



**RESILIENCE** IN THE FACE OF  
SHOCKS AND VOLATILITY

# GROWING OUR CAPACITY TO MANAGE SHOCKS AND VOLATILITY



## CONTENTS

Our Vision and Values .....	1
The Reserve Bank of New Zealand – what we do.....	2
The year at a glance.....	3
Governor's Statement.....	4
Board of Directors' Report for the year ended 30 June 2011 .....	6
Planning and reporting framework.....	11
Strategic Priorities and outcomes 2010-11 .....	12
Reserve Bank organisational structure .....	14
Board of Directors .....	15
Governance.....	16
Chronology .....	20
The year in review .....	22
Monetary policy formulation.....	22
Financial markets:	
Domestic markets	
Foreign reserves management.....	24
Financial system surveillance and policy .....	29
Currency operations.....	32
Depository and settlement services .....	34
Human resources .....	37
Knowledge services .....	39
Internal financial services .....	40
Communications.....	40
Risk assessment and assurance .....	41
Property management and security .....	42
International activities .....	42
Glossary.....	43
Our Financial Statements – an overview .....	44
Strategic Priorities for 2011-12 .....	53
Strategic Priorities over time .....	54
Contents of the Financial Statements .....	57
Management Statement.....	58
Audit Report.....	59
Reserve Bank of New Zealand 2010-11 Financial Statements....	62
Five-year historical financial information .....	110

*Reserve Bank of New Zealand Annual Report and Financial Statements for the financial year ended 30 June 2011, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2011.*

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## OUR VISION

**We promote a sound and dynamic monetary and financial system.**

### WE WORK TOWARDS OUR VISION BY:

- Operating monetary policy to achieve and maintain price stability.
- Assisting the functioning of a sound and efficient financial system.
- Meeting the currency needs of the public.
- Overseeing and operating efficient payment systems.
- Providing effective support services to the Bank.

## OUR VALUES

### INTEGRITY

Being professional and exercising sound judgement.

### INNOVATION

Actively improving what we do.

### INCLUSION

Working together for a more effective Bank.

# THE RESERVE BANK OF NEW ZEALAND – WHAT WE DO

The Reserve Bank of New Zealand (the Bank) is the nation's central bank. It is wholly owned by the New Zealand government. Under the Reserve Bank of New Zealand Act 1989 (the Act), it has three main functions to enable it to contribute to New Zealand's prosperity and advancement:

## MONETARY POLICY

The Bank has operational independence to manage monetary policy to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA). (See pages 22-23 for more detail on monetary policy activity in 2010-11.)

The Bank operates in the financial markets to support the implementation of monetary policy. (See pages 24-28.)

## FINANCIAL STABILITY

The Act also directs the Bank to promote the "maintenance of a sound and efficient financial system" and to avoid "significant damage to the financial system that could result from the failure of a registered bank". (See pages 29-31.) To achieve these requirements, the Bank registers banks and operates a prudential supervision system designed to encourage banks, non-bank deposit takers (NBDTs) and insurance companies to manage their risks carefully.

The Reserve Bank acts as banker to the banks, providing inter-bank settlement facilities and related payment services. (See pages 34-36.)

It advises the government on the operation of the financial system. The Bank manages foreign exchange reserves to enable intervention in the foreign exchange market, if required.

## CURRENCY

The Reserve Bank issues New Zealand's currency. It controls the design and printing of the nation's currency, which it then issues to banks for their customers. The Bank also withdraws from circulation and destroys damaged or unusable currency. (See pages 32-33.)

*These external functions are supported by six internal service departments. (See pages 37-42.)*

*Our internal organisation is illustrated in the chart on page 14. Details of the Reserve Bank Board of Directors are provided on page 15. The role of the Board, and the governance and management of the Bank, are described on pages 16-19.*

## THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation rose from 1.8 percent for the year to June 2010 to 5.3 percent for the year to June 2011. Removing one-off increases in tax and government charges, CPI inflation was 2.7 percent over the June year.
- The Bank lowered the Official Cash Rate (OCR) from 3.0 percent in July 2010 to 2.5 percent in March 2011 following the February Christchurch earthquake. (The Bank held the OCR steady at 2.5 percent on 28 July 2011.)
- The Bank removed some temporary crisis liquidity measures, leaving others in place as European sovereign debt concerns refuelled market volatility.
- The Bank published a review of potential macro-prudential policies to assist in promoting financial stability and managing the credit cycle.
- The Bank determined a set of principles to guide its implementation of the new international regulatory standards for bank capital and liquidity known as 'Basel III', adapting them to suit New Zealand conditions.
- New rules were introduced to ensure that the regulatory capital that New Zealand's four largest banks hold for their farm lending exposures is properly aligned with risk in the sector.
- The Bank completed a review of bank disclosure requirements, and undertook policy work on covered bonds and the implementation of the Bank's Open Bank Resolution policy.
- Governance requirements came into force for non-bank deposit takers, and Cabinet approved a second bill to be introduced to include requirements for licensing, "fit and proper" criteria for directors and senior officers, related-party exposures, and powers to deal with failures.
- Following the enactment of the Insurance (Prudential Supervision) Act 2010, the Bank has developed guidelines, issued the Fit and Proper Standard, and consulted on solvency standards for life, non-life and captive insurers.
- An anti-money laundering Sector Risk Assessment has been published and regulations have been issued. We have commenced designing our risk model and reporting system for reporting entities.
- The Bank started planning the development of a new series of banknotes with upgraded security features.
- The Bank's Auckland office became operational in April 2011 to provide business continuity and disaster recovery capability in the event of a Wellington regional disaster.
- The Bank spent a net \$46.8 million on activities covered by its Funding Agreement.
- A dividend of \$210 million was paid to the Crown.<sup>1</sup>

<sup>1</sup> The dividend to the Crown was confirmed by the Minister of Finance after balance date.

## GOVERNOR'S STATEMENT

The developed world has been through a fragile and very slow recovery since the global financial crisis troughed in mid-2009. Given the severity and nature of the crisis, striking at the financial heart of economies, this is understandable. However, it is now clear that it means a slow grind ahead, with surprises and disappointments that we cannot necessarily foresee.

As well as ensuring price stability, the Bank's focus, therefore, is in ensuring the New Zealand economy and financial system are resilient in the face of shocks and volatility. We are seeking to reduce the likelihood of their being hit by bad shocks, and minimise any damage that they can inflict if we are hit.

Internationally, the US, the world engine of growth for so long, has shown only very slow signs of recovery, leaving markets deeply unsettled. Concerns in Portugal, Ireland, Greece and Spain (the 'PIGS'), the UK, Japan, and more recently Italy, have added to market instability.

Offsetting this, China, East Asia and Australia have generally surpassed growth expectations, with very strong impacts on commodity prices and a very strong kiwi dollar.

At home, the Christchurch earthquake in February 2011 was a major shock, causing significant disruption, destruction and economic uncertainty, hurting some businesses and stressing the insurance sector. The rebuild will be huge, but could also be disruptive, with likely bottlenecks and cost pressures.

Meantime, fall-out in the finance company sector has continued, with the Government carrying a significant liability under the Deposit Guarantee Scheme.

A tax revamp, with increases in GST, the Emissions Trading Scheme and excise tax, has contributed to a hefty rise in headline inflation and some impact on future inflation expectations.

In part related to the above events, revisions to current and past economic data have added to the challenges of reading the current state of the New Zealand economy.

Our objective through these surprises has been to see the New Zealand economy gain confidence and momentum, while staying on top of inflationary pressures. Early in the financial year, we saw value in lifting interest rates off their historical lows, and increased the Official Cash Rate to 3 percent in July 2010.

However, when the February earthquake hit, we cut the OCR back to 2.5 percent in March to 'insure' against a sharp fall in confidence and activity. We have recently signalled that we feel the economy no longer needs this earthquake-related 'insurance' in place.

While the future track of interest rates can be expected to rise to contain underlying inflationary pressures, we have signalled that movements in the OCR are likely to be much more restrained than in previous cycles. This is due to changes in funding costs for banks, exceptionally low mortgage durations, risk premia, and general caution by households and businesses, including de-leveraging.

Over the year there has been ongoing international pressure on the kiwi dollar. While some exchange rate strength is to be expected and is appropriate when our terms of trade has peaked at its highest level in almost 40 years, its recent pressure has concerned us as a drag on the economy, though it does also lessen the need for future OCR increases.

As foreshadowed last year, we have done more preparatory work on a range of macro-prudential tools. Macro-prudential instruments may help bolster financial system resilience and possibly moderate credit cycles, but expectations need to be realistic about what can be achieved. None would provide the definitive answers in terms of moderating the credit cycle, but we believe that, used in tandem, a number could potentially contribute to greater stability through future cycles.

The crisis years have also taught us some things about bank regulation. In particular, we are tightening up on the models that determine capital requirements for lending on housing and agriculture. We have put in place liquidity requirements that have already been shown to work well.

Where relevant for New Zealand, we are moving forwards with the set of new international bank regulatory standards known as 'Basel III'. We have also done work on how to manage banks in stress conditions, learning from the Ireland/Iceland/UK experiences. The main new tool here is Open Bank Resolution, which, when in place, will make it easier to keep the system functioning if a big bank fails.

The Reserve Bank has taken on responsibility for insurance regulation this year. As we begin the significant operational challenge of licensing insurance companies, we are seeking to put in place minimum solvency requirements that will enable insurers to withstand extreme but plausible catastrophes.

Further building system resilience has been our designation of a new NZX central counterparty clearing house.

This provides a modernised equity settlement platform, and offers better protection against contagion in exchange traded derivatives markets.

Industry changes to the retail payments system have provided an opportunity for the Bank to require features that should assist in better managing payments, should a participant experience distress.

We have had to manage our own balance sheet to take into account big moves in the kiwi and fragility in offshore sovereign markets, especially US Treasuries. Our foreign reserves management benchmarking project will help us to do this in the coming year.

As the New Zealand currency ages and security features mature, we can expect a higher rate of attempted counterfeiting. For this reason, we have started work on a multi-year banknote upgrade project to make New Zealand's banknotes even more robust for the next decade.

Following on from learnings from the Christchurch earthquake, we are better able to handle significant Wellington disruptions using our new Auckland office disaster recovery capability.

Internally, our processes and skills have looked resilient through the stress of recent years. We are seeking to build on this strong platform through work on new accounting systems and statistical systems, as well as focusing training on managerial competencies.

We can expect more disruption and fragility ahead, much of it originating from offshore. We cannot predict all of this, but we can plan to be resilient through it.

This resilience is the result of the foresight and hard work of many people at the Reserve Bank. I extend my thanks to staff, senior managers and the Board for their contributions to our work in laying stronger foundations for New Zealand's future.



**Alan Bollard**

Governor

15 September 2011

## BOARD OF DIRECTORS

### REPORT FOR THE YEAR ENDED 30 JUNE 2011

This report is made pursuant to section 53A of the Reserve Bank of New Zealand Act 1989.

The Reserve Bank's Board of Directors is responsible for keeping the performance of the Bank and of the Governor under constant review across all Bank functions. The Reserve Bank of New Zealand Act 1989 sets out the Bank's responsibilities, and mandates that decisions with respect to the bulk of the Bank's functions are the responsibility of the Governor.

The Act specifies (section 8) that: *The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.* In addition, the Act determines responsibilities for the Bank with regard to: managing foreign exchange reserves, issuance of currency (notes and coins), lender of last resort, registration and supervision of banks, oversight of payments systems, designation of settlement systems, regulation of non-bank deposit takers, and licensing and prudential supervision of insurance companies. The Bank has additional powers within the Act to provide other services including settlement account services and securities registry services. Thus the Bank acts as a 'full-service' central bank.

Each year, the Bank publishes a *Statement of Intent* covering the following three years, with a listing of its strategic priorities for the first year. These priorities relate to items that are over and above the Bank's normal course of business. The strategic priorities for the 2010-11 year contained in the 2010 *SOI* were:

1. Investigate the potential for macro-prudential policy tools for New Zealand.
2. Begin unwinding special financial system support and monetary policy stimulus.
3. Identify any appropriate changes to the bank supervision regime, including those based on international regulatory norms.
4. Advance the implementation of the new Non-Bank Deposit Taker (NBDT) regime.
5. Develop and implement the new prudential regime for Insurance.
6. Engage, develop and support staff to meet the challenges of the Bank's evolving responsibilities.
7. Improve business continuity and disaster recovery capability through the establishment of a business support centre in Auckland.

The Board, through its regular meetings and comprehensive reporting from Bank management, monitors the Bank's progress with respect to these strategic priorities. We also keep under review the Bank's progress in meeting its core monetary policy goals and meeting its other responsibilities under the Act. Our view on the Bank's performance in these respects is listed below.

### MONETARY POLICY

The Policy Targets Agreement (PTA) requires the Bank "to keep future CPI inflation outcomes between 1 percent and 3 percent on average over the medium term." The PTA also states that "the Bank shall implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate." The year saw CPI inflation rise to a 21-year high of 5.3 percent for the twelve months to June 2011. Recent headline inflation outcomes have, however, been affected by several major shocks that are not within the direct control of the Reserve Bank.

The PTA explicitly acknowledges that a range of events may push inflation temporarily above 3 percent or below 1 percent. Examples of such events, as specified in the PTA, include: "exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy." All four of these types of event came to pass in 2010-11: internationally traded food and oil prices rose sharply, GST was raised from 12.5 percent to 15 percent, the ETS was introduced, and three devastating earthquakes struck Christchurch. Given the influence of these events that were outside the control of the Bank, the Board has 'looked through' the short-term headline inflation rate and focused on whether the policies of the Bank have been consistent with maintaining inflation within the range specified by the PTA for the medium term.

The Bank began raising the OCR in June 2010 from its historic low rate of 2.5 percent to 2.75 percent. The Bank further raised the rate to 3.0 percent in July 2010 as the economic outlook strengthened, accompanied by anticipated upward pressure on CPI inflation which had started the year near the middle of the target band. The Bank maintained the OCR at 3.0 percent after the September 2010 earthquake. However, in response to the much more devastating February 2011 earthquake, the Bank cut the OCR by 50 basis points (half a percent) to 2.5 percent. It described this cut as an ‘insurance policy’ to guard against a broader loss of economic confidence, at a time when it appeared that the economy as a whole had not recovered as strongly as expected from recession. The Board considered that this approach was consistent with the requirements of the PTA.

The Bank maintained the OCR at this level for the remainder of the 2010-11 year. Information released since June 2011 shows that the economy strengthened in early 2011, with quarterly GDP growth of 0.8 percent in the March 2011 quarter. This growth, and the subsequent June quarter CPI inflation outcome of 1.0 percent, was stronger than had been anticipated by the Bank. Nevertheless, the Bank has managed to maintain medium-term core inflation within the bounds specified by the PTA.

Core inflation can be interpreted as the general trend in price inflation across the bulk of goods and services covered by the Consumers Price Index (CPI), excluding GST effects. The Bank’s ‘factor model’ of core inflation provides one summary measure of this concept. Another useful summary measure, that abstracts from the ‘events’ listed in the PTA, is the ‘CPI excluding government charges, food and fuel’ (CPIx).

Annual core inflation, as measured by these two indices, jumped from 2.0 percent (factor model) and 1.4 percent (CPIx) in the year to June 2010, to 3.3 and 3.4 percent respectively in the year to June 2011. Over the medium term, which may be interpreted as covering the past three years, these two measures of core inflation have averaged 2.5 percent and 2.1 percent respectively, both within one-half of a percent of the mid-point of the medium-term target range. Thus, the Board’s view is that recent monetary policy outcomes, while affected by short-term events, have been consistent with the requirements of the PTA.

The principal shock to headline (CPI) inflation over the past year has been the GST increase, in which the tax rate increased from 12.5 percent to 15 percent on 1 October 2010. This indirect

taxation increase is estimated to have boosted the CPI by 2.0 percentage points in the year to June 2011. Past experience with GST increases accompanied by reductions in other tax rates (as on this occasion), indicates that the boost to headline inflation should be short-lived, provided that monetary policy is implemented in a manner that contains longer-term inflation expectations to within the target range.

As well as monitoring short to medium-term inflation outcomes as described above, the Board has considered the longer-term trend in inflation so as to gauge the Bank’s performance in achieving monetary policy outcomes over successive PTAs. Following passage of the 1989 Act, the Bank was tasked with achieving an annual CPI inflation rate of between 0 and 2 percent by 1992. The policy range was lifted to 0 to 3 percent in 1996 and then changed again to a 1 to 3 percent medium-term range in 2002. In each case, while CPI inflation was the formal measure, the Bank was instructed in the relevant PTA to look through transitory shocks to the CPI.

Now that 20 years have passed since the first target year, we are able to check how inflation has tracked relative to these PTA requirements. We do so by looking at average inflation outcomes for four successive five-year periods, each ending in June: 1992-1996, 1997-2001, 2002-2006, and 2007-2011. The first period corresponds to the 0-2 percent policy target era; the second corresponds to the 0-3 percent era; and the final two periods correspond broadly to the 1-3 percent era.

CPI inflation averaged 2.0 percent, 1.5 percent, 2.7 percent and 3.0 percent respectively for the four periods. These figures indicate an increase in the average inflation rate at the time that the lower bound of the inflation range rose from 0 percent to 1 percent. Similarly, core inflation as measured by the factor model, averaged 2.0 percent, 2.0 percent, 2.6 percent and 2.7 percent respectively. (The Bank’s recently derived ‘sectoral factor model’, available only since 1993, averaged very similar rates of 1.9 percent, 2.7 percent and 2.7 percent respectively over the last three five-year periods.) Core inflation, according to the factor model measure, therefore also rose at the time that the floor of the inflation target rose from 0 percent to 1 percent. Nevertheless, in each case, the average inflation rate was contained to within the relevant target range.

The alternative core measure, CPI inflation excluding government charges, food and fuel, shows a different picture: average core inflation over the four periods is measured as 2.5 percent, 1.6 percent, 2.4 percent and 2.1 percent respectively. These

figures indicate that there has been no trend in inflation over the 20-year period, once we abstract from volatile fuel and food commodity prices and abstract from the effects of changes in government charges and indirect taxes. All these prices are, of course, important for consumers, but government charges and taxes are beyond the direct control of monetary policy, as are global prices of food and fuel.

Monetary policy can moderate the impact of global prices on New Zealand dollar prices of food and fuel through influencing the exchange rate, and the strong exchange rate over 2010-11 has moderated the impact of these prices on the cost of living for New Zealanders. However, a more volatile and, on average, higher exchange rate would have been required in order to offset fully the impacts of these high global prices on domestic food and fuel prices. Greater exchange rate volatility would have been contrary to the PTA requirement that monetary policy be implemented in a way that “avoids unnecessary instability in output, interest rates and the exchange rate”. In keeping with the PTA, the Bank instead largely looked through the impacts of these global price rises (and of the GST and other government-induced price rises) when setting policy over the past year.

