of an assessment of the level of reserves that might be needed to support the liquidity of the foreign exchange market in a crisis. These reserves are not held to support the Bank's own discretionary activities in the foreign exchange market (discussed earlier in this document).

The foreign reserves held by the Bank are financed by borrowing undertaken by The Treasury's Debt Management Office. The proceeds of these borrowings are in turn provided to the Bank in the form of foreign currency loans that are closely aligned to the overall mix of foreign currency assets the Bank wishes to hold. This helps ensure that risks the Bank takes in holding reserves are fully reflected in the Crown's overall financial management. Raising the level of foreign reserves therefore raises the Crown's gross debt, but leaves its net debt unchanged.

Holding foreign currency reserves provides a degree of 'risk insurance' but also normally entails modest costs. The costs arise because, on average, the New Zealand Government can typically only borrow (and raise foreign currency) at slightly higher interest rates than the Bank can expect to

earn by investing in highly liquid, highly rated foreign government bonds. The cost fluctuates from year to year (some years even generating a modest positive return), but the annual direct cost to the Crown of maintaining New Zealand's current intervention capacity has averaged less than \$10 million in recent years. These costs have been falling as a result of looking for smarter ways to fund and hold reserves, and specific (unusually favourable) conditions in the markets in which the reserves are financed mean that we expect foreign reserves to earn a modest positive return in the current financial year.

¹¹ Although the Bank has been delegated powers to undertake a limited amount of such intervention without prior authorisation should the Minister not be able to be contacted quickly.

¹² The methodology used in this review was itself reviewed by the International Monetary Fund team that reviewed the New Zealand financial system in late 2003.

Section 4

Other functions

Currency issuance and management

Under Section 25 of the Reserve Bank Act, the Reserve Bank has the responsibility, and the sole right, to issue bank notes and coins in New Zealand. Issuing bank notes and coins is one of several buttresses that help ensure that the Reserve Bank retains the ability to achieve and maintain price stability. (Banks need to hold other Reserve Bank deposit liabilities in order to purchase notes and coin.) The Reserve Bank focuses on ensuring that the currency issue is managed in a secure and cost-effective way, to meet this dimension of the payment needs of New Zealand households and businesses. Substantial efficiency gains have been achieved in recent years through a number of initiatives, several of which have made the Reserve Bank's currency operations a model from which other central banks have sought to learn.

Our statutory role in the currency area includes determining the design and composition of the notes and coins. Consistent with our focus on a cost-effective approach to the currency issue, in 2004/5 the Bank undertook an extensive review of New Zealand's 'silver' coinage. The Bank consulted widely with a range of interested parties, commissioned surveys of retailers and the general public, and released proposals for public discussion. On 31 March 2005, after evaluating all the information collected, the Bank announced that, although the designs on the coins will not be changed, the following changes will be made:

- The 10, 20, and 50 cent coins will be made smaller and the inner core of the coins will be changed to steel.
- The new 20 and 50 cent coins will be nickel-plated to give a silver appearance and the 10 cent coin will be copper-plated.
- The 20 cent coins will have a distinctive edging, and the 10 and 50 cent coins will be unmilled.
- The 5 cent coin will be withdrawn from circulation.

To implement the changes, the Reserve Bank invited several overseas mints to submit tenders for the supply of new coins. After an extensive evaluation process, it was announced recently that the Royal Canadian Mint had been awarded the contract to supply New Zealand coins for the

period 2006 to 2009. The Bank has invited tenders for the sale for scrap of old coins that will be recovered after the changeover in 2006.

The introduction of new coins will bring major ongoing benefits, but there will be transition costs for many businesses that handle coins. The largest costs will be for the recalibration of coin 'changer' vending machines, and coin counting and sorting equipment. The adjustments required will vary from full machine replacement (in a very small number of cases affecting old machines) to a 15 second reprogramming for parking 'pay and display' type machines. It will be relatively simple to reprogramme the many modern coin vending machines that have been used in New Zealand since about 1992.

