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# Reserve Bank of New Zealand

## Statement of Intent

*For the period 1 July 2004 to 30 June 2007*

### Contents

Introduction	2
Governor's Statement	3
Governance and Structure	4
Functions and Operations	7
Objectives 2004 to 2007	10
Capacity Building	15
Projected Income and Expenditure for the Year to 30 June 2005	17
Appendix A: Key Document References	19

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## Introduction

This *Statement of Intent* has been prepared as a pilot document for an accountability obligation that will be required of the Reserve Bank from 2005 onwards. As a result of impending legislation, under section 162A of the Reserve Bank of New Zealand Act 1989 (the Act), the Reserve Bank will be required, prior to each financial year, to provide the Minister of Finance with a *Statement of Intent* traversing the following three years.

The Act is expected to stipulate that the Reserve Bank's *Statement of Intent* must contain:

- key background information about the Reserve Bank and its operating environment;
- the nature and scope of the Bank's functions and its principal areas of operations;
- the nature of the Bank's specific objectives;
- the proposed strategies for achieving objectives and carrying out operations;
- the proposed strategies for managing the organisational health and capability of the Bank; and
- a statement of the projected income and expenditure for the first financial year in the three financial year period to which the *Statement of Intent* relates.

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## Governor's Statement

The Reserve Bank of New Zealand has changed over the years, but the Bank is still focused on its traditional role of preserving value in a modern economy. We do this by producing currency, preserving its domestic purchasing power, stabilising nominal economic activity through monetary policy, bank regulation, and helping exchange through the oversight of payments and settlements systems.

For many years we have been a world leader in new central bank practice. While we expect to stay at the forefront of central bank thinking, there is enough innovation going on in other central banks for us to learn much from their experiences.

For many years eliminating New Zealand's high inflation was the dominant objective of the Reserve Bank. However, with that objective achieved, the economy, expectations, and business practices are changing. As a result, we still view keeping inflation expectations low as very important, but with stable inflation we can now apply more attention to financial systems, to banking, to exchange rates, and to trans-Tasman issues.

These developments will occupy a lot more of our attention for the next few years. A few examples are as follows:

- With price stability, exchange rate variability has become more evident and continues to be a major challenge when carrying out monetary policy.
- The "Australianisation" of the banking system has meant we need to reassess the way we supervise banks and our contingency plans for crisis management.
- Technical developments in financial flows mean we need to pay attention to the regulation of payments and settlements.
- Our "silver" coinage is costly and starting to look old-fashioned, and needs rethinking.

Over the last few years, the Reserve Bank has been through considerable downsizing and restructuring. Big challenges for the year ahead are to:

- reinvigorate our financial system surveillance function;
- deal with some issues that are specific to systemically important banks and to crisis management;
- set up satisfactory processes for foreign exchange intervention;
- introduce a new treasury system for the Reserve Bank; and
- organise ourselves internally to handle the New Zealand dollar's entry into Continuous Linked Settlement Bank.

Some of this work will spill over into future years. This also means a renewed focus on the Reserve Bank's capabilities. Some of our infrastructure is looking dated and needs reinvestment. We will require a few more staff for the additional work that we are handling, and we have been targeting a broader skill set, including commercial bank experience. To help get the best out of all of this, we plan to pay more attention to developing our management skills.

Much of our work is business as usual, but the focus on reinvigorating certain functions and systems means we will have to look closely at resources and their use. The Funding Agreement over the last five years has been based on achieving expenditure reductions from rationalisation. The scope for achieving significant savings as a result of rationalisation is reduced, and we are now planning limited expenditure increases, consistent with the increased scope of our activities and reinvestment in critical systems.



Alan Bollard  
Governor

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## Governance and Structure

The Reserve Bank is New Zealand’s central bank. Its core role is the promotion of a sound and efficient monetary and financial system. This enables participants in the New Zealand economy to conduct their business using a currency that holds its value within a financial system that is stable, reliable and efficient.

The Reserve Bank is wholly government owned and is constituted under its own statute. The underlying idea behind the Reserve Bank’s governance arrangements is that the Bank has clearly defined objectives, and then a high degree of autonomy as to how it achieves those objectives. The intention is to ensure that the Bank isn’t deflected from carrying out the tasks set for it through the parliamentary and democratic process.