In its June 2011 *Monetary Policy Statement*, the Bank projected that CPI inflation would fall back after the GST rate increase drops out of the index. It projected that CPI inflation will be maintained within a range of 1.8 percent to 2.5 percent over the December 2011 to March 2014 period. One risk is that longer-term inflation expectations may now be reflecting the current high headline rate and/or other potential inflationary factors. The Reserve Bank’s two-year-ahead inflation expectations series jumped to 3.0 percent in June 2011, after staying within the 2.6 - 2.8 percent range for the previous six quarters. For the same five-year periods as defined above, average two-year ahead inflation expectations have been 1.8 percent, 2.0 percent, 2.5 percent and 2.7 percent respectively. Thus, there has been an upward trend in inflation expectations over the past 20 years.

The June quarter 3.0 percent figure is the equal highest rate of two-year-ahead inflation expectations recorded since March 1991. It will be important that the Bank’s monetary policy actions are consistent with reducing these inflation expectations if medium-term inflation is to be contained within the target band. A fall in the headline rate, once the impact of the GST rise on inflation washes through, should assist in this regard.

Overall, the Board is satisfied that monetary policy has been implemented both in the past year and over the past two decades in a manner consistent with the requirements of successive PTAs and the Act. Nevertheless, recent core inflation outcomes and inflation expectations are around the top of the medium-term target, and will need to be reduced in order for the Bank to maintain medium-term inflation outcomes consistent with the 1-3 percent target.

## STRATEGIC PRIORITIES

The first five of the Bank’s strategic priorities listed in the 2010-11 SOI relate to the Bank’s roles with respect to financial stability. The first strategic priority relates to the potential introduction of macro-prudential policy tools for New Zealand. The Bank has investigated such tools for some years, and other countries are also experimenting with new macro-prudential policy tools.

The introduction in New Zealand of the core funding ratio has placed this country ahead of most others in formulating and implementing a liquidity-based requirement on banks. Its introduction has proceeded smoothly. The ratio provides an instrument that could temper excess liquidity in the financial system of the kind that was observed, for instance, during the lead-up to the global financial crisis (GFC). The IMF, in its 2011 country report on New Zealand, praised the introduction of this instrument as a means to reduce excess liquidity of banks. It noted also that the changed funding practices of banks (especially the banks’ greater reliance on domestic deposit taking) have had the impact of raising market interest rates relative to the OCR, thus implying a tighter monetary stance for a given OCR than was the case previously.

The scope for active, as opposed to passive, use of the core funding ratio is still under investigation, as is the scope for the introduction of other macro-prudential policy instruments. These investigations are proceeding internationally as well as domestically, and there is still little international consensus on the nature and use of instruments that may temper macro-prudential concerns. The Board supports the Bank’s investigation of policy instruments, beyond the core funding ratio, that could be used to control financial market excesses without relying exclusively on interest rate and/or exchange rate transmission channels for their effects. This support comes with the important proviso that any new policy instruments are well targeted and avoid material distortions to financial market efficiency.

The Bank's second strategic priority for 2010-11 was the unwinding of special financial system support and monetary policy stimulus. The unwinding of special financial system support proceeded smoothly, with no apparent liquidity problems in the markets. The Christchurch earthquakes, however, complicated the unwinding of monetary policy stimulus; indeed, the Bank provided extra stimulus following the February 2011 earthquake. This stimulus remained in place as at June 2011.

The third strategic priority involved changes to the supervisory regime for banks influenced, in particular, by ongoing international developments. The Basel 3 regime is a key international influence and has been reflected in changes to the prudential regime for banks in New Zealand. The Reserve Bank has not adopted all elements of the new international proposals since some are considered to be inappropriate for this country. One example is the leverage ratio which could prove distortionary for banks' lending decisions if adopted. The new regime has been discussed widely with the Board and with the banks.

The Board is comfortable that the regime in New Zealand has been designed to suit the requirements of the New Zealand economy and banking system, for instance in its treatment of risk weights on agricultural lending. A welcome modification that the Reserve Bank introduced for the supervisory regime for banks was the overhaul of bank disclosure requirements. The new requirements have led to more easily digested disclosure documents for customers and a reduction in compliance costs for banks.

The fourth and fifth strategic priorities relate to the development and implementation of new regulatory regimes for non-bank deposit takers (NBDTs) and for insurance companies respectively. Given the performance of the NBDT sector in recent years and the different nature of the insurance industry from the deposit-taking industry, these new responsibilities for the Bank have required it to gear up its regulatory capacity, including its staff. It has made considerable progress in doing so. The Bank has also made headway in finalising the prudential regime for NBDTs and in publishing guidelines relating to the supervisory framework for insurance companies.

The general insurance sector came under extra pressure during the year as a result of the Christchurch earthquakes, and Government assistance was called upon in relation to one major

insurance company. These events highlighted the importance of adopting standards that maintain confidence in the insurance industry in the face of major shocks.

The Board anticipates that the Bank's involvement in setting standards for these two sectors will improve outcomes. However, we are also acutely aware that most financial activities are based on calculated risks and so failure of institutions cannot be ruled out. Indeed, if standards were so strict that failure could be ruled out, this would almost certainly mean that the standards were overly stringent, preventing the financial sector from playing its full role in intermediating financial transactions and risk. Thus, despite the Reserve Bank's involvement with banks, NBDTs and insurance companies, individual agents and their advisers must still be responsible for taking appropriate precautions when dealing with any financial institution.

The economic and financial consequences of the earthquakes have highlighted the importance of organisations having in place well prepared disaster recovery strategies. The Bank's seventh strategic priority for 2010-11 related directly to this issue. The Bank successfully met its target of establishing a small office in Auckland to provide business continuity for its major functions in the event of a regional disaster in Wellington. This is an aspect of risk management that has been a major priority for the Board, and directors are delighted that the office is now running smoothly with a small staff, linked through to Wellington by excellent IT facilities. If Wellington, and that city's staff, were to be put out of action, the Auckland office could ensure that critical functions of the Bank would continue. The Board commends the Bank's management for completing this vital project.

The Bank had an internally-focused strategic priority of encouraging, developing and supporting staff to meet the Bank's evolving responsibilities. It continues to be an institution with high levels of staff satisfaction and a positive approach to staff training (as evidenced by surveys). There is now greater scope for staff to develop within the organisation as the breadth of its regulatory responsibilities has expanded. There is also beneficial movement of staff both to and from the private sector, and in some cases former staff return to more senior roles at the Bank after experience either in the private sector or in international financial institutions. These movements are positive both for the Bank and for other organisations, ensuring a beneficial cross-fertilisation of ideas between the Bank and others.

## OVERALL ASSESSMENT AND OUTLOOK

The Bank is a complex institution that requires not only skill in setting and implementing policies, but also skill in controlling and managing a substantial balance sheet. The Bank's balance sheet expanded over the year from \$26.4 billion to \$31.1 billion, largely as a result of government-related transactions. It holds substantial foreign reserves, of which \$2.2 billion were held in unhedged foreign currencies as at 30 June 2011. The Board recognises that this unhedged position, which has been adopted for policy purposes related to the maintenance of stability and liquidity in the foreign exchange market, leads to volatility in the Bank's annual financial position as a result of exchange rate fluctuations.

Overall, the Bank recorded a net profit of \$144 million for the 2010-11 financial year and the Board supported a dividend payment to the Crown of \$210 million. The Board notes that the Bank's net operating expenditure as defined by its five-yearly funding agreement, at \$46.8 million, was \$1 million below the level budgeted in the funding agreement for 2010-11. This continues a pattern of responsible cost-control within the Bank.

Credit for the positive outcomes achieved by the Bank must go to all Bank staff, with particular acknowledgement of the role played by Dr Alan Bollard, the Bank's Governor. Recent years have been challenging for central banks and financial supervisors globally. The fact that the New Zealand banking sector and economy have come through the GFC and its aftermath in reasonable shape indicates that the Bank, in conjunction with others, has played a positive role in helping to prevent the very poor outcomes experienced in many other countries.

However, at the time of writing, the global fiscal and financial outlook is still fraught with major problems and uncertainties. At a macroeconomic level, the developed world faces dangers of further stagnation while inflationary pressures have emerged in some countries and in some sectors, especially commodities. On the financial stability front, there remains danger to the financial systems in a number of countries.

In this context, the Board has given strong support to the Bank's work in introducing an Open Bank Resolution (OBR) scheme. Such a scheme would save the taxpayer potential liability for massive costs as borne by some European governments in recent

years, and would enable the banking system to keep operating in the (unlikely) event of a bank failure. The Board considers that the finalisation of this scheme is a high priority for the Bank and for New Zealand as a whole.

The Reserve Bank has an important role to play in maintaining financial and economic stability in New Zealand. Despite the current global instabilities, we are confident that the Bank has the expertise to steer New Zealand's financial and monetary system through this challenging period.



**Arthur Grimes**  
Chair  
18 August 2011



**Hugh Fletcher**  
Deputy Chair  
18 August 2011

## PLANNING AND REPORTING FRAMEWORK

TABLE 1

Where the *Annual Report* fits

	2010-11	2011-12	2012-13	2013-14	2014-15
(I) PLANNING	5 YEAR FUNDING AGREEMENT				
	STATEMENT OF INTENT				
		ANNUAL • KPIs • Budget • Strategic Priorities			
(II) REPORTING	ANNUAL REPORT				
	MONETARY POLICY STATEMENTS (QUARTERLY)				
	FINANCIAL STABILITY REPORTS (SIX-MONTHLY)				

This *Annual Report* covers the first year of the Funding Agreement for the five years ending 30 June 2015, signed on 8 June 2010 and ratified by Parliament on 20 July 2010. This provided funding of \$47.8 million for 2010-11, increasing to \$56.4 million by the final year, 2014-15. The funding allows for additional regulatory responsibilities, the initial stages of upgrading New Zealand's banknotes, and the establishment of an office in Auckland.

## STRATEGIC PRIORITIES AND OUTCOMES 2010-11

The Bank adopts a number of Strategic Priorities in addition to its business-as-usual activities. Last year, we adopted a number of priorities, which we report on here. Priorities for the 2011-12 year are on page 53.

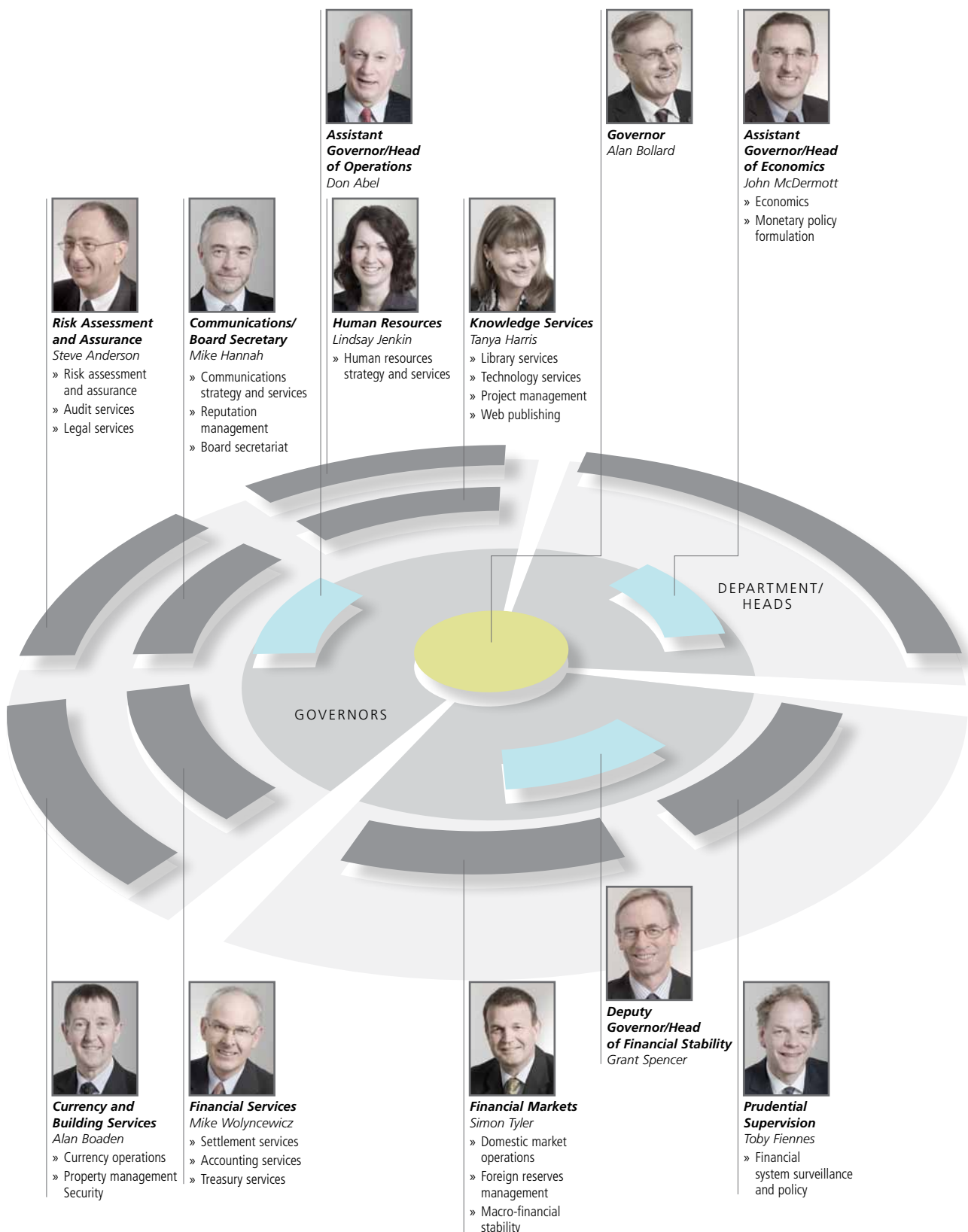
PRIORITY 1:	OUTCOME:
<p><b>MACRO-PRUDENTIAL POLICY TOOLS</b></p> <p>Investigate the potential for macro-prudential policy tools for New Zealand.</p>	<p>The Bank has now analysed several prudential instruments that could have a role in promoting financial stability and managing the credit cycle in New Zealand. We have presented our initial conclusions in the <i>Financial Stability Report</i>, an on-the-record speech and a preliminary report available on our website<sup>2</sup>. In March, the Bank held a workshop on macro-prudential policy with participants from the Treasury, academia, central banks and other international agencies. Work in this area is continuing.</p>
<p><b>PRIORITY 2:</b></p> <p><b>FINANCIAL SYSTEM SUPPORT</b></p> <p>Begin unwinding special financial system support and monetary policy stimulus.</p>	<p><b>OUTCOME:</b></p> <p>We removed the final special liquidity operation, the 'Tuesday Open Market Operation', in November 2010, as a decline in usage indicated it was no longer required. Further adjustments to our liquidity management regime were not implemented last year because of the volatility in financial and funding markets as European sovereign credit concerns continued. In addition, changes to global liquidity standards are still being developed as part of the Basel III process. The Bank will wait until global standards are better developed before making further changes in New Zealand.</p>
<p><b>PRIORITY 3:</b></p> <p><b>BANKING SUPERVISION REGIME</b></p> <p>Identify any appropriate changes to the bank supervision regime, including those based on international regulatory reforms.</p>	<p><b>OUTCOME:</b></p> <p>The Bank determined a set of principles to guide its implementation of the new international regulatory standards for bank capital and liquidity known as Basel III. The Bank envisages adopting most of the Basel III measures, but adapting them in ways that are fit for New Zealand conditions. The Bank also developed new rules to ensure that the regulatory capital that New Zealand's four largest banks hold for their farm lending exposures is properly aligned with risk in the sector. We completed a review of bank disclosure requirements, and undertook policy work on covered bonds and the implementation of the Bank's Open Bank Resolution policy.</p>
<p><b>PRIORITY 4:</b></p> <p><b>NON-BANK DEPOSIT TAKER REGIME</b></p> <p>Advance the implementation of the new Non-Bank Deposit Taker (NBDT) regime.</p>	<p><b>OUTCOME:</b></p> <p>The governance requirements under Part 5D of the Reserve Bank of New Zealand Act 1989, and the Deposit Takers (Credit Ratings, Capital Ratios, and Related Party Exposures) Regulations 2010, came into force on 1 December 2010. These represent the final components of the regulatory regime for NBDTs under Part 5D.</p> <p>The Bank has continued its work on the second stage of the prudential regime for NBDTs, releasing proposals for consultation in late 2010. Cabinet approvals for a new bill were obtained in June 2011, with the bill to be introduced in the second half of 2011.</p>

<sup>2</sup> *Macro-prudential instruments for New Zealand: A preliminary assessment*, Yuong Ha and Bernard Hodgetts, <http://www.rbnz.govt.nz/research/workshops/March2011/4344140.pdf>

PRIORITY 5:	OUTCOME:
<p><b>INSURANCE PRUDENTIAL REGIME</b> Develop and implement the new prudential regime for insurance.</p>	<p>The insurance prudential regime now provides core policy proposals and decisions. The industry has clear key minimum standards that the Bank expects of licensed insurers. Following the enactment of the Insurance (Prudential Supervision) Act 2010, the Bank has developed guidelines, issued the Fit and Proper Standard and consulted on solvency standards for life, non-life and captive insurers.</p>
PRIORITY 6:	OUTCOME:
<p><b>ENGAGE, DEVELOP AND SUPPORT STAFF</b> Engage, develop and support staff to meet the challenges of the Bank's evolving responsibilities.</p>	<p>With the Bank's expanding prudential supervision responsibilities almost fully in place, we have focused on establishing and training teams to meet these new responsibilities. Since the global financial crisis, the development of macro-financial tools has driven new research and development. Management have facilitated a collaborative team-based approach to these new fields of work through cross-functional projects and regular forums for sharing information and knowledge, supported by our operational departments.</p>
PRIORITY 7:	OUTCOME:
<p><b>ESTABLISH AUCKLAND OFFICE</b> Improve business continuity and disaster recovery capability through the establishment of a business support centre in Auckland.</p>	<p>The Auckland office became operational in April 2011. The purpose of the office is to improve business continuity and disaster recovery capability in the event of a Wellington regional disaster. It provides day-to-day and business continuity functionality across foreign reserve management and domestic market liquidity operations, middle-office treasury support and payment and settlement services.</p>