The Bank will assist those in the coin-handling business by:

- distributing production coins for testing and for the calibration of machines six months before the first issue day;
- facilitating the transfer of new coins to retailers; and
- facilitating the return of old coins to main centres.

The Bank has been working closely with the industry to ensure a smooth transition and to keep to a minimum any operational risks surrounding the changeover.

Early next year the Bank will launch a public awareness programme to explain what will happen when the new coins are issued and what people should do with their old coins.

The Bank plans to issue the new coins around July 2006. Experience from the introduction of the euro notes and coins in 2002 suggests that four to six weeks after the first issue of the new coins they will have largely replaced the existing coins. The Bank expects to 'demonetise' the current coins about three months after the new coins are issued. From that date they need no longer be accepted as payment for goods and services. However, the Bank itself, or its agents, will always redeem the coins at face value. The period between the introduction of the new coins and the formal demonetisation of the old ones will be shorter than we have adopted in the past (when the 1 and 2 cent

coins and \$1 and \$2 dollar notes were demonetised). However, the three-month period between issuance and demonetisation of the old coins is the same as was used for the highly-successful launch of the euro notes and coins in 2002. Under Section 26 of the Act, the Minister of Finance's consent is required for the Reserve Bank to demonetise any notes and coins that have already been issued. Earlier this year, the Minister agreed to the Bank's plans to demonetise the existing 5, 10, 20, and 50 cent coins in 2006, although a date has yet to be specified.

It is not expected that the Bank will need to make any other changes to these coins, unless it decides to change the designs, for at least 20 or 30 years.

Electronic payment media have become increasingly widely used in recent decades, and stored value cards have also begun to have a greater presence internationally. In the longer term, this raises issues as to whether central banks, such as the Reserve Bank, should eventually consider issuing some form of electronic money themselves, to complement the current physical currency. We continue to monitor the literature in the area and to be alert to any future international developments.

Banking and settlement services

Section 32 of the Reserve Bank of New Zealand Act 1989 allows the Bank to provide settlement account services for financial institutions on agreed terms and conditions. Settlement services are provided through the Exchange Settlement Account System (ESAS), a real-time gross settlement system. Transactions in excess of \$32 billion were settled across ESAS system on average each working day of the last financial year. At present ten of the registered New Zealand banks and Continuous Linked Settlement Bank (CLS) hold settlement accounts in ESAS. Pricing in the ESAS system is set to recover the Reserve Bank's operational and development costs.

Under section 34 of the Act, the Bank also provides some banking services to the Government; in particular, the overnight balance in the Crown's operating accounts is held at the Reserve Bank. These two operational roles are somewhat interconnected and together also help underpin

our ability to secure effective control over monetary conditions.

Austraclear clearing and settlement System

Section 35 of the Reserve Bank Act enables the Bank to provide securities registry services. The Bank is the system operator of the electronic securities clearing and settlement service is provided to both investors and financial service providers. Beneficial owners of securities deposit them with the Bank's wholly-owned subsidiary New Zealand Central Securities Depository Limited (NZCSD) which acts as custodian trustee. NZCSD holds debt and equity securities with a combined value of almost \$90 billion dollars. The average daily value of securities settled and cash transferred by the Austraclear system exceeds \$8 billion. A commercial charging structure is in place which generates a return on the capital invested in the system.

The Austraclear and ESAS systems are highly integrated. The systems are the cornerstone of the institutional national payments infrastructure and operating these systems provides a further useful window for the Bank on developments affecting participants in the New Zealand financial markets. It is, of course, essential that the systems are well supported and meet international operating standards for payments and settlements. The Bank is committed to undertaking a major upgrade of these systems before the end of 2007 and will ensure that the applications and associated databases are appropriately supported by relevant vendors after that date.

The Bank formerly acted as registrar and paying agent for issuers of debt securities. Effective from December 2004, the Bank withdrew from the business of providing registry services for issuers.