The Reserve Bank’s authority and accountability are based on three key documents:

- the Reserve Bank of New Zealand Act 1989 (the Act);
- the Policy Targets Agreement (PTA); and
- the Bank’s Funding Agreement.<sup>1</sup>

The Reserve Bank Act specifies the Reserve Bank’s functions and duties. Features of the Act include:

- a statement that the Reserve Bank’s primary function is “to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices”;
- requirements as to how monetary policy shall be conducted, including procedures for setting policy targets;
- authority for the Reserve Bank to deal in foreign exchange, along with related ministerial powers;
- a requirement that the Reserve Bank use its powers 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”;

- specific powers in relation to bank registration and supervision, and emergency powers for dealing with a financial crisis, including being “lender of last resort”;
- a monopoly on issuing currency in New Zealand;
- governance rules, including how Governors and Deputy Governors are appointed and dismissed, the role of the Bank’s Board of Directors, and other accountability requirements; and
- rules for the management of the Reserve Bank’s finances, including the negotiation of five-year Funding Agreements.

The Policy Targets Agreement (PTA) is a written undertaking between the Minister of Finance and the Governor, which details the monetary policy outcomes that the Bank is required to achieve. A new PTA is negotiated whenever a Governor is appointed or reappointed.

The Funding Agreement is a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Reserve Bank’s revenues can be retained by the Bank to meet its operating costs, with the remainder typically going to the Crown.

The Reserve Bank also subscribes to a mission statement and statement of values.<sup>2</sup>

## Management Structure

The Reserve Bank Act makes the Reserve 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 alone. The Governor is appointed for a five-year term. The Act sets specific procedures for the appointment, reappointment, and dismissal of the Governor.

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<sup>1</sup> For where to access these documents, see Appendix A.

<sup>2</sup> See Appendix A.

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The Reserve Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Operations, and the heads of the Bank's various departments. The Bank's departmental structure is illustrated in the table on page 6.

The Reserve Bank has a Board of Directors, which monitors the performance of the Governor and the Bank on behalf of the Minister of Finance. The Board carefully scrutinises each monetary policy decision and the processes that went into making it, and resolves whether or not it appears to be consistent with the Act and the PTA. Likewise, all the Bank's other activities are monitored regularly. The Board, through an Audit Committee, also reviews the Bank's financial statements. Each year the Board writes an assessment of the Bank's performance, which is provided as advice to the Minister of Finance and made public later in the Bank's *Annual Report*.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. The Minister of Finance can only appoint a Governor recommended by the Board, so in effect the appointment process involves a double-veto. The Board can recommend to the Minister of Finance that the Governor be dismissed, if the Board believes that the Governor's performance has been "inadequate". The Board appoints the Deputy Governor on the Governor's recommendation.

The Board typically meets nine times a year and it also provides the Governor with advice, generally on governance issues. The current Board is Dr Arthur Grimes (Chair), Mr Paul Baines, Mr Hugh Fletcher, Mr John Goulter, Mrs Alison Paterson (Deputy Chair), Rt Hon Ted Thomas, Dr Marilyn Waring and, as Governor, Dr Alan Bollard. Board members are appointed for five-year terms.<sup>3</sup>

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<sup>3</sup> More information is provided on the non-executive directors in the Bank's *Annual Reports*.

## Reserve Bank Organisational Structure

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

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# Functions and Operations

## Monetary Policy Formulation

The Reserve Bank Act stipulates that the Reserve Bank's primary function is "to achieve and maintain stability in the general level of prices". The specifics of the monetary policy objective are set separately in a published Policy Targets Agreement (PTA), as described earlier. The current PTA requires the Bank to maintain inflation, as measured by the Consumers Price Index, between 1 and 3 per cent per annum 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".

Under the Act, the Governor has complete discretion to determine monetary policy, provided that it is directed to the policy target specified in the PTA. Neither the Government nor the Board of Directors have any involvement in day-to-day decision-making, although the Act does provide scope for the Government to intervene in exceptional circumstances, overriding the PTA and setting a new target for monetary policy, though it must do so publicly.

Monetary policy is mainly implemented by the Reserve Bank every six weeks setting an Official Cash Rate (OCR) around which the Reserve Bank lends to, and borrows from, registered banks. The OCR thus has a direct influence on other short-term interest rates.

To a limited extent, the Reserve Bank can also attempt to reduce the highs and lows of the exchange rate cycle by using its foreign currency reserves to buy or sell New Zealand dollars. This could assist the Bank to "avoid unnecessary instability in output, interest rates and the exchange rate", as required by the PTA.