# RESERVE BANK ORGANISATIONAL STRUCTURE

## AS AT 30 JUNE 2011



# BOARD OF DIRECTORS



## NON-EXECUTIVE

### **Dr Arthur Grimes** 1

Chair Reserve Bank of New Zealand  
Board of Directors  
Economist

#### CORPORATE INTERESTS

- » The Hugo Group Ltd – Chair

#### OTHER INTERESTS

- » Financial Markets Authority – Associate member of the Board
  - » GT Research & Consulting – Principal
  - » Motu Economic & Public Policy Research Trust – Senior Fellow
  - » National Infrastructure Advisory Board – Member
  - » Postal Network Access Committee – Chair
  - » Reserve Bank Superannuation Fund – Trustee
  - » University of Waikato – Adjunct Professor of Economics
  - » Urban Technical Advisory Group to Minister of the Environment<sup>3</sup>
  - » Wellington Jazz Trust – Trustee
- First appointed 13 March 2002 – current term expires 12 March 2012

### **Hugh Fletcher** 2

Deputy Chair Reserve Bank of New Zealand  
Board of Directors  
Chair Reserve Bank of New Zealand Board of Directors' Audit Committee  
Company Director

#### CORPORATE INTERESTS

- » Fletcher Building Limited – Director
- » Insurance Australia Group Limited – Director
- » IAG New Zealand Holdings Limited – Chair
- » IAG New Zealand Limited – Chair
- » IAG Finance (New Zealand) Limited – Director
- » NGC Holdings Limited – Director
- » NZI Staff Superannuation Fund Nominees Limited – Director
- » Rubicon Limited – Director
- » Vector Limited – Director

#### OTHER INTERESTS

- » Dilworth Trust – Trustee
  - » L.E.K. Consulting – Member Australian and New Zealand Advisory Board
  - » The New Zealand Portrait Gallery – Trustee
  - » The University of Auckland Foundation – Trustee
- First appointed 10 June 2002 – current term expires 9 June 2012

### **Dr Chris Eichbaum** 3

University Lecturer  
» Victoria University of Wellington – Reader in Government, School of Government  
First appointed 1 August 2008 – current term expires 31 July 2013

### **Professor Neil Quigley** 4

Deputy Vice-Chancellor (Research),  
Victoria University of Wellington

#### CORPORATE INTERESTS

- » Victoria Link Limited – Chair
- » iPredict Limited – Chair
- » Predictions Clearing Limited – Director
- » Te Puni Village Limited – Director
- » Wetox Limited – Director

#### OTHER INTERESTS

- » 2025 Taskforce Adviser<sup>4</sup>
  - » New Zealand Qualifications Authority – Board member
  - » New Zealand Tertiary Education Consortium – Chair
  - » Adam Art Gallery Funding Trust
  - » Adam Art Gallery Trust
  - » Education New Zealand Trust – Trustee
  - » Wellington College Board of Trustees – Chair
  - » Wellington College Foundation – Trustee
- First appointed 1 February 2010 – current term expires 31 January 2015

### **Sue Sheldon CNZM** 5

Company Director

#### CORPORATE INTERESTS

- » Contact Energy Limited – Director
- » FibreTech Holdings Limited – Director
- » FibreTech New Zealand Limited – Director
- » Freightways Limited – Chair
- » Nimbus Bedware Ltd and EnviroSave Ltd<sup>5</sup> – Director
- » Paymark Limited – Director
- » Smiths City groups of companies<sup>6</sup> – Director
- » Telecom Corporation of New Zealand Limited – Director

#### OTHER INTERESTS

- » Sue Sheldon Advisory Ltd
  - » Wool Grower Holdings and Wool Industry Network<sup>7</sup>
- First appointed 1 May 2009 – current term expires 30 April 2014

### **Keith Taylor** 6

Company Director

#### CORPORATE INTERESTS

- » Butland Management Services Ltd – Director
- » Gough Gough & Hamer Ltd – Director
- » Port Marlborough Ltd – Director

#### OTHER INTERESTS

- » Earthquake Commission – Deputy Chairman
  - » Government Superannuation Fund Authority – Board member
  - » New Zealand Qualifications Authority – Board member
  - » Southern Cross Healthcare – Director<sup>8</sup>
  - » Takeovers Panel – Member
  - » NZ Fire Services Superannuation Scheme – Trustee<sup>9</sup>
- First appointed 1 July 2009 – current term expires 30 June 2014

### **Kerrin Vautier CMG** 7

Consulting Research Economist

#### CORPORATE INTERESTS

- » Fletcher Building Ltd – Director

#### OTHER INTERESTS

- » High Court – Lay Member under the Commerce Act
  - » External Adviser to Deloitte. Partnership Board<sup>10</sup>
  - » Auckland City Mission – Chair<sup>11</sup>
  - » Musica Sacra Trust – Chair
- First appointed 9 February 2010 – current term expires 8 February 2015

## EXECUTIVE

**Dr Alan Bollard**, Governor

## SECRETARIAT

**Mike Hannah**, Board Secretary

<sup>3</sup> To January 2011; <sup>4</sup> 1 August 2010 – 31 October 2010; <sup>5</sup> To 8 June 2010; <sup>6</sup> To 31 December 2010; <sup>7</sup> To 28 September 2010; <sup>8</sup> From November 2010; <sup>9</sup> From December 2010; <sup>10</sup> To 30 September 2010; <sup>11</sup> From 26 October 2010

## GOVERNANCE

### AUTHORITY AND ACCOUNTABILITY

The Reserve Bank of New Zealand is wholly owned by the New Zealand government. The Bank's authority, funding and accountability are based on:

- **the Reserve Bank of New Zealand Act 1989**, which specifies the Reserve Bank's functions and duties;
- **the Policy Targets Agreement (PTA)**, a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve;
- **the Bank's Funding Agreement**, a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs;
- **the Statement of Intent**, an annual three-year statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the three years, and projected income and expenditure for the first financial year; and
- **the Annual Report**, an annual accountability document, including presentation of financial statements.

The Reserve Bank also subscribes to a statement of its Vision and Values. These can be found on page 1.

### THE GOVERNOR

The Reserve Bank Act makes the Bank's Chief Executive – the Governor – accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor. The Governor is appointed for a five-year term. The Act sets specific criteria for the appointment, reappointment, and dismissal of a Governor. The current Governor, Dr Alan Bollard, took up his appointment in September 2002 and was reappointed in May 2007 to a further five-year term expiring in September 2012.

### MANAGEMENT STRUCTURE

The Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Financial Stability, a Head of Operations, a Head of Economics, and the heads of the Bank's various departments, as outlined on page 14. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, the Head of Operations and the Head of Economics are currently designated Assistant Governors.

The Governor receives advice from a number of internal committees within the Bank. These are:

- the Senior Management Group, which meets weekly to consider the management and day-to-day operation of the Bank;
- the Monetary Policy Committee, which meets fortnightly to advise the Governor on economic and financial market conditions to assist monetary policy deliberations;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions, typically eight times a year;<sup>12</sup>
- the Financial Systems Oversight Committee, which meets fortnightly to consider policy issues relating to prudential regulation and supervision of the financial system;
- the Macro-Financial Committee, which meets fortnightly to advise the Governor on macro-financial stabilisation policies and tools;
- the Asset and Liability Committee, which meets monthly to consider strategic management of the Bank's assets and liabilities; and
- the Communications Committee, which meets weekly to consider external communications issues and the Bank's credibility and reputational interests.

### BOARD OF DIRECTORS

The Reserve Bank has a Board of Directors, the membership of which is shown on page 14. Under the Act, the Board of Directors must comprise not less than five and not more than seven non-executive members, who are appointed for five-year terms by the Minister of Finance. In addition, the Governor is a Board member. The Chair must be a non-executive member, and is appointed by the non-executive directors for a renewable term of 12 months. The current Chair is Dr Arthur Grimes.

The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. The Board provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 6–10. It has the responsibility to confirm that *Monetary Policy Statements* are consistent with the PTA, and it monitors the six-monthly *Financial Stability Reports*. It offers its view to the Minister on the amount to be paid as a dividend. The Board performs its role through regular meetings at which it receives extensive briefings on the Bank's activities, decisions and policies. At these meetings, the Board also provides advice

<sup>12</sup> This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of narrow information sources. During the year, the two external advisers were Mr Earl Rattray and Ms Pip Dunphy.

to the Governor. The Board does not direct Bank policy, monetary or otherwise.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. If it believes that the Governor's performance, in meeting the requirements of the PTA or in carrying out his or her other duties, has been 'inadequate', then it can recommend to the Minister of Finance that the Governor be dismissed. The Board also appoints the Deputy Governor on the recommendation of the Governor.

The Board of Directors' Audit Committee monitors the external and internal audit functions. The Committee also receives reports from the Bank's external auditor and reviews the Bank's annual financial statements. Directors on that committee during the year were Hugh Fletcher (Chair), Sue Sheldon, Keith Taylor and Kerrin Vautier.

The Board of Directors held nine scheduled meetings and the Audit Committee three scheduled meetings, as well as considering and advising on additional information during the year.

## PARLIAMENTARY SCRUTINY

The Bank's activities are scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, hearings are held covering the quarterly *Monetary Policy Statements*, the six-monthly *Financial Stability Reports*, and the Bank's annual financial performance.

## PUBLIC ACCOUNTABILITY

An important aspect of the governance of the Bank is its transparency.

The Bank publishes an annual *Statement of Intent* and an *Annual Report*, which report on the Bank's governance, objectives, strategies, key performance indicators and performance. It releases a quarterly *Monetary Policy Statement*, which explains current monetary policy and provides detailed economic projections. It also publishes a six-monthly *Financial Stability Report*, assessing the robustness of the New Zealand financial system. On our website ([www.rbnz.govt.nz](http://www.rbnz.govt.nz)), a *Statement of Principles* summarises our bank registration and supervision policies.

We also make information on our policies and activities widely available via an extensive website, quarterly *Reserve Bank Bulletins*, research papers, discussion papers, speeches, media interviews and brochures.

<sup>13</sup> No interest is paid on currency in circulation. When notes and coins are issued to a trading bank, the trading bank will pay for the currency that is issued by paying funds to the Reserve Bank from that bank's exchange settlement account with the Reserve Bank. The Reserve Bank invests the proceeds it receives, and the earnings on those investments are known as 'seigniorage'.

## FINANCIAL MANAGEMENT

### *Financial management overview*

Foreign reserves management, New Zealand dollar liquidity management and currency operations materially impact on the size and structure of the Bank's balance sheet as well as its financial performance. The nature and extent of the Bank's principal financial activities are described in more detail in the financial statements on pages 57–109.

The Governor is responsible for the Bank's financial management. He decides on its financial management strategy and he makes all key financial management decisions after consulting the Bank's Asset and Liability Committee. Implementation of strategic decisions is delegated to the Financial Markets department. The Board's role is to provide advice to the Governor and to monitor the Bank's financial performance.

The Bank's financial performance is primarily impacted by:

- The size and performance of the Bank's foreign reserves management and market operations functions. This includes management of the Bank's open foreign exchange position, as well as provision of New Zealand dollar liquidity to participants in the domestic financial system.
- Changes in both foreign exchange rates and interest rates.
- The extent of available funds in the form of equity.
- Currency in circulation.<sup>13</sup>

The Bank's reported net income will fluctuate from year to year because the Bank's unhedged foreign currency reserves will generate profits and losses as foreign exchange rates change.

### *Funding of the Bank's operations*

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 Bank's equity.

Under the Act, the Minister of Finance and the Governor are required to enter into a funding agreement to specify the amount of the Bank's income that may be used to meet expenses in each financial year. The funding agreement comes into force only after it is ratified by Parliament. The Act provides for each funding agreement to apply for a period of five consecutive financial years.

The Bank's funding arrangements are designed to strike an appropriate balance between providing a high degree of operational independence and providing strong incentives for effective management of operating expenditure, while ensuring

accountability for use of resources. Capital expenditure is funded by the Bank, with depreciation of fixed assets included in annual operating expenses.

The funding agreement requires that the Bank include in its *Annual Report* a comparison of expenditure against the specified amount of net operating expenses for each year, together with a comparison of cumulative expenditure against the cumulative specified amount of net operating expenses for the term of the agreement.

In 2010, the Governor and the Minister of Finance signed the Funding Agreement for the five-year period 1 July 2010-30 June 2015. The Funding Agreement provides for \$47.8 million in the first year (2010-11) increasing to \$56.4 million in year five (2014-15).

The agreement focuses on extending capacity in new regulatory and supervision areas; commencing a programme for upgrading New Zealand banknotes; upgrading information technology; and improving business continuity capability and building infrastructure, in particular, establishing the Auckland office.

#### *Annual distributions paid by the Bank*

The Act requires the Bank to publish in its *Statement of Intent* a 'statement of dividend principles'. The Bank's statement of dividend principles is shown below.

#### STATEMENT OF DIVIDEND PRINCIPLES

*The Bank should maintain sufficient equity for the financial risks of performing its functions. Equity in excess of that required to cover those risks will be distributed to the Crown.*

*In general, unrealised gains should be retained by the Bank until they are realised in New Zealand dollars. However, the Bank may recommend the distribution of unrealised gains where the Bank believes that the probability of the gain being realised is high.*

Each year, the Bank makes a recommendation to the Minister of Finance of the amount to be paid as a dividend. The Minister decides how much should be paid having regard for the recommendation of the Bank, the views of the Board of the Bank and any other relevant matters.

## RISK MANAGEMENT

The Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is making policy errors in relation to monetary policy, or the financial or banking systems, thereby causing damage to the economy and to the Bank's reputation and credibility. Other more specific risks include:

- credit and interest rate risks associated with our day-to-day liquidity management in domestic financial markets;
- risks associated with holding foreign currency reserves, including credit, interest, and exchange rate risks;
- risks associated with processing and storing currency, including risks of forgery, theft and robbery;
- risks associated with the operations of payments systems, which can arise from technical faults; and
- risks associated with being a small organisation, such as the loss of key staff.

The Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management.

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

- The Bank's Risk Assessment and Assurance department, which is responsible for providing advice on and monitoring the Bank's risk management frameworks (as well as the internal audit role).
- A Risk Unit within the Bank's Financial Markets department, which provides specialised advice on financial market risk management. This includes recommendations on interest rate, credit and liquidity risk limits, and the reporting of specialised measures of financial risk.

In addition, succession planning is a management priority. A Business Continuity Planning strategy has been adopted, with a number of initiatives completed, including establishment of an Auckland office to mitigate business support risk in the event of a regional disaster in Wellington.

The Board and its Audit Committee also contribute to the review of the Bank's risk management processes.

## CONFLICTS OF INTEREST

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank staff, including Governors and directors. The policy requires that all staff act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that staff must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts.

Governors and departmental managers are required to provide the Bank with regular updates as to their personal interests, so that any potential conflict of interest is recorded. This is done quarterly. If any other staff have a particular concern, they can also record their interests in the same way.

Staff must not be personally involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. This includes domestic wholesale money, bond and foreign exchange markets, interest and exchange rate futures, options and swaps markets, and instruments linked to shares of regulated entities. At no time can Reserve Bank staff own or control shares in entities (or their parent companies) that the Reserve Bank regulates. The policy states that staff must not use inside information to benefit when depositing or withdrawing funds from financial institutions, or purchasing or selling bonds or shares, or when changing between fixed and floating rates for a loan. It is unacceptable to use inside information, whether to avoid losses or to make gains.

Under sections 56 and 61 of the Reserve Bank Act, the Minister must have regard to the likelihood of conflict of interest in appointing a director to the Board, and directors must disclose their interests in any contract with the Bank. On appointment to the Board, directors sign a declaration that they will observe confidentiality in relation to the affairs of the Bank and will not make use of any confidential information they may acquire regarding Bank operations. They also provide lists of their other directorships and major interests in relation to which they would not wish to receive relevant Board papers or participate in discussions.

## GOVERNORS' INTERESTS

The Governors note the following related interests. In each case, appropriate steps have been taken to ensure that no conflicts arise:

**Dr Bollard:** The interests of his wife, Jenny Morel, in No 8 Ventures Management Limited and family interests in forestry.

**Mr Spencer:** None.

**Dr Abel:** None.

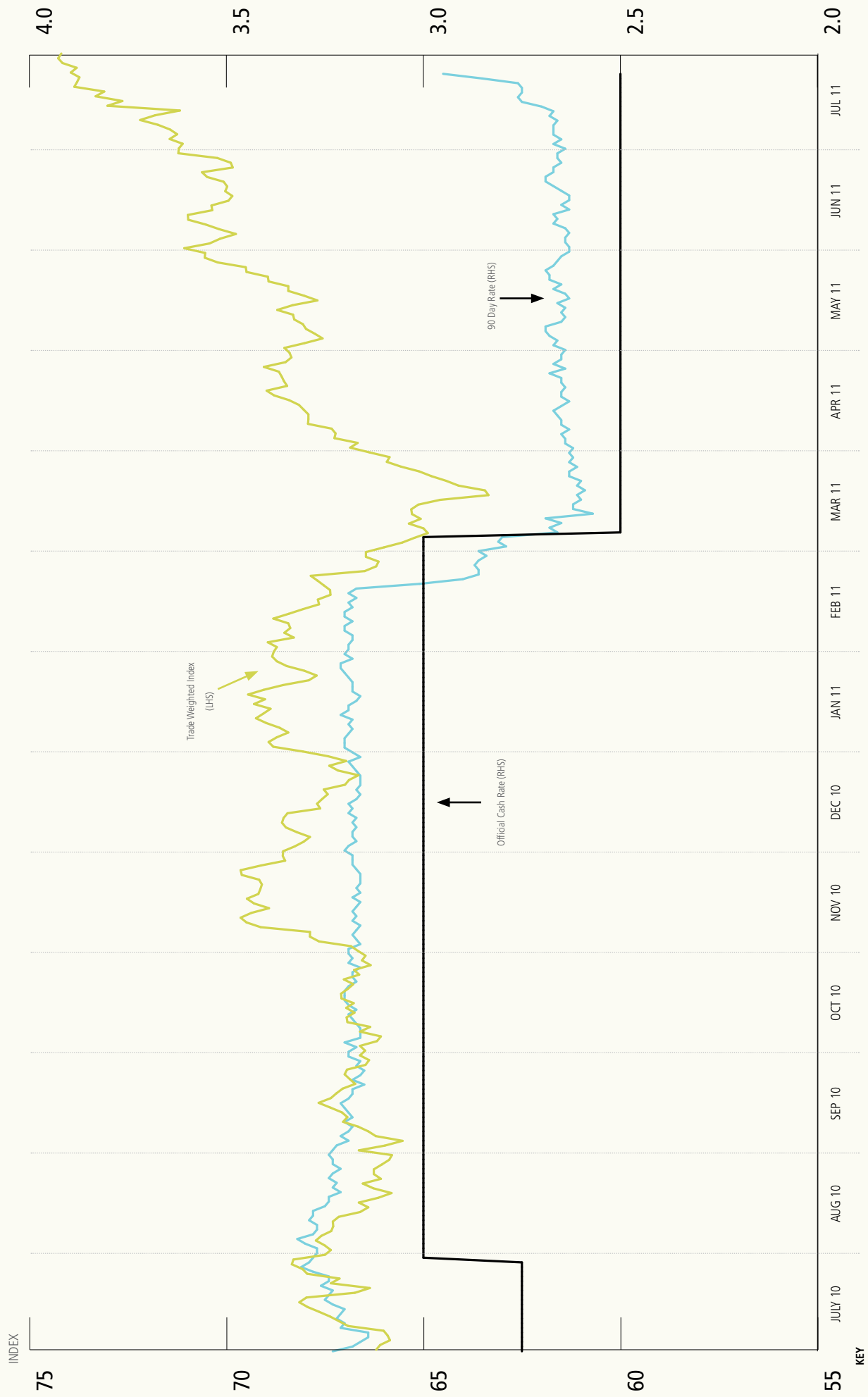
**Dr McDermott:** None.

## MANAGEMENT AND MONITORING PROCESSES

Within the Bank, all activities and expenditure must be authorised and in accordance with a comprehensive set of Bank policies and procedures. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Departments are required to provide regular reports that describe progress to date on outputs and projects, and to explain any significant variances. The expenses of the Governor are reviewed by the Chair of the Board of Directors' Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are monitored closely.

The internal audit function within the Bank is performed by its Risk Assessment and Assurance department. The Bank is audited externally by the Auditor-General, who has contracted Chris Barber, using the staff and resources of PricewaterhouseCoopers, as her agent. In addition, the Minister of Finance can order a performance audit.





Graph 1

■ TWI (LHS)    
 ■ 90-day rate (RHS)    
 ■ Official Cash Rate (RHS)

# THE YEAR IN REVIEW

## MONETARY POLICY FORMULATION

### THE OBJECTIVE OF THE MONETARY POLICY FORMULATION FUNCTION IS:

To achieve and maintain stability in the general level of prices. The current Policy Targets Agreement (PTA) requires that the Bank “keep future CPI inflation outcomes between 1 and 3 percent on average over the medium term”. It also requires that: “In pursuing its price stability objective, the Bank shall... seek to avoid unnecessary instability in output, interest rates and the exchange rate.”

### IN OUR 2010-13 STATEMENT OF INTENT, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### OUTCOME

- Stability in the general level of prices.

#### INITIATIVES AND STRATEGIES

- Support our business-as-usual monetary policy advice will be our core objective. This includes providing advice on the withdrawal of monetary policy stimulus in light of current and prospective financial market conditions, and any changed economic behaviour on the part of households and firms as a result of the global financial crisis.
- Leverage new modelling and forecasting capability through exploiting KITT, the Bank’s new primary forecasting model, and refining and using more extensively our alternative models.

- Monitor and evaluate international thinking about how monetary policy and financial stability policy should interact, particularly the ways in which flexible inflation targeting may be augmented to take account of the effects of asset price cycles, leverage, and prudential and fiscal policy on economic activity and inflation.
- Improve the quality, accessibility, relevance and reliability of Reserve Bank statistics, including by completing the implementation of the Financial Sector Information System (FSIS).

### AND OUR PERFORMANCE WOULD BE MEASURED BY:

#### KEY PERFORMANCE INDICATORS

- Reserve Bank forecasts of CPI inflation should be comfortably within the target range in the second half of our forecast horizon.
- Measures of underlying inflation should generally lie within the target range.
- Unnecessary instability in output, interest rates and the exchange rate should be avoided.
- The Bank’s reputation for comprehensive knowledge about the economy, thorough analysis and credible judgement, should be maintained or enhanced.
- The MPS provides a basis for assessment of the Bank’s performance in pursuing its price stability target as defined in the PTA.

## ECONOMY

The economic environment was shaped by significant developments over the year, most importantly the earthquakes in Canterbury and the substantial lift in our export commodity prices. In a year in which the New Zealand economy expanded by an estimated 1.5 percent, it stood up well to significant domestic challenges.

Growth was assisted by international developments. Our main trading partner economies continued to improve following the global financial crisis. This underpinned strength in prices for New Zealand’s commodity exports, as well as in the New Zealand dollar. Some headwinds for global activity persisted, however, with many economies facing challenging fiscal positions and lingering inflation pressures. Despite this, export volumes grew by an estimated 1.8 percent over the year.

Domestically, economic activity expanded at a gradual pace. Household spending increased and business confidence lifted. Nevertheless, there remains lingering spare capacity and high unemployment. Over the past year, household and firms have also focused on improving debt positions.

With signs that the economy was improving, the Bank had begun to remove the extraordinary level of support implemented during the recession, with the OCR increased by 25 basis points to 3.0 percent in July of 2010. However, the significant disruptions to lives and the economy caused by the Canterbury earthquakes prompted the Bank to subsequently reduce the OCR in March 2011 by 50 basis points. This was done to guard against a marked deterioration in economic activity that a fall in confidence might cause.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

Monetary policy has remained focused on the maintenance of price stability and avoiding unnecessary instability in output. To support this function over the past year, the Bank has produced a significant body of work examining the economic impact of the Canterbury earthquakes. It has also focused on the debt positions of New Zealand households and businesses. To assist with assessment of economic conditions, we have also drawn on our close ties with government agencies and private sector organisations to ensure that monetary policy remains abreast of developments across all sectors of the economy.

Our modelling and forecasting capabilities continue to be developed to help us formulate monetary policy. We have deepened our understanding of the labour market, and the interaction between the real economy and financial markets.

Using our close ties with other central banks and international organisations, we continue to keep a close watch on international developments, particularly inflation and fiscal debt positions. Additionally, we are examining the early, post-crisis, international lessons on the interaction of monetary and financial stability policy.

Our research engagements have included conferences or workshops on:

- The transmission of international shocks to open economies (co-hosted with the Australian National University's Centre for Applied Macroeconomic Analysis).
- Macro-prudential policies.
- National accounts and financial statistics (with support from Statistics New Zealand).
- New Zealand's macroeconomic imbalances, their causes and possible remedies (in conjunction with the Treasury and Victoria University of Wellington).

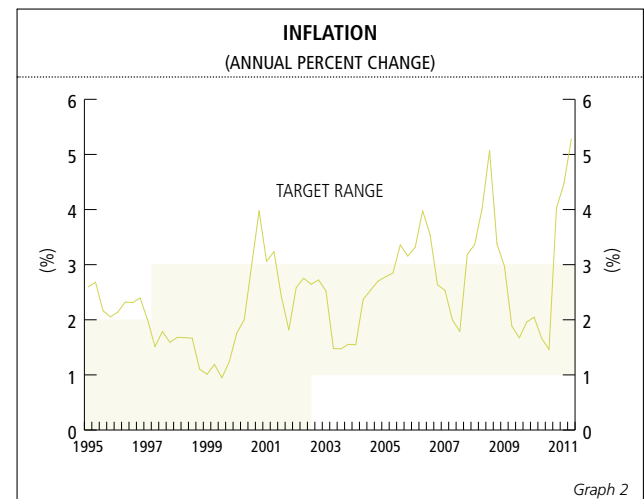
Our research programme includes macro-prudential policy, exporter behaviour and performance, consumer behaviour, interest rate yield curves, and the effects of monetary policy on the macroeconomy. The results of this work have been presented at national and international conferences.

During the past financial year, the Bank advanced a number of initiatives to improve the quality, accessibility, relevance and reliability of statistics. The second stage of implementation of the FSIS was completed, enabling our analysts access to more timely, higher-quality data for policy advice. We expect to make more

improvements to this tool. The Bank has also started a project to assess the feasibility of producing flow-of-funds statistics and sectoral financial accounts and balance sheets for New Zealand.

## HOW WE PERFORMED

### – KEY PERFORMANCE INDICATORS



Graph 2

The *Monetary Policy Statement* is the full assessment and accountability document for our monetary policy key performance indicators.

Monetary policy has continued to focus on ensuring that medium-term inflation remains comfortably within the 1 to 3 percent target band. Over the year to June 2011, headline CPI inflation rose to 5.3 percent. The PTA recognises that the annual rate of the CPI will vary from the medium-term trend of inflation because of a range of events whose impact would be temporary. These include changes in indirect taxes and government policy changes affecting prices. Removing one-off changes to government charges, such as the increases in the rate of GST and the excise tax on tobacco, and the impact of the Emissions Trading Scheme, CPI inflation was 2.7 percent over the June year.

Domestic activity has been stronger than expected following the Canterbury earthquakes, and inflation expectations have been elevated due to the increase in the rate of GST. With output starting to increase, underlying inflation pressures are expected to rise. As this occurs, it would be appropriate to gradually reduce monetary policy stimulus to ensure medium-term inflation remains contained. However, developments in global economic and financial markets have been very dismal recently. The Bank will need to monitor the situation carefully since there is now a real risk that global economic activity slows sharply.

## FINANCIAL MARKETS

Domestic markets

Foreign reserves management

### THE OBJECTIVES OF THE DOMESTIC MARKETS AND FOREIGN RESERVES MANAGEMENT FUNCTIONS ARE TO:

- Support the effective implementation of monetary policy.
- Assist in the efficient functioning of the New Zealand financial system.
- Manage official foreign reserves; and provide effective support and execution for the Bank's foreign exchange market intervention policy.
- Manage the Crown's financial liquidity.
- Maintain an effective crisis intervention capability.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### OUTCOMES

- Adequate banking system liquidity.
- Short-term interest rates consistent with monetary policy.
- Confidence in the efficient functioning of New Zealand financial markets.
- Foreign reserves available for efficient foreign exchange intervention and crisis management.

#### INITIATIVES AND STRATEGIES

- Continue to review and adjust the provision of temporary back-up liquidity facilities put in place through the crisis as warranted by financial market conditions.

- Implement the review of foreign reserves asset allocation and management approach.
- Promote the development of capital markets in areas where the Bank has powers and responsibilities (i.e., in money, bond and foreign exchange markets).

### AND OUR PERFORMANCE WOULD BE MEASURED BY:

#### KEY PERFORMANCE INDICATORS

- Short-term wholesale interest rates should be relatively stable and maintained at levels consistent with the OCR.
- There is no evidence of payment failures due to shortage of cash in the banking system.
- Domestic market operations are expected over the medium term to generate a positive return for the domestic markets function, as an indicator that operations are running effectively.
- Foreign reserves are held at the level agreed with the Minister.
- Foreign reserves are held in a liquid and secure form, suitable for foreign exchange market intervention.
- The Foreign Reserves Management portfolio is managed efficiently; yielding a net return that meets or exceeds that of its benchmark.

*The Reserve Bank operates regularly in the financial markets to implement monetary policy, to manage the New Zealand government's foreign reserves and to ensure an adequate level of liquidity in the banking system. The Bank implements monetary policy and supports the functioning of the financial system through the use of its own balance sheet which constitutes New Zealand dollar assets and liabilities as well as foreign reserves.*

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

One of the Bank's key initiatives for the year was to review and adjust the provision of temporary liquidity facilities put in place during the global financial crisis. In line with this, we removed the final special liquidity operation, the 'Tuesday Open Market Operation', in November 2010, as a decline in usage indicated the operation was no longer required.

Further adjustments of our liquidity management regime were not implemented last year due to the ongoing volatility in financial and funding markets. In addition, changes to global liquidity standards are still being developed as part of the Basel III process. The Bank will wait until global standards are better developed before making further changes in New Zealand.

Another key initiative was to implement the review of our foreign reserves asset allocation and benchmarking framework that has been ongoing for the last couple of years. Progress has been made on this review and we expect to finalise the first stage of implementation in the coming year as part of our Strategic Priorities for 2011-12.

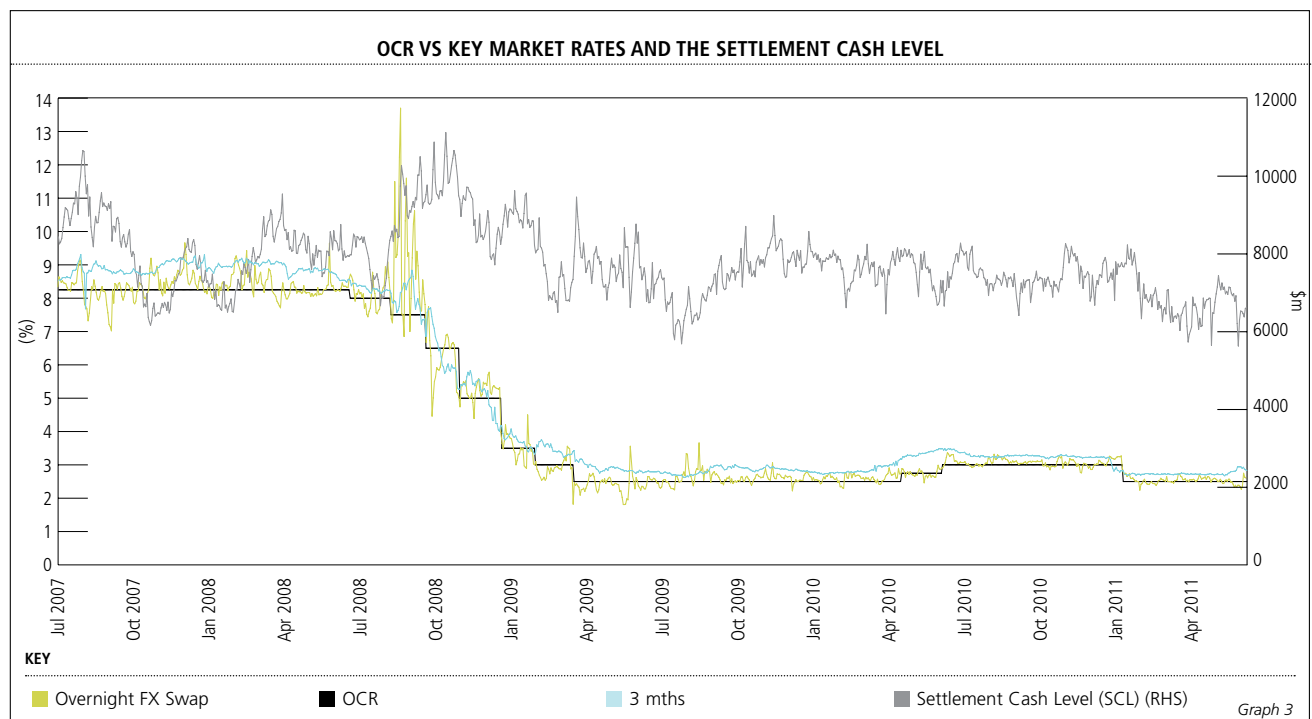
A major initiative was to promote the development of the New Zealand capital markets in areas where the Bank has

expertise and interest. In this regard, we developed criteria for the acceptance of New Zealand covered bonds in our liquidity operations. The Bank of New Zealand issued the first repo-eligible New Zealand covered bond issue in October 2010.

The Reserve Bank has also taken an active role in the development of the markets as part of the New Zealand Financial Markets Association (NZFMA). We have helped the NZFMA develop a more robust New Zealand dollar exchange rate fixing mechanism to replace the Reserve Bank's New Zealand dollar Trade Weighted Index fixing rates. The Bank has also engaged with the NZFMA on issues such as the forthcoming Basel III standards and the implications for the New Zealand capital markets.

We also put in place a swap agreement with the People's Bank of China in April 2011, to give the Bank the capacity to lend Chinese renminbi (RMB) to local banks trying to settle financial transactions in RMB in times where normal market channels are not working correctly.

Finally, we adjusted our criteria covering the eligibility of counterparties in our domestic liquidity operations, to allow for the possibility of New Zealand Financial Market Infrastructure entities (for example, the NZX Central Counterparty system) accessing liquidity on a secured basis from the Bank in the event of market stress.



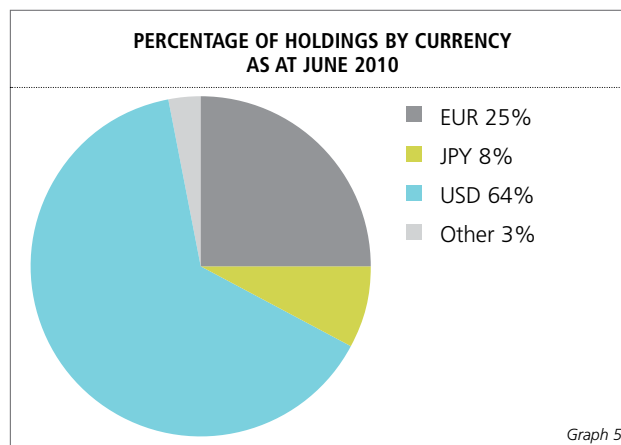
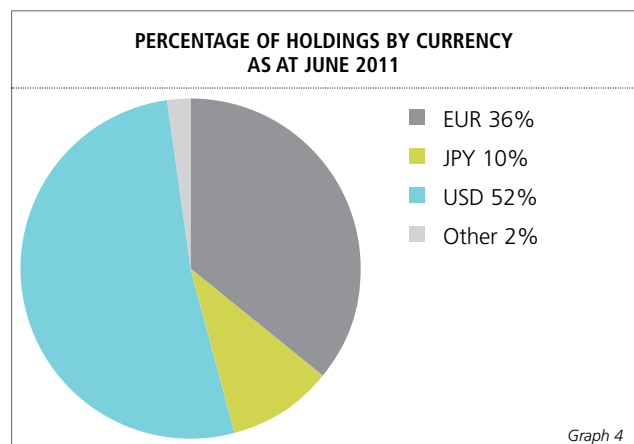
## HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

### Domestic markets

The year to the end of June 2011 has been a more settled period for the domestic financial markets (see Graph 3).

Liquidity conditions have been more stable reflected in less variable short-term interest rates compared to previous years and a reduced demand for cash by banks. There has been a reduced demand for settlement cash over the year as banks have substituted New Zealand government securities for settlement cash in their liquid asset holdings as well as receiving an increase in deposit funding from their retail customers over the year.