Typically, the Reserve Bank makes eight scheduled OCR decisions annually, of which four are announced at the same time as the Reserve Bank publishes its quarterly *Monetary*

*Policy Statements (MPSS)*. These documents set out the Bank's views on the economy and inflationary pressures, and the basis for the OCR decision of the day. Intervention in the foreign exchange market could occur at any time.

## Market Operations

The Reserve Bank's OCR decisions are given effect via the Bank's domestic market operations. The Bank is always available to lend overnight cash to banks at 25 basis points (0.25 per cent) above the OCR, and to borrow overnight cash at 25 basis points below the OCR. This has the effect of constraining short-term interest rates within 25 basis points of the OCR, given the scale of the Bank's presence in the market.

Day-to-day, the Reserve Bank then undertakes further activities in the financial markets to ensure that interest rates remain stable around the OCR, often described as "managing liquidity". The commercial banks bank with the Reserve Bank and the balances in their accounts fluctuate substantially from day to day. For example, money flows in and out as the Government spends and collects taxes, and as people's need for cash fluctuates, especially around holiday times. Unless the Reserve Bank somehow offsets these ebbs and flows, the risk is that short-term interest rates would fluctuate between the rates established by the Bank's lending and deposit facilities.

To avoid this, the Reserve Bank maintains a presence in the financial markets, specifically to smooth out these very short-term peaks and troughs. Most days, the Reserve Bank either mops up money when the Government has been spending more than it collects in taxes, or puts money into the system when the reverse applies. Various methods are used to do this, but in essence they all involve the Reserve Bank either borrowing from or lending to the financial markets.

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The Reserve Bank also undertakes a number of functions for the Debt Management Office (DMO). These include selling Treasury bills, government bonds and index-linked bonds at competitive tenders, to a timetable, and to amounts determined by the DMO. The allocation of responsibilities and functions between the Bank and the DMO is made explicit in an agency agreement.

## Foreign Reserves Management

The Reserve Bank holds and manages New Zealand's foreign exchange reserves to maintain a capacity to intervene in the foreign exchange market. Intervention could be required to reduce the peaks and troughs of the exchange rate cycle, as described earlier, or to provide liquidity in a crisis. The Minister of Finance decides the amount of foreign exchange reserves that the Bank shall hold.

Under the Act, the Reserve Bank can enter the foreign exchange market on its own volition, or it can be directed to do so by the Minister of Finance.

## Financial System Surveillance

The Reserve Bank has responsibility for registering and supervising banks, to help maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure. The Reserve Bank has extensive powers to respond if a bank fails or is in financial distress.

Under the Act, no organisation in New Zealand can use the word "bank", "banking" or "banker" in its title or name, unless it has been registered by the Reserve Bank as a bank. The Reserve Bank sets specific criteria for bank registration, which the Reserve Bank makes available on its website.<sup>4</sup>

Banks registered in New Zealand are then subject to a specific monitoring regime set by the Reserve Bank, though it is important to note that banks in New Zealand

and depositors' savings are not protected by any kind of government or Reserve Bank guarantee.

The Reserve Bank's approach to bank supervision involves a combination of incentives and regulatory supervision. Registered banks are required to issue quarterly public disclosure statements revealing the details of their finances, along with their credit ratings. In addition, in those disclosure statements, directors of banks are required to attest whether or not their banks' risk management systems are adequate and are being properly applied at all times. Directors can be imprisoned if they knowingly make false or misleading attestations.

Regulatory interventions include minimum capital requirements in line with international norms, limits on a bank's exposure to connected parties, and requirements that there be at least two independent non-executive directors on banks' boards of directors. These and other requirements are conditions of bank registration.

The Reserve Bank continuously monitors registered banks' financial soundness, their compliance with their conditions of registration, and other prudential requirements. It also carefully assesses broader financial sector developments, including internationally.

Later this calendar year, the Reserve Bank will begin publishing regular *Financial System Reports* in which the Bank will assess the state of the New Zealand financial system in terms of both its soundness and efficiency.

In addition, the Reserve Bank is required to have a capacity to respond if a bank fails or gets into financial distress. The aim in that situation would be to quickly resolve the bank's difficulties and prevent a wider crisis developing across the financial system as a whole. Ultimately, with the consent of the Minister of Finance, the Reserve Bank can give directions to a registered bank and we can recommend to the Minister that a bank be placed in statutory management. The Reserve Bank can also act as "lender of last resort" to the financial system, providing liquidity in a crisis.