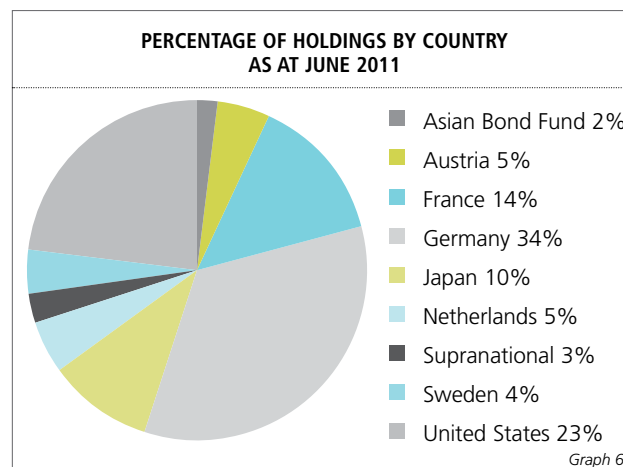
The Reserve Bank’s balance sheet has expanded over the year, reflecting the Treasury’s decision to place more cash at the Bank. This has stemmed from their decision to pre-fund deficits by issuing more government securities over the past year while investor demand has been strong. This cash is then held at the Bank and we invest that cash back into the market so as to maintain a relatively stable settlement cash level. We have invested the funds in short-term high-quality foreign currency assets, hedged for currency risk, as well as short-term New Zealand dollar reverse-repo transactions<sup>14</sup> against New Zealand government bonds. Reverse-repos have become a more common means of injecting liquidity because of the improvement in the liquidity of the government bond market that has resulted from, the Treasury’s larger debt programme in recent years.



### Foreign reserves management

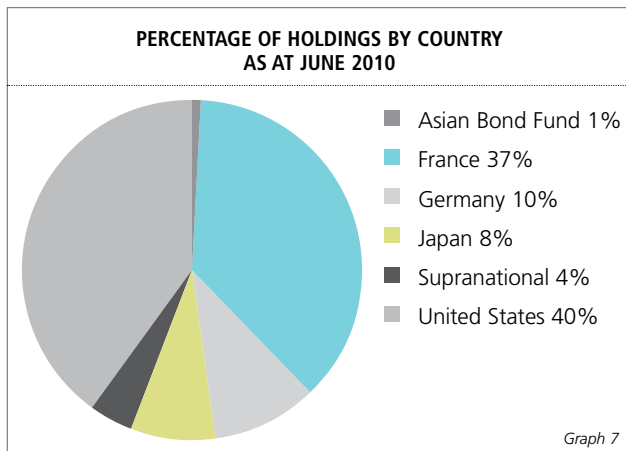
Our management of foreign reserves has had to take account of volatility associated with easy liquidity conditions in most major foreign reserves markets, following the global financial crisis and the ongoing European sovereign debt concerns.

The Bank’s portfolio is dominated by holdings of short-term government and near-government securities of the highest credit quality and liquidity. But easy monetary policies and resultant excess liquidity have seen the yields on these types of investments fall to historically low levels – in some cases to zero or even negative interest rates – so reducing our returns.



<sup>14</sup>A reverse repo, or repurchase agreement, is a loan in which one party – the bank that needs to borrow cash – sells the security to the other party (the Reserve Bank) and agrees to repurchase it on the agreed date. A repo is the opposite of a reverse repo. In this case, the Reserve Bank will sell a security now, and agree to buy it back again in the future.

<sup>15</sup>Graphs 4 and 5 show the currencies in which foreign reserve assets are denominated. This differs from the net foreign currency exposure by currency on page 51, because the net exposures also take into account foreign currency liabilities and foreign currency swap transactions.



Graph 7

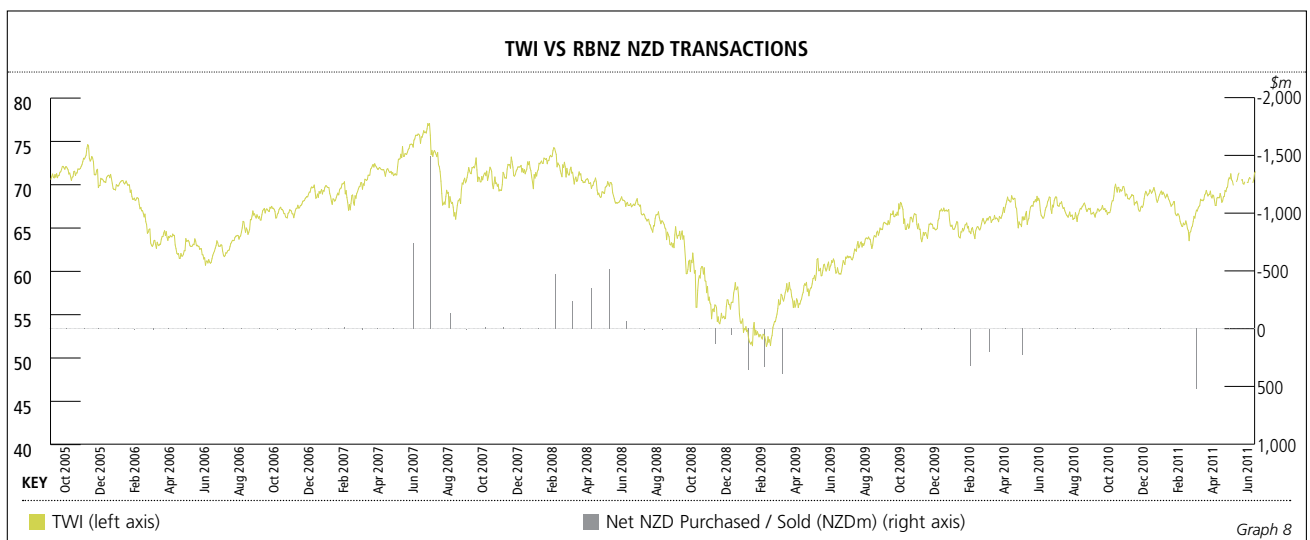
As Graphs 6 and 7 illustrate, our response to this has been to look to move away from very low-yielding US government securities and into higher-yielding reverse-repo investments and securities issued by AAA-rated supranational organisations. In addition, we have looked to move investments in government securities out of the US and into core European sovereigns where interest rates are higher.

The ongoing European sovereign debt concerns have also had a significant impact on financial markets and on our foreign reserves investment strategy. The Bank has always held its European investments in the highest-quality sovereign entities, such as France and Germany, and not in the likes of the Republic of Ireland, Portugal or Greece. This year, we

diversified by reducing our exposure to French government and near-government issuers, and increased our holdings of German government and near-government investments (widely perceived as being the strongest issuers in the euro area), and also some of the other AAA-rated European sovereign issuers.

We are holding slightly fewer foreign reserves than at the start of the year because we reduced our unhedged foreign reserves (Graph 8) as rising European sovereign debt concerns and the effects of the earthquakes in Christchurch and Japan pushed the New Zealand dollar down for a period. We are aiming to bring the Bank's unhedged reserves and thus our open foreign exchange position back towards the long-term benchmark level of SDR 1000m. By the end of the year, this objective had been largely achieved.<sup>16</sup>

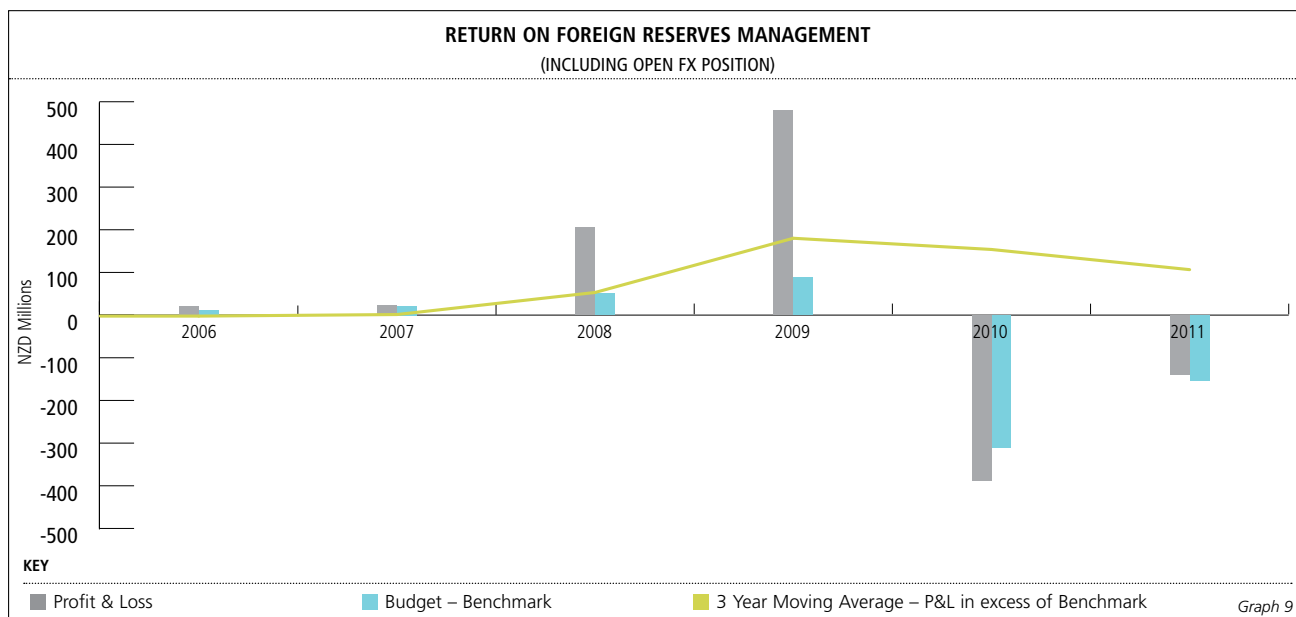
Even though we held less unhedged reserves, the overall foreign reserves recorded a financial loss for the year. This is primarily because of the rise in the New Zealand dollar, which reduces the New Zealand dollar value of the Bank's unhedged foreign reserves. Graph 9 illustrates that most of this loss reflects the volatility associated with the Bank's core benchmark open foreign exchange position held for the purpose of providing the capacity to respond effectively to a crisis in the foreign exchange markets. The New Zealand dollar value of this core position will tend to fluctuate with the cyclical nature of the New Zealand dollar, with gains and losses tending to balance out as long as the New Zealand dollar does not trend against the six currencies in our currency portfolio.<sup>17</sup>



Graph 8

<sup>16</sup> See page 51.

<sup>17</sup> Unhedged foreign reserves generally have a higher ongoing carrying cost associated with them as New Zealand interest rates tend to be higher than offshore rates. Our approach is to manage our reserves such that a portion (SDR 1000 m) is held on an unhedged basis on average over time for use in a crisis situation when unhedged reserves would likely be most effective.



Over the medium term, our key performance indicator is for the return on the Bank’s reserves portfolio to exceed its benchmark. Graph 9 provides an estimate of a relevant benchmark. For the current financial year we would have anticipated recording a loss on foreign reserves of NZD 153 m if we had held our unhedged reserves exactly at our benchmark SDR 1000 m level. The actual loss recorded was slightly less than this (NZD 140 m), as we had reduced the level of some of our excess unhedged reserves during the year when the NZD was lower, and changes in credit spreads led to favourable movements in the value of our long-term foreign exchange liabilities. We assess performance against this benchmark over a longer period than just one year, as exchange rates are volatile and the Bank’s reserves management approach takes a longer-term horizon than just one year. On a medium-term basis, significant unrealised gains recorded during the global financial crisis are now being balanced by unrealised losses as the New Zealand dollar heads back to previous highs.

## FINANCIAL SYSTEM SURVEILLANCE AND POLICY

### THE OBJECTIVES OF THE FINANCIAL SYSTEM SURVEILLANCE AND POLICY FUNCTION ARE:

- To register and supervise banks so as to promote the maintenance of a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.
- To regulate non-bank deposit takers (NBDTs) and to regulate and supervise the insurance sector. This is done in a manner that will be relevant to New Zealand and that delivers a cost-effective balance between regulatory requirements and self- and market-discipline.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### OUTCOMES

- A sound and efficient financial system in New Zealand.
- International and local confidence in New Zealand's financial system.

#### INITIATIVES AND STRATEGIES

- Enhance the Bank's monitoring of risks to bank balance sheets and profitability.
- Review disclosure requirements of banks as part of the Bank's continuous review of compliance costs.
- Develop, with the Treasury as required, the high-level features of post-deposit guarantee regulatory arrangements, if any.
- Continue implementing regulatory arrangements for the NBDT sector, and review the effectiveness of these regulatory arrangements by the end of 2012.
- Identify any appropriate changes to the bank supervision regime, especially in the areas of capital and liquidity requirements, including those based on international regulatory reforms.
- Refine our crisis preparedness, focusing on practical solutions and enhancing trans-Tasman coordination.

- Develop and implement the supervisory framework for the insurance sector.
- Develop and implement the Anti-Money Laundering and Countering the Financing of Terrorism supervisory regime.
- Monitor and evaluate international thinking about how monetary and financial stability policy should interact, and investigate the potential for macro-prudential policy tools to assist existing prudential and monetary policy approaches.

### AND OUR PERFORMANCE WOULD BE MEASURED BY:

#### KEY PERFORMANCE INDICATORS

- Banks comply with Conditions of Registration and maintain the required minimum capital ratios and liquidity requirements.
- NBDT regulations in place and NBDTs comply with the regulatory regime.
- The Treasury is promptly notified of and consulted with on:
  - any issues with any entities in the Deposit Guarantee Scheme; and
  - significant policy developments, in particular in prudential and macro-prudential regulation.
- The Bank has in place the people, procedures and systems to implement the Insurance (Prudential Supervision) Bill when it comes into force.
- The Bank has in place the people, procedures and systems to implement the AML/CFT supervisory regime and has publicly communicated the core features of its proposed regulatory arrangements.
- Measures included in the *FSR* provide a basis for assessment of the New Zealand financial system's stability and efficiency and the performance of the surveillance function.

## FINANCIAL SYSTEM ENVIRONMENT

Financial system resilience has improved since the financial crisis with banks lifting their funding and liquidity buffers over the past two years and remaining well capitalised. As a result, the system is well positioned to support the economy.

Financial institutions have faced volatile global financial markets, a weaker-than-expected domestic economic recovery, and the disruption and damage caused by the Christchurch earthquakes.

Yet banks have continued to lift their capital ratios and increase their core funding, despite testing conditions in the wholesale funding markets, and some of the larger banks have also issued covered bonds offshore, helping to diversify their funding.

More non-performing loans have been recorded, but they remain at manageable levels. Banks also appear more willing to lend, although households and businesses have been choosing to reduce or constrain debt, resulting in weak credit growth over the period.

The landscape of the NBDT sector continues to change: some entities have merged, others have failed, including South Canterbury Finance Limited. The remaining NBDTs generally appear to have reasonable capital positions, and better risk and liquidity management, supported by the introduction of regulations at the end of 2010. However, they are also facing difficult operating conditions due to weak credit demand, heightened competition from banks, and low depositor confidence in the sector.

Insurers globally have had their own severe challenges, given the earthquake and tsunami in Japan, floods in Australia, and the Christchurch earthquakes. This is expected to increase the cost of reinsurance, particularly in regions affected by catastrophes. Although AMI Insurance, with a large amount of Christchurch business, has required a support arrangement from the government, the insurance sector overall is sound and functioning well. Provisional licensing of insurers under the Insurance (Prudential Supervision) Act 2010 is under way, and may lead to some changes in the sector as insurers merge and some insurers exit the industry.

The payment and settlements systems have been functioning well, and were not materially affected by the earthquakes.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

The Bank continues to monitor international thinking about the interactions between financial stability and monetary policy, which is under active consideration by central banks and academics. Our work on macro-prudential instruments has considered their possible implications for financial stability and monetary policy.

The Bank has been working to implement the new international regulatory standards for bank capital and liquidity known as Basel III. We envisage adopting most of the Basel III measures, but adapting them in ways that are fit for New Zealand conditions. As the Bank's liquidity policy is similar in substance to the Basel III liquidity standards, it is not proposed to revisit it in the near term to make it strictly consistent with Basel III. Further work was undertaken to improve the large banks' modelling of credit risk for farm and housing lending. New rules took effect to ensure that the regulatory capital that New Zealand's four largest banks hold for their farm lending exposures is properly aligned with the risk in the sector. Most of the large banks also now have new Bank-accredited models in place for housing capital that were developed to improve risk measurement.

In other areas, the Bank consulted on a formal framework for the issuance of covered bonds, and imposed a 10 percent limit on the issuance of covered bonds by locally incorporated banks. A major overhaul of bank disclosure requirements has also been carried out, which has significantly reduced banks' compliance costs, while resulting in more manageable disclosure documents that are better aligned with the needs of their key readers.

We embedded private prudential data from banks in our approach to banking supervision this year, and enhanced our reporting and analytical capabilities. The use of private prudential data complements publicly disclosed information and allows more frequent and timely assessment of the condition of individual banks and of the sector as a whole. In addition, we have maintained a high degree of active engagement with the major banks and key sector stakeholders throughout the year.

The Insurance (Prudential Supervision) Act 2010 was passed into law on 7 September 2010. Good progress has been made in developing the supervisory framework, including the publication of guidelines for relevant areas; namely, licensing, risk management and governance for licensing of insurers, and the approval of rating agencies.

During the year, the final components of the prudential regime for the NBDT sector under Part 5D of the Reserve Bank of New Zealand Act 1989 came into force. Preparation for a required review of the whole NBDT regime is getting under way, with completion expected in 2012, for presentation to the House in 2013.

Under the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) Act, we have published Risk Assessment Guidance to assist reporting entities in undertaking their own business-level assessments. Further guidance and a Code of Practice for reporting entities are expected for release in 2011. AML/CFT regulations have been issued and the AML/CFT Act will take full effect on 30 June 2013.

The Bank and the Treasury jointly provided advice to the government on the case for introducing deposit insurance, following the expiry of the extended deposit guarantee on 31 December 2011. The government does not favour deposit insurance, as it is difficult to price and blunts incentives for both financial institutions and depositors to monitor and manage risks properly.

In the area of crisis preparedness, we have begun consultation on pre-positioning banks' internal systems to ensure operability of the Open Bank Resolution policy. This policy is intended to enable authorities to respond to individual bank failures with as little disruption to the banking system as possible, and without straining fiscal resources. The Bank and the Treasury have also continued to work with Australian authorities on enhancing trans-Tasman coordination and cooperation, focusing particularly on dealing with stress situations.

## HOW WE PERFORMED

### – KEY PERFORMANCE INDICATORS

Our *Financial Stability Reports (FSRs)*, which are required under the Reserve Bank of New Zealand Act, assess the performance of New Zealand's financial institutions and payments systems, the risks and vulnerabilities facing the financial system and the measures we are taking to help promote its soundness and efficiency. Our May 2011 *FSR* summarised work we have been doing to enhance our analysis of the efficiency of the financial system and presented some preliminary analysis of the efficiency of New Zealand's banks. We also discussed the implications of the Canterbury earthquakes on financial stability, and the effects on insurers, banks, businesses and households.

*FSRs* over the past year have continued to track developments in both global and domestic financial regulation. We discussed the new Basel III global standards for bank capital adequacy and liquidity, and our work on the role macro-prudential tools could play in promoting financial stability. We also reported on a range of policy initiatives, including a consultation process on the pre-positioning of banks for a system of Open Bank Resolution, new capital adequacy requirements for banks' farm lending exposures, and a new policy on covered bond issuance by banks. We kept stakeholders abreast of progress in implementing the final stages of the NBDT regime and the introduction of the new insurance regime.

This year, the banks have maintained, and usually significantly exceeded, the required minimum capital ratios and liquidity requirements that are set out in banks' Conditions of Registration. Our analysis shows that all banks are now in compliance with Conditions of Registration after corrective action was taken to address a single breach earlier in the year.

The Bank is now well positioned to implement the new insurance legislation when it becomes effective from March 2012. An insurance supervision team with the required skills has been recruited, processes have been developed, and an information management system has been designed to manage the interaction and licensing of insurers.

All required regulations are now in effect under Part 5D of the Reserve Bank of New Zealand Act, and we are monitoring ongoing compliance by NBDTs. There are no outstanding exemption applications, and all granted exemptions have been gazetted. Any material breaches of the regulations have been identified and accordingly dealt with, and any identified non-material breaches have been remedied. NBDTs are, in the main, compliant with the regulatory regime.

We now have a fully resourced anti-money laundering team in place. A Sector Risk Assessment has been published, outlining our views of the money-laundering risks in our sector. We have engaged with, and surveyed, our population of reporting entities, and have commenced designing our reporting entity risk model and reporting system.

We continue to consult with the Treasury on issues related to prudential regulation, and we keep the Minister of Finance informed on these issues. This year we have consulted with the Treasury on key policy developments, including in relation to NBDTs, the insurance sector, and the Bank's Open Bank Resolution policy.

## CURRENCY OPERATIONS

### THE OBJECTIVE OF THE CURRENCY FUNCTION IS:

- To meet the currency needs of the public by ensuring, as the sole issuer of currency, the supply and integrity of bank notes and coins.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### OUTCOME

- Legal tender that meets the currency needs of the public.

#### INITIATIVES AND STRATEGIES

- Implement a new Currency Management System for the management of currency operations.
- Review the effectiveness and efficiency of the Currency Operations 'wholesale' business model.
- Investigate possible enhanced security features for bank notes.
- Lift the quality of \$5 notes in circulation through a 'swap' programme.

### AND OUR PERFORMANCE WOULD BE MEASURED BY:

#### KEY PERFORMANCE INDICATORS

- All orders for notes and coins from banks that meet the Reserve Bank's guidelines are supplied within agreed times.
- Notes and coins in general circulation are of a good quality as indicated by surveys of the condition of currency in circulation.
- The number of counterfeit notes in circulation should be fewer than 10 per million notes in circulation.

The resilience of our currency rests on its integrity and the Bank's responsibility for this is reflected in our work programmes, especially in a significant new project to upgrade the security features and quality of our notes.

We meet the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand bank notes and coins, as well as maintaining the quality and verifying the authenticity of currency in circulation.

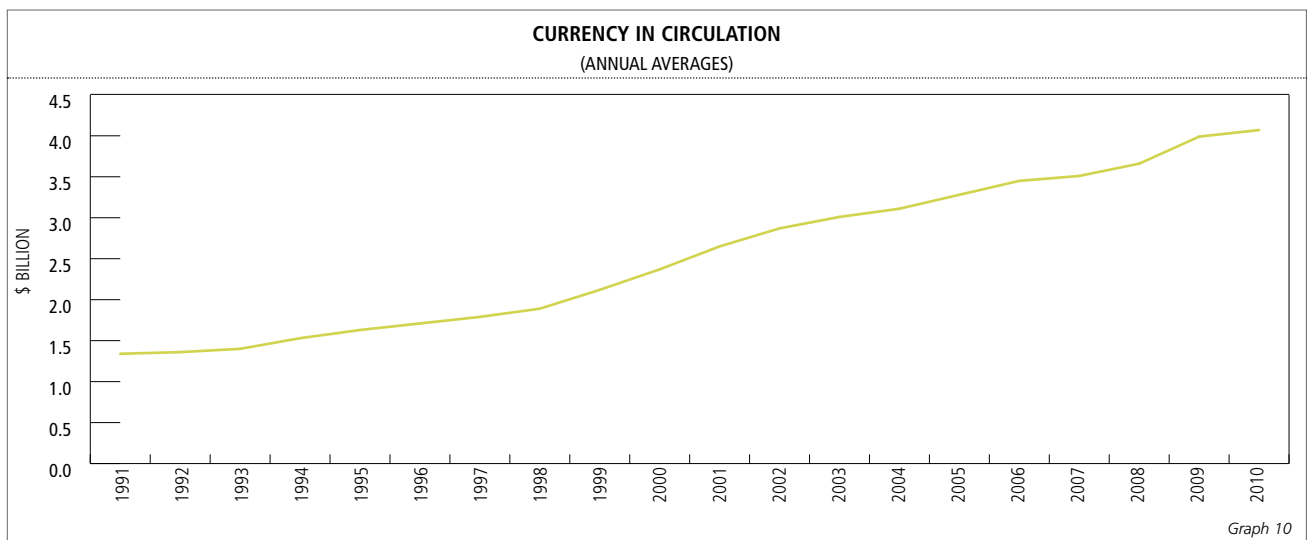
Cash remains an important means of undertaking transactions in New Zealand. The value of currency in circulation grew by 6 percent to \$4.17 billion in the year to 30 June 2011. Over the 10 years to June 2011, currency in circulation rose by 63.6 percent.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

The Bank's new Currency Management System went live in early August 2010. The new system improves the electronic tracking of currency through note processing operations, enhances security and upgrades reporting capabilities.

The 'wholesale' cash model continues to enable the Bank to achieve its currency objectives in an efficient manner. The Bank continues to monitor the cash-handling industry so that its own operations and policies take account of technological advances and other changes in the industry.



The Bank started planning the development of a new series of banknotes with upgraded security features. Information has been gathered from surveys of the general public and retailers, as well as from some other central banks that have recently introduced new banknote series. Technical discussions were held with interested parties including banks, retailers and representatives of the blind community.

The Bank worked closely with banks and cash-in-transit companies to help ensure cash was made available in Christchurch after the September and February earthquakes. The Bank issued \$140 million of currency in the eight days after the February earthquake. Most of this cash was sent to Christchurch but some was sent to other areas where ATM demand increased.

## HOW WE PERFORMED

### – KEY PERFORMANCE INDICATORS

During 2010-11, the Reserve Bank received 1,105 orders for currency for a total value of \$1,793 million. The Bank met all these orders on schedule and in the denominations requested. This helped ensure that the public's needs for currency were met during the year

The Bank has issued 2.4 million new \$5 banknotes to two cash-in-transit (cash delivery) companies as part of a 'Five Dollar Swap Programme' to improve the quality of \$5 banknotes in circulation. The two companies will issue the new notes to their customers and return used notes to the Bank. These will be quality checked and destroyed if unfit.

The number of counterfeit bank notes in New Zealand is low by international standards. In 2010-11, there were 450 counterfeits found in circulation by the Reserve Bank, cash-in-transit companies, banks and the Police. This represented 3.4 counterfeits per million notes in circulation. This was an increase over the rate of 1.8 recorded in 2009-10 but was still well below both international levels and the upper limit of 10 specified in the key performance indicator.

## DEPOSITORY AND SETTLEMENT SERVICES

### THE OBJECTIVE OF THE DEPOSITORY AND SETTLEMENT SERVICES FUNCTION IS:

- To ensure that payments system infrastructure services are provided efficiently and meet international standards.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### OUTCOME

- An efficient, reliable and secure payments system that supports the smooth functioning of the economy.

#### INITIATIVES AND STRATEGIES

- Complete the technical and business analysis of working with NZX in regard to clearing systems and decide on a course of action.
- Continue to make enhancements to NZClear and ESAS as agreed with industry representatives.
- Establish interfaces that will facilitate inter-operability between ESAS/NZClear and other providers' payment and settlement systems, to increase efficiency and reduce risk.

- Improve business continuity planning and disaster recovery capability for the payment systems through the establishment in Auckland of a business support centre.
- Build "Settlement Before Interchange" functionality within ESAS to replace the retail settlement function performed by ISL, so reducing payment settlement risk.

### AND OUR PERFORMANCE WOULD BE MEASURED BY:

#### KEY PERFORMANCE INDICATORS

- Availability of ESAS/NZClear during core hours is at least 99.95 percent, as measured over a year.
- Customer satisfaction with operations and with system development is demonstrated through an annual customer survey in which an approval level of 90 percent or more is achieved.
- All risks are well managed as demonstrated by quarterly external audits.
- International standards for payment and settlement systems (CPSS and IOSCO) are complied with.

## SETTLEMENT ACTIVITY

The Bank provides specialised financial services, mainly to financial institutions. These services comprise operation of the Exchange Settlement Account System (ESAS) and operation of the NZClear securities settlement system.

Most major financial institutions have a New Zealand dollar cash account with the Reserve Bank. These are known as exchange settlement accounts, and those financial institutions use those accounts, which comprise the ESAS system, to make payments to each other in real time. ESAS is a designated payment system under the Reserve Bank Act. This means that once a payment has been processed in ESAS, it cannot be reversed. This provides certainty to the recipients of those payments, which is very important given that in excess of \$25 billion is paid through this system each day.

One of the account holders in ESAS is Continuous Linked Settlement Bank (CLS). CLS is an international institution that processes the majority of foreign exchange payments made in major economies. By making payments through CLS, financial institutions can achieve simultaneous settlement of both legs of

foreign exchange transactions. When the CLS service is used, it eliminates settlement risk for foreign exchange transactions – the risk that one party makes a payment to purchase one currency but the other party fails to meet its obligation to pay the other currency.

The NZClear service allows buyers and sellers of securities to settle transactions efficiently and securely. The system provides for buyers of New Zealand dollar-denominated equities and bonds to receive those securities at the same time as payment of cash is made for those purchases. Each transaction is settled individually – there is no netting of obligations. NZClear also allows financial institutions to make payments of cash to each other, and once those payments are made, they cannot be reversed. The Bank administers securities on behalf of members of the NZClear system, with a value totalling more than \$140 billion, and each day payments with a value totalling more than \$7 billion are made by members of NZClear.

ESAS and NZClear, together with CLS, provide certainty to financial institutions in processing their high-value transactions, which is particularly important during periods of financial instability.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

In 2010, the Bank and NZX reviewed clearing and settlement arrangements in New Zealand with a view to working together more closely to improve efficiency in the securities settlement industry. The Bank and NZX agreed, in a memorandum of understanding, that NZX Limited would provide a new central counter-party settlement service; that the Bank would continue to provide real-time gross settlement services by operating NZClear; and that the two systems would be interoperable. The memorandum of understanding includes provision for a joint industry advisory council to monitor the performance of the industry and make suggestions for improvements.

During the year, NZX launched a new central counterparty settlement system, which provides depository services and which competes with NZClear. An interface operates between the two depositories, which provides for efficient movement of securities between the systems.

In July 2010, NZClear also established an interface to registries, which allows securities to be electronically lodged into the system or uplifted and moved to another account at the relevant securities registry. The interfaces with NZX and registries have eliminated the manual processing of more than 60,000 transactions per annum, significantly increasing efficiency while reducing operational risk.

Settlement systems are able to apply to become designated settlement systems under the Reserve Bank Act. Designation provides statutory backing to the rules of the settlement system and provides additional legal certainty to settlements effected through those systems. NZClear has applied to be a designated settlement system and extensive interaction has occurred with the joint regulators. The joint regulators require that the rules of the NZClear system must be changed before the system is designated and the Bank has commenced consultation with members on proposed changes to the NZClear system's rules.

The Bank has also developed a new system to effect the settlement of retail transactions. 'Settlement Before Interchange' involves an enhancement to ESAS that will allow institutions to update their records for their customers' transactions and to settle the value of those transactions at regular intervals each day. At the time of writing, the system development has been completed and the system is being tested by the institutions, with live use expected from November 2011.

A further major accomplishment was establishment of a small Bank office in Auckland. While the Bank's key systems are already mirrored in Wellington and Auckland, the Auckland business office mitigates the risk associated with all our specialist staff being located in Wellington in the event of a major physical disruption in Wellington.

## HOW WE PERFORMED

### – KEY PERFORMANCE INDICATORS

Tables 2-4 set out key statistics for the operation of ESAS and NZClear.

The average value of transactions passing through ESAS decreased again this year, although the decrease is not as marked as that which occurred immediately following the global financial crisis. Transaction volumes passing through NZClear continued to fall.

The system was available to users 99.91 percent of core hours, narrowly under the target of 99.95 percent. No major system disruptions occurred during the year.

In the annual customer survey, users of ESAS and NZClear have continued to report very high levels of satisfaction. In 2011, the satisfaction rating was 100 percent (2010: 97 percent).

On behalf of the Auditor-General, Chris Barber, using the staff and resources of PricewaterhouseCoopers, undertakes external audits of the NZClear system each quarter and ESAS each year, and audit reports are reviewed by the Bank's Audit Committee. All audit opinions were unqualified. Improvements designed to enhance the management of risk associated with operating these systems are made continuously.

TABLE 2  
Key ESAS statistics

	2007	2008	2009	2010	2011
AVERAGE DAILY TRANSACTION VOLUMES	6,081	7,024	7,156	6,929	<b>7,383</b>
AVERAGE DAILY TRANSACTION VALUES	\$36.3BN	\$38.9BN	\$36.8BN	\$28.6BN	<b>\$26.6BN</b>

TABLE 3  
Key NZClear statistics

	2007	2008	2009	2010	2011
AVERAGE DAILY TRANSACTION VOLUMES	1,097	1,119	973	899	<b>854</b>
AVERAGE DAILY TRANSACTION VALUES	\$6.6BN	\$6.3BN	\$6.8BN	\$7.0BN	<b>\$7.6BN</b>

TABLE 4  
Key ESAS-NZClear statistics

	2007	2008	2009	2010	2011
ESAS-NZCLEAR SYSTEM AVAILABILITY DURING CORE HOURS	99.92%	99.23%	99.77%	99.93%	<b>99.91%</b>

## HUMAN RESOURCES

### THE OBJECTIVE OF HUMAN RESOURCES IS:

- To provide strategic human resource advice and support services.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- Engage, develop and support staff to meet the challenges of the Bank's evolving responsibilities.
- Support management in further developing their values-based leadership competencies.
- Continue an annual review of key-role risk within the Bank and mitigation strategies.

- Enhance the Bank's staff appraisal and personal development programme.
- Facilitate excellent management processes and decision making throughout the Bank; provide a supportive environment for staff to perform at their best; and continue to develop the skills and knowledge required.
- Ensure the Bank's Values of integrity, innovation and inclusion are central to all staff initiatives.
- Complete the biennial staff satisfaction survey in 2011.
- Ensure staff are adequately informed to cope with a crisis, and that there is sufficient back-up to ensure Bank operations are maintained.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

The performance of the Bank in times of growth and change is dependent on our employees. Our hiring, development and retention strategies all strive to retain and develop the best people. We encourage a working environment where all staff can develop their skills and knowledge, and contribute fully.

The continual development and growth of leaders remains a high priority for the Bank. During the year, managers attended both individually targeted and Bank-centralised developmental training, while emerging leaders participated in programmes aimed at preparing them for management roles.

A major development initiative was introduced this year with an online performance management system, which encourages individual development planning. Training initiatives included programmes to develop quality performance conversations and collaborative leadership.

Another major initiative was achieved this year with the opening of the Bank's business continuity office in Auckland. With smart technology, the team in Auckland is linked virtually to the Wellington site and work side by side with their colleagues in the key areas of financial markets, middle office and settlements.

TABLE 5  
Human resource statistics

	2006	2007	2008	2009	2010	2011
TOTAL STAFF AT 30 JUNE (FTE)	223	221	223	237	243	<b>250</b>
AVERAGE YEARS OF SERVICE AT 30 JUNE	7.4	7.4	7.6	7.6	7.9	<b>8.0</b>
ANNUAL STAFF TURNOVER	9.3%	12.3%	17.4%	9.3%	12.5%	<b>12.4%</b>

## REMUNERATION

### Staff

The Reserve Bank spent \$27 million on personnel in 2010-11. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 6 shows the number of staff who received over \$100,000 in total remuneration<sup>18</sup>, in bands of \$10,000.

TABLE 6  
Remuneration in 2010-11

TOTAL REMUNERATION (\$)	STAFF NUMBERS 2011
100,000 TO 109,999	22
110,000 TO 119,999	13
120,000 TO 129,999	6
130,000 TO 139,999	8
140,000 TO 149,999	9
150,000 TO 159,999	10
160,000 TO 169,999	6
170,000 TO 179,999	5
180,000 TO 189,999	6
190,000 TO 199,999	1
200,000 TO 209,999	1
210,000 TO 219,999	1
230,000 TO 239,999	1
240,000 TO 249,999	2
260,000 TO 269,999	1
270,000 TO 279,999	1
280,000 TO 289,999	1
320,000 TO 329,999	1
340,000 TO 349,999	1
400,000 TO 409,999	1
590,000 TO 599,999	1
<b>TOTAL STAFF RECEIVING \$100,000 OR MORE</b>	<b>98</b>

### Non-executive directors' remuneration

Non-executive directors' remuneration consists of directors' fees. Directors' fees represent consideration for services provided to the Bank for acting as directors of the Bank. Certain non-executive directors receive additional remuneration due to their involvement in Board committees or special review tasks. All remuneration paid to non-executive directors is included in the following table. There are no fees paid to the Governor, who is an executive director of the Bank.

TABLE 7

NON-EXECUTIVE DIRECTORS	2010 (\$)	2011 (\$)
A GRIMES (CHAIRMAN)	55,500	<b>51,000</b>
A PATERSON	19,814	<b>0</b>
C EICHBAUM	25,500	<b>27,500</b>
H FLETCHER (DEPUTY CHAIR)	34,179	<b>37,875</b>
J GOULTER	16,729	<b>0</b>
S SHELDON	27,500	<b>27,500</b>
K TAYLOR	27,500	<b>27,500</b>
K VAUTIER	10,721	<b>27,500</b>
N QUIGLEY	12,054	<b>31,500</b>
<b>TOTAL</b>	<b>229,497</b>	<b>230,375</b>

## INSURANCE AND INDEMNITY ARRANGEMENT

Section 179 of the Reserve Bank Act provides that every officer, employee or director of the Bank is not personally liable for acts done or omitted to be done in the exercise or performance in good faith of that person's functions, duties or powers under the Act. Under section 179A of the Act, the Crown provides an indemnity to every officer, employee or director of the Bank and certain other persons for any liability arising as a result of exercising or failing to exercise any power conferred under the Act, unless the exercise or failure to exercise the power was in bad faith.