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<sup>4</sup> [www.rbnz.govt.nz/banking/index.html](http://www.rbnz.govt.nz/banking/index.html)

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The Reserve Bank has responsibility for overseeing the payment system. The Bank is empowered to recommend to the Minister of Finance that a payment system be “designated”, which confers legal certainty on the finality of payments made through that system.

## Currency Operations

As the sole issuer of currency, the Reserve Bank is required to ensure that sufficient currency is always available to meet the needs of the community. The Reserve Bank acts as a wholesale distributor of bank notes and coins to the banking system, but does not redistribute bank notes and coins between banks and other financial institutions. The Reserve Bank also provides collectors’ currency.

## Settlement, Registry and Depository Services

The Reserve Bank provides a number of financial services. These include:

- *Registry:*  
The Reserve Bank conducts retail securities registry functions for organisations that borrow money by issuing debt securities. The provision of this service is outsourced and the Bank has decided to exit the retail registry business by late 2004.
- *Austraclear:*  
Austraclear is a service that provides real-time electronic clearing and settlement services for debt and equity securities. Members can also use this system to transfer cash.
- *Exchange Settlement Account System (ESAS):*  
The Exchange Settlement Account System is a real-time banking service by which financial institutions, currently all banks, make high value payments to each other.
- *Provision of core banking services to the Government:*  
The Reserve Bank provides overnight banking services to the Government.

## Other Outputs

For accounting purposes, the Reserve Bank also includes among its functions a classification called “Other Outputs”, which span a number of departments and include the provision of economic policy advice and overseas representation and liaison.

The Reserve Bank maintains relationships with a wide range of overseas central banks, especially in the Asia-Pacific region, international financial institutions, and international forums. The Reserve Bank works closely with the International Monetary Fund, and is a shareholder in the Bank for International Settlements.

## Overseas Investment Commission

The Reserve Bank provides the secretariat of the Overseas Investment Commission, although on 20 July 2004 the Minister of Finance announced his intention to disestablish the Commission and for its work to be done within Land Information New Zealand.

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## Objectives 2004 to 2007

The Reserve Bank has an annual planning and budgeting procedure that sets goals and priorities for the coming financial year. Longer-term goals and priorities also emerge from this process.

The following are the Reserve Bank's priorities and key projects for the financial year from 1 July 2004 to 30 June 2005, as established in early 2004. They are over and above the Bank's day-to-day activities, as described earlier. These priorities and key projects should be read alongside the overview of the Bank's longer-term direction presented in the "Governor's Statement" earlier in this document. Their achievement or otherwise will be reported in the Bank's 2005 *Annual Report* in the same manner as in previous *Annual Reports*.

### Priorities and Key Projects

#### 1 July 2004 to 30 June 2005

##### **1 *Rethinking outsourcing policies***

- Develop, consult on, and begin implementing an "outsourcing" policy for systemically important banks. This policy is to ensure that the board of a bank, or a statutory manager, has unambiguous legal and operational reach over that bank's core functions and resources if a service provider, including a parent bank, fails to deliver.

##### **2 *Resolve whether alternatives are possible to mandatory local incorporation for systemically important banks***

- Decide whether a "buttressed-branch" organisational form is an acceptable alternative to requiring local incorporation of systemically important banks, and initiate any necessary legislative or regulatory initiatives following from that decision.

##### **3 *Test the Reserve Bank's capacity to manage a bank failure***

- Develop and test techniques and processes for managing financial system stress, including a major bank failure, and undertake a bank failure exercise.

##### **4 *Refine foreign exchange intervention strategy and processes***

- Develop and maintain capability to manage the Reserve Bank's new levels of reserves and capital.
- Design a decision-making framework and intervention protocols for intervening in the foreign exchange market to reduce, at the margin, the extremes of the exchange rate cycle.
- Continue to develop foreign exchange intervention protocols for combating dysfunction in the foreign exchange market.

##### **5 *Identify policy options to reduce exchange rate variance***

- Identify structural explanations for New Zealand's exchange rate variability, and its costs and benefits to the economy, and ensure that the Reserve Bank's monetary policy arrangements are appropriate for an economy in which the exchange rate fluctuates.
- Research additional policy tools that might assist in reducing interest rate and/or exchange rate variability.

##### **6 *Identify monetary policy approaches that deal best with uncertainty***

- Identify different types of uncertainties facing monetary policy decisions and best practice responses when setting monetary policy.
- Investigate additional forecasting approaches that represent low-cost, credible alternatives to current model-based projections, and integrate them into the monetary policy process, as alternative perspectives.