The Bank also provides income protection insurance to specified senior executives, and for other staff it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

<sup>18</sup> Total remuneration includes the annual cost to the Reserve Bank of all elements of contracted remuneration (salaries, any benefits provided, fringe benefit tax, superannuation), plus any bonuses or redundancy payments. The information in table 6 sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Minister of Finance on the recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governor. The Bank's remuneration policy is to pay all staff on the basis of performance on the job, while having regard to prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.

## KNOWLEDGE SERVICES

### THE OBJECTIVE OF KNOWLEDGE SERVICES IS:

- To provide core technology and information platforms that give a high level of uninterrupted service in a secure environment.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- FSIS implementation will ensure key business benefits are realised by completing the migration of remaining surveys, and developing new surveys for NBDTs and the insurance sector and for other external data.
- Ensure that users can use Bank systems effectively and efficiently. Develop systems to make our management of the information technology environment more efficient.
- Continue developing the Bank's information technology security systems to maintain industry best practice and improve our ability to respond to increasing threats.
- Refresh the Bank's website to better deliver content and services.
- Extend the Intranet and make more use of personalised and collaborative tools.
- Establish a managed information architecture and sound information management platform.
- Review and, where appropriate, upgrade or replace older internally supported computer applications.
- Improve management and archival processes around documents, email, network drive files and physical records, in line with the Public Records Act.
- Enhance and develop museum services as part of a wider public education programme.
- Continue to enhance the Bank's business continuity infrastructure, through the establishment in Auckland of a business support centre for critical functions and other back-up computing arrangements.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

Over the last year, we have continued to review new technologies and business processes to continue to build on the Bank's information technology investments for the future.

Further development was completed on the Financial Sector Information System (FSIS), expanding its capability for wider use as the standard Bank repository for times series information.

We are continuing to build a common information platform to support the new supervisory functions across the insurance, NBDT, anti-money laundering and banking sectors.

Payments systems continue to evolve with a number of projects under way to refresh systems, processes and upgrades to networks. In conjunction with the Financial Services department the Bank's financial management information system has been replaced.

The wide area network and back-up systems were upgraded to improve bandwidth, resiliency, and reduce operating costs. Software was refreshed on the Bank's website to further enhance the delivery of information to users. The Intranet has been refreshed to increase collaboration and knowledge sharing across the Bank.

Project management and business continuity planning disciplines are being increased across the Bank.

## INTERNAL FINANCIAL SERVICES

### THE OBJECTIVE OF INTERNAL FINANCIAL SERVICES IS:

- To provide financial control for the Bank's activities. Services provided include financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- Continue to enhance workflows, reports, and processes for financial control and financial operations and securities transactions.
- Replace the Bank's financial management information system during 2011.
- Revise reporting for financial market operations to give effect to portfolio management changes.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

The Bank's Financial Services Group is responsible for financial control of the Bank's activities. Financial Services Group processes transactions for the Bank's foreign reserves and liquidity management operations, as well as providing transactional services for other Bank functions. The group also provides management and financial reporting, and internal accounting services such as compliance reporting against limits, expenditure control reports and planning and budgeting services.

The Bank's core treasury system continued to be enhanced, and from August 2010 this system has been used to manage processing of the Bank's currency. The treasury system was also upgraded. We have been evaluating and designing changes to the treasury system required to implement benchmarking of performance of the foreign reserves management function. Implementation of these changes will occur in 2011-12.

The Bank implemented a new financial management information system which went into live production on 1 July 2011.

## COMMUNICATIONS

### THE OBJECTIVE OF COMMUNICATIONS IS:

- To provide strategic advice and management for the Bank's external and internal communications and for the maintenance of its reputation and credibility.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- Monitor media, maintain communication relationships, and provide timely information and strategies to ensure the Bank's key messages are delivered and understood, and to address credibility risks and opportunities.
- Develop appropriate communication vehicles for the Bank's expanded role in the prudential supervision of non-bank financial institutions.
- Provide communications services for crises, including simulation.
- Enhance financial literacy, through promotion of the Bank's role as prudential regulator and support for interagency financial literacy programmes.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

Our Strategic Priorities have been supported by speeches and news releases, alongside our 'set piece' communications around *MPSs* and *FSRs*. Early themes of recovery from the global financial crisis and recession were overtaken by the impact of the Canterbury earthquakes. While we kept audiences informed of the economic and insurance impacts, after the devastating February quake we posted information to our website showing branches and ATMs as they re-opened.

Through the year, we also published our thinking on potential macro-prudential tools to mitigate credit and asset booms and busts.

Prudential responsibilities are a larger part of the Bank's business, and we communicated developments in: supervision regimes for NBDTs and insurance sectors; covered bonds; disclosure requirements; Open Bank Resolution; and new rural lending capital requirements.

Many more speeches are delivered off the record, allowing us to explain our activities to general audiences while ensuring markets are not confused by repeated messages.

We continued to support our Museum and to sponsor education initiatives, including the Bank's annual 'Monetary Policy Challenge' for senior secondary school students. Teams compete to deliver their own 'Official Cash Rate decision'. The competition was won by Kristin School (Auckland), ahead of Tauranga Boys' College and Scots College (Wellington). Details of the competition are available at <http://www.rbnz.govt.nz/challenge>.

A board game, *Skint to Mint*, designed in conjunction with Young Enterprise Trust to teach senior secondary school students about risks and rewards in investments, was launched successfully to schools, supported by teacher development workshops. Further development and promotion of the game to wider audiences is under review.

## RISK ASSESSMENT AND ASSURANCE

### THE OBJECTIVE OF RISK ASSESSMENT AND ASSURANCE IS:

- To assist in the identification of risk and the maintenance of efficient risk management; to provide assurance over operations, procedures and internal control systems; and to provide legal advice.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- Monitor the Bank's approach to risk management, utilising the enterprise-wide risk map.
- Continue a comprehensive internal audit programme to provide assurance on the Bank's control environment.
- Continue to provide quality legal advice.

## HOW WE PERFORMED

### – INITIATIVES AND STRATEGIES

The Risk Assessment and Assurance unit continued to provide risk-related advice to managers and governors on the various issues that arose in the operation of the Bank during the year.

The year's internal audit programme was completed as planned and all issues identified were reported to the appropriate level of management.

The annual update of Bank-wide risk maps was undertaken, providing a useful opportunity for management, Governors and the Board to focus on the risks facing the Bank.

The Bank continues to make extensive use of services provided by in-house legal counsel in support of all its functions.

## PROPERTY MANAGEMENT AND SECURITY

### THE OBJECTIVE OF THE PROPERTY MANAGEMENT AND SECURITY INTERNAL SERVICE IS:

- To provide appropriate accommodation for the Bank to ensure that all functions, including cash operations, can be conducted unimpeded in a secure environment.

### IN OUR 2010-13 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

#### INITIATIVES AND STRATEGIES

- Refurbish Bank accommodation as required to meet the needs of additional staff.
- Assist in locating and setting up a suitable Auckland office.
- Implement cost-effective measures to further enhance energy efficiency.

## HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Bank maintains its own building in Wellington. It leases a small office in Auckland and a business continuity site in Wellington. We manage security operations to ensure the Bank has secure, appropriate accommodation at all sites.

A comprehensive external maintenance programme for the Wellington building was completed.

The small office leased in Auckland was refurbished for daily Reserve Bank operations and for use as an out-of-Wellington business continuity site.

Investigations have shown that additional efficiency gains can be made during summer months by the replacement of some equipment that was installed when the building was constructed in 1972.

The Security Team has maintained the required high level of security, particularly in relation to the safe custody of cash reserves and the regular cash operations with banks.

Two tenants occupying three floors of the Bank building did not renew their leases. Two of the three floors have subsequently been leased to a new tenant. The remaining floor will undergo a full refurbishment before being offered to the market for lease.

## INTERNATIONAL ACTIVITIES

In order to further the work of the Reserve Bank, the Bank regularly engages across a wide number of international organisations, central banks, prudential regulators and other multilateral organisations. The Bank learns from these engagements but also promotes New Zealand's interests through a number of vehicles, including, for example, direct interaction with the IMF constituency office and secondment of Bank staff to the IMF.

The Bank also continues its engagement with EMEAP (Executive Meeting of East Asian and Pacific) central banks and monetary authorities. The BIS (Bank for International Settlements) continues to be an active partner for liaison across not just macro-prudential issues, but also monetary policy developments both within the Asian region and for small open economies like New Zealand. The Reserve Bank also maintains formal and informal relationships across the global central banking community.

In the South Pacific area, the Bank plays a significant role in supporting the development of financial capability through the moneyPACIFIC project. This is a financial education programme focused on making it easier for Pacific people to find out more about the cost of remittances and other financial products. It is about engaging people, building their awareness about finance, and increasing their ability to make financial decisions.

## GLOSSARY

### AML/CFT

Anti-Money Laundering and Countering the Financing of Terrorism

*Under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, the Reserve Bank is one of three supervisors tasked with ensuring firms comply with new obligations designed to help deter and detect money laundering and terrorist financing.*

### BIS

Bank for International Settlements

*An international financial institution based in Switzerland, owned by about 50 central banks and providing a range of financial services to central banks, international financial institutions and governments.*

### CLS

Continuous Linked Settlement

*An international system run by CLS Bank International aimed at reducing foreign exchange settlement risk (Herstatt risk). It primarily provides a payment versus payment system for settling foreign exchange transactions.*

### CPSS

The Committee on Payment and Settlement Systems

*A forum for 25 central banks to monitor and analyse developments in domestic payment, settlement and clearing systems, and cross-border and multicurrency settlement schemes. The Committee also focuses on standard-setting activities.*

### EMEAP

Executive Meeting of East Asian and Pacific central banks and monetary authorities

*A cooperative organisation of central banks and monetary authorities in the East Asia and Pacific region, comprising Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.*

### ESAS

Exchange Settlement Account System

*A banking service for institutions that need to make regular high-value payments with each other. All the current account holders are banks.*

### FSIS

Financial Sector Information System

*The Reserve Bank's central database for time-series data.*

### FSR

Financial Stability Report

*A six-monthly report assessing the soundness and efficiency of the New Zealand financial system.*

### IOSCO

International Organisation of Securities Commissions

*A worldwide organisation of securities regulators, including the New Zealand Securities Commission.*

### ISL

Interchange and Settlement Limited

*A non-real time switch system which enables the settlement of transactions from the processing of cheques, direct debit, direct credits, automatic payments and Eftpos.*

### KITT

Kiwi Inflation Targeting Technology

*A forecasting model used to help formulate the Bank's economic projections.*

### MPS

Monetary Policy Statement

*A quarterly assessment, accompanying an OCR Review, of how the Reserve Bank proposes to achieve its targets; how it proposes to formulate and implement monetary policy during the next five years; and how monetary policy has been implemented since the last Monetary Policy Statement.*

### NBDTs

Non-bank deposit takers

*Finance companies, building societies and credit unions which take deposits from the investing public.*

### NZCLEAR

*A real-time settlement system providing the financial markets with clearing and settlement services for high-value debt securities and equities.*

### OCR

Official Cash Rate

*The interest rate set by the Reserve Bank to meet the inflation target specified in the Policy Targets Agreement.*

### PTA

Policy Targets Agreement

*A contract, negotiated between the Government and the Governor of the Reserve Bank, defining the Bank's price stability target.*

### SDR

Special Drawing Right

*Unit of account of international reserve assets created by the International Monetary Fund (IMF) to supplement the reserves of IMF member countries. Its value is based on a basket of key international currencies.*

## OUR FINANCIAL STATEMENTS – AN OVERVIEW

Key financial statistics for 2010-11 are:

	2011 (\$M)	2010 (\$M)
Dividend payment to government	210	335
Net interest income	302	325
Net profit/(loss) <sup>19</sup>	144	(111)
Net operating expenses <sup>20</sup>	46.8	43.2
Funding agreement	47.8	46.9
Total assets	31,090	26,357
Foreign reserves intervention capacity	9,130	11,260
Total equity <sup>21</sup>	2,509	2,574

- The Bank returned to profitability in 2011 despite continued volatility in interest rates and foreign exchange rates including overall appreciation in the New Zealand dollar.
- Net interest income was sound, but below the level received in 2010. Interest revenue in the first half of the 2010 financial year was boosted by non-recurring income from loans made during the height of the global financial crisis. These loans matured during the 2010 year.
- The dividend for 2011 is lower than in 2010 and is consistent with ensuring the Bank has sufficient equity for the financial risks attached to the Bank's functions.
- Operating expenditure continues to be within the amount provided for in the five-year Funding Agreement.

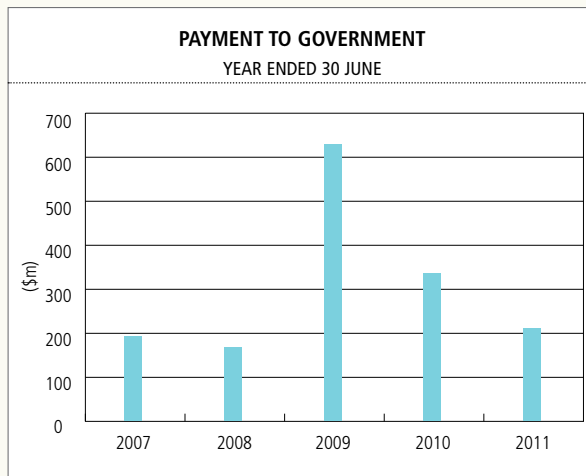
<sup>19</sup> After accounting revaluations due to changes in foreign exchange and interest rates.

<sup>20</sup> For both 2011 and 2010, net operating expenses stated in this table exclude actuarial gains and losses on the Bank's defined benefit superannuation scheme. Prior to 1 July 2010, actuarial gains and losses were included in net operating expenses subject to the Funding Agreement.

<sup>21</sup> After provision has been made for dividends.

## DIVIDEND PAYMENT IS BELOW THAT FOR 2010 BUT IS STILL SUBSTANTIAL

	2011 (\$M)	2010 (\$M)
Dividend	210	290
Voluntary dividend payment	-	45
<b>TOTAL PAYMENT TO GOVERNMENT</b>	<b>210</b>	<b>335</b>



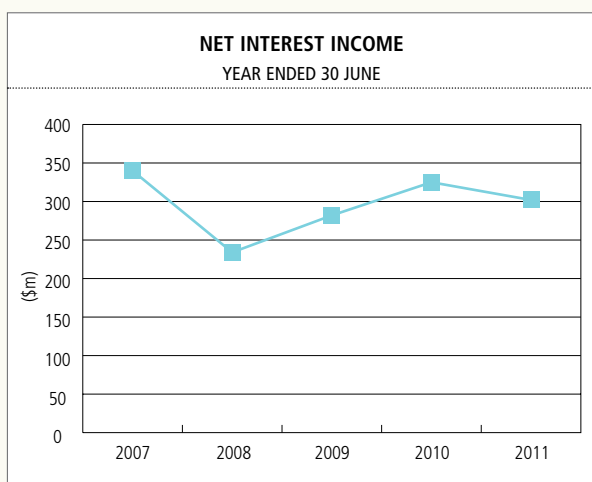
The dividend payment to government for the financial year to 30 June 2011 is \$210 million. This has been calculated using the dividend principles on page 18. The dividend for 2010 included a \$45 million voluntary payment made because the Bank required less capital as the global financial crisis abated.

Dividends are generally sourced from realised income. Realised income was lower than in 2010 because net interest income reduced in 2011. The dividend is calculated to ensure that the Bank has sufficient equity for the financial risks that it faces.

The dividend is not directly related to net profit, due to the timing of realisation of revaluation gains and losses arising from changes in foreign exchange rates and interest rates, and also due to changes in the assessed equity requirements of the Bank.

## UNDERLYING NET INTEREST INCOME REMAINS SOUND

	2011 (\$M)	2010 (\$M)
Net interest income	302	325



Each year, the Bank receives a large flow of net interest income from the investment of funds received as payment for notes and coins issued to banks and the investment of the Bank's equity.

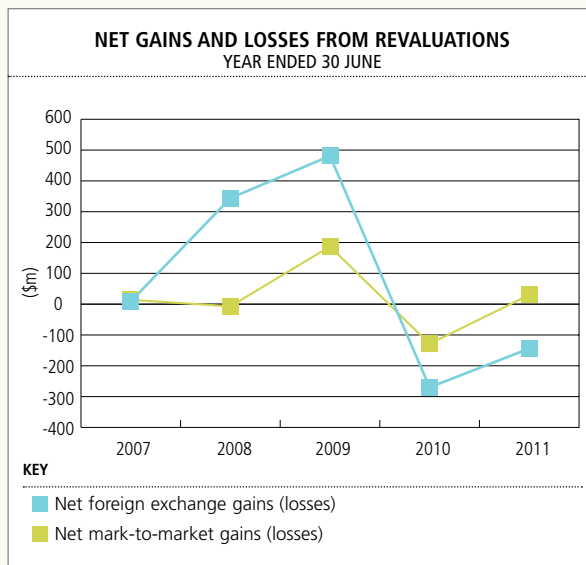
Net interest income declined in the 2011 financial year because revenue in the first half of the 2010 financial year included returns from loans advanced during the global financial crisis. Those loans, which largely matured by December 2010, were made before interest rates hit their low point during the crisis and consequently generated non-recurring interest revenue in the 2010 year.

## VOLATILE FOREIGN EXCHANGE AND INTEREST RATES CAUSE VOLATILITY IN THE REPORTED INCOME

	2011 (\$M)	2010 (\$M)
<b>INCOME INCLUDES:</b>		
Foreign exchange gains (losses)	<b>(144)</b>	(270)
Gains (losses) from changes in the market value of financial instruments	<b>31</b>	(129)
<b>TOTAL</b>	<b>(113)</b>	(399)

The Bank has a policy of holding some of its foreign reserves on an unhedged basis to allow it to deliver a more effective response in the event of a crisis affecting the country's foreign exchange market and to smooth more extreme exchange rate movements.

The New Zealand dollar value of the Bank's unhedged reserves can change markedly from year to year and this volatility is reflected in the Bank's reported profit, as are changes in the value of financial instruments that are due to movements in interest rates.



## CORE OPERATING EXPENSES REFLECT COSTS OF ISSUING CURRENCY AND THE BANK'S INCREASED RESPONSIBILITIES

	2011 (\$M)	2010 (\$M)
<b>OPERATING EXPENSES:</b>		
Staff expenses	27.3	26.2
Net currency-issued expenses	6.7	3.9
Asset management expenses	7.3	8.0
Other operating expenses	13.3	13.4
Underlying operating expenses	54.6	51.5
Actuarial loss (gain) on defined benefit superannuation scheme	0.4	(2.0)
<b>TOTAL OPERATING EXPENSES</b>	<b>55.0</b>	<b>49.5</b>

Operating expenses, excluding actuarial losses and gains, rose by \$3.1 million from \$51.5 million in 2010 to \$54.6 million in 2011.

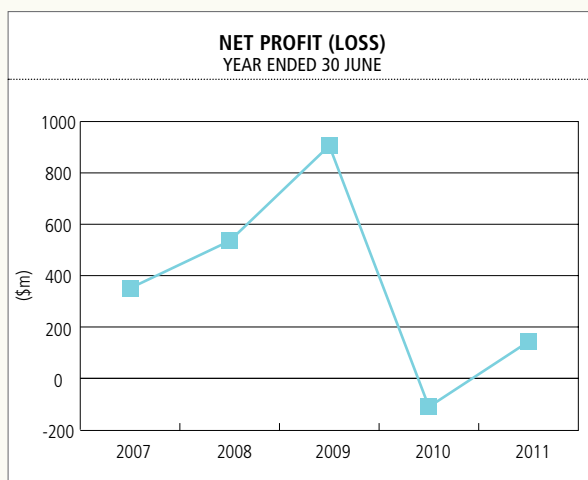
This increase reflected the cost of issuing additional currency. This was due to an increase in demand for notes and coins, including following the Christchurch earthquake in February.

The Bank has managed to contain increases in underlying costs while completing the recruitment of additional staff for the Bank's new regulatory responsibilities for non-bank deposit takers and insurers, as well as opening an Auckland office late in the financial year.

## OVERALL, A SUBSTANTIAL PROFIT TURNAROUND HAS OCCURRED DESPITE FURTHER, BUT LOWER, FOREIGN EXCHANGE LOSSES

	2011 (\$M)	2010 (\$M)
<b>INCOME:</b>		
Net interest income	302	325
Foreign exchange gains (losses)	(144)	(270)
Gains (losses) from changes in the market value of financial instruments	31	(129)
Other investment income	2	5
<b>Net investment income</b>	<b>191</b>	<b>(69)</b>
Other operating income	8	8
<b>TOTAL INCOME</b>	<b>199</b>	<b>(61)</b>
Total operating expenses	55	50
<b>NET PROFIT (LOSS)</b>	<b>144</b>	<b>(111)</b>

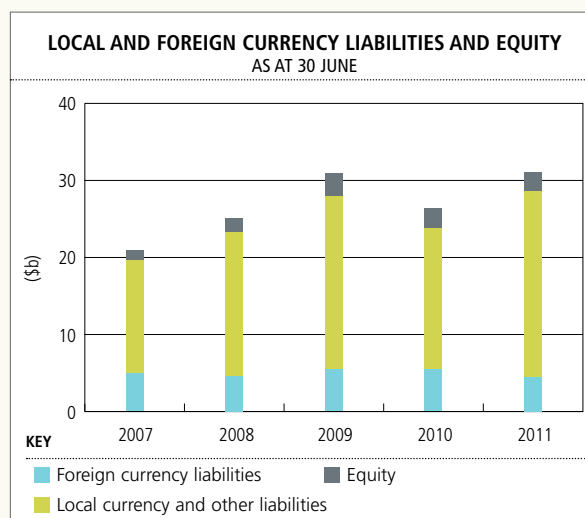
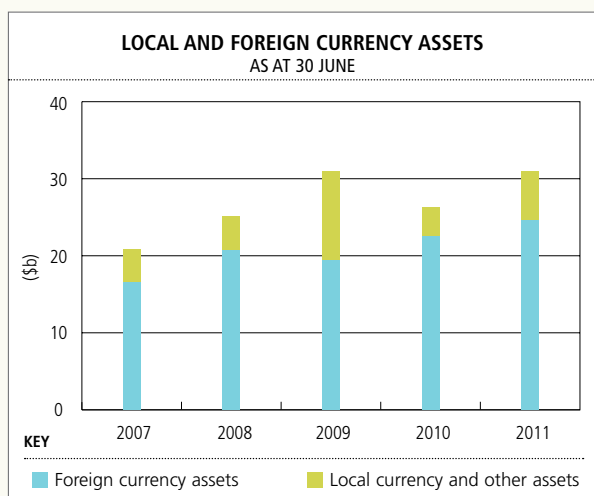
The Bank reported a net profit of \$144 million, reflecting income from its portfolio of domestic and foreign currency-denominated securities, offset partially by losses on its unhedged foreign reserves, arising from appreciation in the New Zealand dollar.



## BALANCE SHEET EXPANDS AS DEPOSITS FROM THE GOVERNMENT HAVE INCREASED AND ARE INVESTED

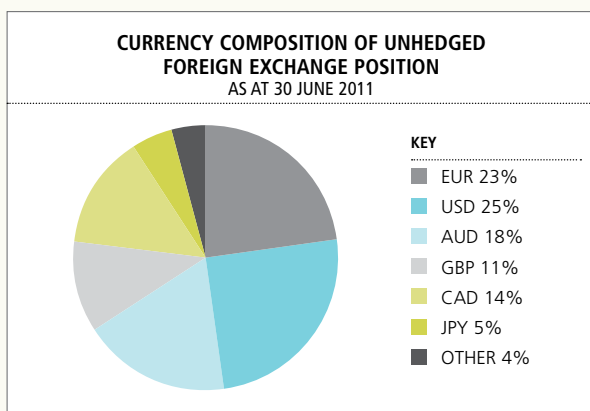
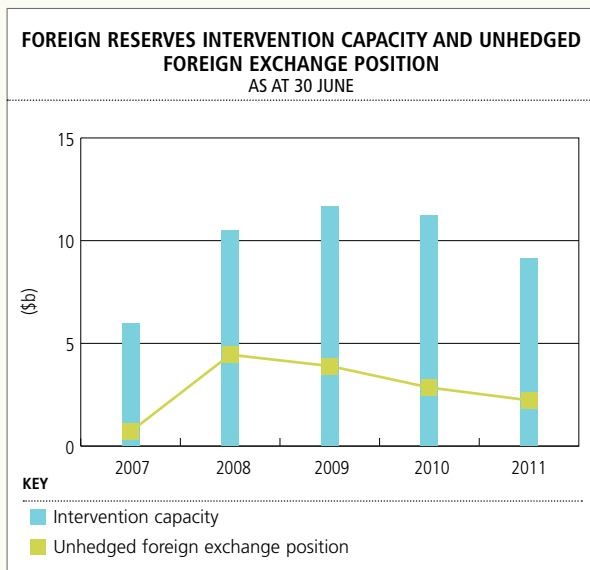
	2011 (\$M)	2010 (\$M)
<b>FINANCIAL POSITION AS AT 30 JUNE</b>		
<b>ASSETS:</b>		
Foreign currency financial	24,647	22,612
Local currency financial	6,360	3,658
Other assets	83	87
<b>Total assets</b>	<b>31,090</b>	<b>26,357</b>
<b>LIABILITIES AND EQUITY:</b>		
Foreign currency financial	4,481	5,533
Local currency financial	19,711	14,015
Currency in circulation	4,173	3,938
Other liabilities	216	297
Equity	2,509	2,574
<b>TOTAL LIABILITIES AND EQUITY</b>	<b>31,090</b>	<b>26,357</b>

- At 30 June 2011, total assets were \$31.1 billion (2010: \$26.4 billion).
- Growth in assets is attributable to the investment of increased deposits placed with the Bank by the New Zealand government. The government has generated these funds through its debt-issuance programme.



## UNHEDGED FOREIGN EXCHANGE POSITION REDUCES

	2011 (\$M)	2010 (\$M)
Unhedged foreign exchange position	2,227	2,851



The foreign reserves intervention capacity is the measure of the Bank's ability to quickly sell foreign currency and buy New Zealand dollars, should market conditions warrant such an action.

An unhedged foreign exchange position allows the Bank to sell foreign currency outright without having to later purchase or borrow foreign currency, but it also means that the Bank's foreign assets and liabilities are not exactly matched or 'hedged'. Movements in foreign currency exchange rates may therefore result in valuation losses or gains.

During the past year, the foreign reserves intervention capacity fell from \$11.3 billion to \$9.1 billion. Intervention capacity and unhedged reserves were at their highest levels during the global financial crisis and the Bank has since reduced its holdings of both hedged and unhedged foreign reserves. In the case of unhedged foreign reserves, the Bank has progressively moved back towards its benchmark holding of SDR 1 billion (equivalent to approximately NZD 1.94 billion at 30 June 2011).

The pie chart shows the composition of foreign currencies included in the unhedged foreign exchange position.

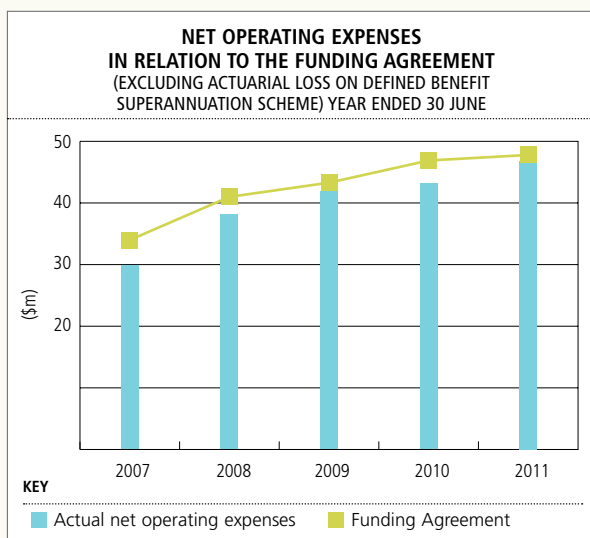
## SPENDING REMAINS INSIDE THE FIVE-YEAR FUNDING AGREEMENT

	2011 (\$M)	2010 (\$M)
<b>NET OPERATING EXPENSES IN RELATION TO THE FUNDING AGREEMENT</b>		
Staff expenses	27.3	26.2
Net currency-issued expenses	6.7	3.9
Asset management expenses	7.3	8.0
Other operating expenses	13.3	13.4
<b>Total operating expenses excluding actuarial loss on defined benefit superannuation scheme</b>	<b>54.6</b>	51.5
Income from operations	7.8	8.3
<b>Actual net operating expenses</b>	<b>46.8</b>	43.2
<b>Net operating expenses specified in the Funding Agreement</b>	<b>47.8</b>	46.9
Funding Agreement under-expenditure	1.0	3.7

The Funding Agreement is a five-year agreement between the Minister of Finance and the Governor of the Reserve Bank to finance the Bank's operating expenses.

The net figure is based on operating expenses less income from services such as transaction fees and rents received from the letting of office space.

Net operating expenses (excluding actuarial gains and losses) were \$46.8 million in 2011. This was \$1.0 million below the \$47.8 million level provided for in the Funding Agreement for the 2011 year.



# RESERVE BANK STRATEGIC PRIORITIES FOR 2011-12

PRIORITY	EXPLANATION	DEPARTMENT
1. ASSESS THE IMPACT OF THE CANTERBURY EARTHQUAKES AND THE IMPLICATIONS FOR THE BANK'S MONETARY POLICY.	The economic impacts of the Canterbury earthquakes, especially the February 2011 event, are complex and significant. The Bank has identified key focus areas for investigation and impact analysis (e.g., the size and magnitude of the recovery expenditure, period of recovery, insurance and banking industries, household and Crown balance sheets). A consequent understanding of the inflation implications for both the near and medium terms will assist in developing an appropriate monetary policy response.	ECONOMICS
2. DEVELOP AN IMPLEMENTATION FRAMEWORK FOR MACRO-PRUDENTIAL POLICY TOOLS IN NEW ZEALAND AND CONSIDER THE INTER-RELATIONSHIP WITH MONETARY POLICY.	The Bank has identified a number of macro-prudential policy instruments that it would contemplate using in appropriate circumstances to promote greater financial and macro stability. This work will develop the framework required to assist decision making on when and how to deploy these instruments, potentially to influence the credit cycle. We will need to understand the impact of such policies in mitigating credit booms and increasing the resilience of the financial system. We also need to understand whether macro-prudential policies have collateral macroeconomic effects, implying interaction with traditional (e.g., monetary) policies.	FINANCIAL MARKETS ECONOMICS
3. ENSURE THAT INSURERS ARE ON THE PATH TO OBTAINING A FULL LICENCE BY SEPTEMBER 2013, MEETING AT LEAST THE PROVISIONAL LICENSING REQUIREMENTS BY MARCH 2012.	The Insurance (Prudential Supervision) Act requires all insurers to be licensed by March 2012. Existing insurers who were already carrying on business in New Zealand before September 2010 can, subject to meeting certain criteria, operate under a provisional licence from March 2012 but must then achieve full licence status by September 2013 by fully meeting all requirements of the Act.	PRUDENTIAL SUPERVISION
4. DEVELOP A PLAN FOR THE IMPLEMENTATION OF BASEL III PRUDENTIAL REQUIREMENTS FOR BANKS, SUITABLY ADAPTED FOR NEW ZEALAND CONDITIONS.	The Basel III package of capital and liquidity reforms was endorsed by G20 leaders in November 2010. We consider there is a strong case to implement most of the new standards in New Zealand. However, we need to fully assess the potential impact of the standards, undertake detailed policy analysis and consult with industry prior to reaching final decisions on Basel III implementation. An important consideration will be how to adopt Basel III in a way that is fit for New Zealand conditions.	PRUDENTIAL SUPERVISION
5. DEVELOP CROSS-FUNCTIONAL CAPABILITIES AMONG OUR STAFF TO SUPPORT THE BANK'S WIDER RANGE OF RESPONSIBILITIES.	As the Bank's role has expanded, we need to retain and develop broader staff capabilities and flexibility to enable the Bank's overall success in fulfilling its wider range of functions. Through a programme of cross-skilling, rotations and staff development, we will provide an interesting and challenging work environment that maintains growth of skills and knowledge amongst our staff.	HUMAN RESOURCES BANK-WIDE
6. IMPLEMENT A NEW ASSET ALLOCATION AND PERFORMANCE BENCHMARKING FRAMEWORK FOR FOREIGN RESERVES.	The post-global financial crisis environment has provided lessons relevant to the structure of the Bank's foreign reserves. This project will provide a system that facilitates management and monitoring of the foreign reserves portfolios, including allowing for a wider range of investment assets and the establishment of benchmarks for assessing performance of the foreign reserves management function.	FINANCIAL MARKETS FINANCIAL SERVICES GROUP KNOWLEDGE SERVICES GROUP
7. UNDERTAKE INITIAL PLANNING AND CONSULTATION FOR A NEW (SERIES 7) ISSUE OF BANK NOTES.	An important objective for the Bank is to maintain confidence in the national currency by minimising the potential for counterfeiting. The introduction of polymer bank notes in 1999 substantially improved the quality and integrity of New Zealand's currency. With the rapid innovation of copying and printing technologies, however, this situation might change in the near future. After 12 years of the current Series 6 bank notes, it is now appropriate to upgrade and modernise our notes.	CURRENCY

## STRATEGIC PRIORITIES OVER TIME

THEME	2007-08	2008-09	2009-10	2010-11	2011-12
ECONOMIC MODELLING	Model redevelopment: Upgrade the current policy and forecasting model.	Economic model construction and implementation: Introduce a state-of-the-art model into the policy and forecasting process.			
MONETARY POLICY	Macroeconomic policy framework: Assess how to maintain price stability while avoiding unnecessary damage to the external sector.		Support effective monetary policy for inflation targeting in a world of volatile financial and economic conditions.	Begin unwinding special financial system support and monetary policy stimulus.	Assess the impact of the Canterbury earthquakes and the implications for the Bank's monetary policy.
STATISTICS		Financial Sector Information System (FSIS) development: Design and build an integrated computer application.	Implement our Financial Sector Information System (FSIS), significantly improving the management of statistics and enabling new prudential data collections.		
BANK LIQUIDITY			Ensure the banking system has sufficient liquidity to meet its ongoing funding needs.		
FOREIGN RESERVES MANAGEMENT					Implement a new asset allocation and performance benchmarking framework for foreign reserves.
MACRO-PRUDENTIAL POLICY				Investigate the potential for macro-prudential policy tools for New Zealand.	Develop an implementation framework for macro-prudential policy tools in New Zealand and consider the inter-relationship with monetary policy.
BANK REGULATION	Basel II implementation: Develop and implement policy on bank capital requirements under Basel II.	Prudential liquidity policy: Develop and implement a prudential liquidity policy for registered banks.	Ensure that the registered banks maintain adequate capital, through close monitoring of asset quality and prompt supervisory responses.	Identify any appropriate changes to the bank supervision regime, including those based on international regulatory reforms.	Develop a plan for the implementation of Basel III prudential requirements for banks, suitably adapted for New Zealand conditions.

THEME	2007-08	2008-09	2009-10	2010-11	2011-12
NON-BANK DEPOSIT TAKERS	Financial sector regulatory arrangements: Help develop and implement new non-bank regulatory arrangements.	Extended prudential regulatory regime: Implement new regulatory arrangements for NBDTs and develop a prudential regime for the insurance sector.	Introduce a prudential regime for the insurance sector, and implement new regulatory arrangements for NBDTs.	Advance the implementation of the new NBDT regime.	
INSURANCE				Develop and implement the new prudential regime for Insurance.	Ensure that insurers are on the path to obtaining a full licence by September 2013, meeting at least the provisional licensing requirements by March 2012.
CURRENCY					Undertake initial planning and consultation for a new (Series 7) issue of bank notes.
HUMAN RESOURCE DEVELOPMENT	Management: Enable managers to continually develop leadership and management competencies.	Management: Support management in further developing their values-based leadership competencies.	Engage and develop staff to meet the challenges of a volatile financial and economic environment.	Engage, develop and support staff to meet the challenges of the Bank's evolving responsibilities.	Develop our staff capability across the Bank's full range of responsibilities.
BUSINESS CONTINUITY			Improve business continuity and disaster recovery capability through the establishment of a business support office in Auckland.	Improve business continuity and disaster recovery capability through the establishment of a business support centre in Auckland.	