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## 7 *Treasury system implementation*

- Complete implementation and testing of software, so the Bank's new treasury system is operational by 30 June 2005.

## 8 *Silver coinage review*

- Finalise a strategy to provide "silver" coin that is more cost-effective to produce and more user-friendly for the public and cash handlers.

## 9 *Develop and implement management and key person strategy*

- Enhance the Reserve Bank's management capacity by developing a range of resources, programmes and processes based on the Bank's management profile.

## Major Projects

### 1 *Electronic document management system implementation*

- Implement a replacement records and document management system, including revised file classification and email migration, by 31 March 2005.

### 2. *CLS implementation*

- Ensure that the Reserve Bank is ready to commence live processing of New Zealand dollars in CLS Bank before November 2004, as scheduled by CLS Bank.<sup>5</sup>

### 3 *Business continuity planning (BCP)*

- Review, confirm and implement agreed BCP strategies and any incremental infrastructure upgrades by 30 June 2005.

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5 CLS Bank is an international agency for settling foreign exchange transactions in real time, thereby reducing the so called Herstatt risk of settlements not being completed because a crisis occurs during a period when a transaction is incomplete, due to time zone differences. For making New Zealand dollar transactions CLS Bank will utilise the Reserve Bank's Exchange Settlement Account System (ESAS).

## Departmental Priorities

The planning process described earlier also requires that each of the Bank's departments prepare its own plan for the coming year and beyond. The following is a synopsis of those plans, as set in early 2004.

### Economics Department

The Economics Department is responsible for economic forecasting, monetary policy advice, and related research and analysis. It also advises the Reserve Bank on other aspects of economic policy, and undertakes some aspects of the Bank's international activities.

The Department sees the core strategic goal for monetary policy as being the development of a monetary policy framework that makes the best possible contribution to New Zealand's welfare. To that end, inflation targeting appears to be the best of the various options available, having successfully reduced inflation and inflation expectations at a time when most other macroeconomic variables, though not the exchange rate, have also stabilised.

Since the Reserve Bank began inflation targeting in the mid-1980s, its approach has steadily evolved. In recent years, the Reserve Bank's PTAs have been amended to put more emphasis on making sure that the way price stability is achieved and retained does not transfer instability into other variables, such as output, interest rates or the exchange rate.

The challenge now for the Reserve Bank is to implement monetary policy in a way that satisfies those objectives. At times, this more complex mix of priorities may require the Bank to make interest rate adjustments sooner or later than would otherwise be the case, accepting that this involves extra risk, hopefully in return for greater macroeconomic stability in general.<sup>6</sup>

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6 For more information, see box 1, page 15, *RBNZ Annual Report 2003*.

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In addition, meeting this challenge from here on may, on rare occasions, involve foreign exchange intervention aimed at taking the highs and lows off the exchange rate cycle, the Reserve Bank having recently acquired the balance-sheet capacity to do this.<sup>7</sup> New Zealand still has a marked exchange rate cycle, despite greater overall macroeconomic stabilisation since inflation targeting was adopted.

Another continuing issue is how to manage the inevitable uncertainties that apply when trying to describe how the economy works, how monetary policy interacts with the economy, the current economic situation, and likely future shocks.

Looking ahead, specific objectives include:

- better understanding the implications of current and alternative monetary policy options for overall economic outcomes, with particular regard to excess exchange rate variance and financial instability;
- better understanding the implications of uncertainty for policy choices; and
- better understanding the transmission of international economic shocks to New Zealand, so as to reduce uncertainty when making monetary policy decisions.

Proposed strategies for attaining these objectives include:

- continuing research on the objectives described above;
- using external resources to boost internal capabilities, through:
  - encouraging expert visitors with relevant expertise and different perspectives;
  - improving our New Zealand university networks; and
  - improving our networks among policy experts in Wellington; and
- organising a major conference during the next three years to focus thinking and research, and to provide a structure for bringing external resources to bear on those issues.

## Financial Stability Department

The Financial Stability Department is required to promote a sound and efficient financial system. To do this, it is responsible for registering and supervising banks, overseeing the payment system, monitoring financial markets, managing foreign exchange reserves, maintaining the Reserve Bank's capacity to intervene in the foreign exchange market, implementing Official Cash Rate decisions, and managing liquidity flows associated with government transactions.

The Department's creation, in early 2003, reflected the Reserve Bank's judgement that financial stability issues were going to be of increasing importance. At the same time, the Bank concluded that its approach to banking supervision and financial crisis prevention remained correct, but more was needed to build our capacity to respond if a bank or the financial system ever did get into trouble.

This comes in the face of an increasingly challenging environment, both in New Zealand and elsewhere. More and more, international banks are managing their affairs as global businesses, regardless of whether they operate in foreign jurisdictions as branches or subsidiaries. Core functionality, such as information technology, financial accounting and risk management, increasingly spans countries. The legal boundaries between different parts of banking groups are becoming less relevant. For the Reserve Bank, a critical ongoing issue will be whether systemically-important banks in New Zealand are still sufficiently complete as entities that they can be kept running if the offshore parent bank fails.

During 2004/05, the Reserve Bank will contribute to work between Australian and New Zealand authorities on a framework for closer integration of prudential regulation and failure management regimes between the two jurisdictions. A working party of the Australian and New Zealand Treasuries and the relevant financial sector supervisory agencies will develop policy options for closer integration. In addition, the Reserve Bank will consult with banks on implementation of those parts of the new Basel Capital Accord that are relevant and appropriate to New Zealand. The Accord is an internationally-agreed framework for determining the

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<sup>7</sup> For more information, go to [www.rbnz.govt.nz/foreignreserves/intervention/index.html](http://www.rbnz.govt.nz/foreignreserves/intervention/index.html).

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minimum levels of capital that banks must hold to ensure that they are able to withstand unexpected adverse events. In 2003, the IMF led a review of New Zealand's financial system, known as a Financial Sector Assessment Programme (FSAP). The FSAP team found the financial sector in good shape and gave a generally positive report. There were a number of recommendations designed to preserve the financial system's stability in the medium to longer term.

The banking regulation guidelines that New Zealand was assessed against were designed with more conventional supervision systems in mind. Nevertheless, New Zealand is largely compliant with most of the guidelines. Where it is not compliant, this generally reflects a conscious choice, and other mechanisms are in place for achieving the objectives underlying the guidelines.

The FSAP assessment made several recommendations relating to banking supervision and regulation, particularly around gathering supervisory information, the governance of banks, the Reserve Bank's role in anti-money laundering policies, crisis management, and coordination with Australian authorities. Most of these areas had already been identified by the Bank and are on its work agenda.

Work on crisis management is a key Bank priority. This falls into three areas: assured and rapid access to the balance sheet of a bank in crisis; assured ability to operate that bank; and practical options for dealing with a crisis. The Reserve Bank will also enhance its operational ability to respond to a range of banking crises, including through the use of periodic crisis training exercises. More generally, the Reserve Bank is bolstering its information-gathering about the banking system, by, for example, setting up a new section to, among other things, implement and oversee independent reviews of banks' governance structures, systems and controls, and to oversee appropriate follow-up to these reviews.

The Department has identified as challenges going forward:

- the increased need for trans-Tasman financial regulatory cooperation and coordination, due to the current ownership by the major banks in Australia of the systemically important banks in New Zealand;

- the increasing complexity of the banking and financial sectors, and conglomeration in the banking system, including in Australia; and
- an increasing focus on wider "financial stability" issues, rather than just price stability.

Looking ahead, specific objectives include:

- further developing the Reserve Bank's procedures for responding to a bank failure or crisis;
- managing increased foreign reserves to provide a capacity to undertake foreign exchange interventions, if required, including to ameliorate extremes in the exchange rate cycle;
- promoting sound and efficient payment systems, given the Bank's new responsibilities in this area; and
- better understanding longer-term trans-Tasman financial integration issues.

## Currency and Building Services Department

The Currency and Building Services Department is responsible for meeting the currency needs of the public, including distribution of bank notes and coins on demand to banks, the design of new bank notes and coins, the detection of counterfeits, and the destruction of worn or damaged bank notes or coins. The Department also manages the Reserve Bank's Wellington building.

The Department has identified as strategic goals for the next three years:

- reducing the number of surplus bank notes being machine processed following seasonal peaks;
- replacing outdated bank note processing machines; and
- providing "silver" coinage that is more cost effective to produce and more convenient for the public and cash handlers. A change to plated steel and downsizing of the existing range of "silver" coins is under consideration.

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## Financial Services Group

The Financial Services Group is responsible for the Reserve Bank's financial management, including financial statements and management accounts, treasury accounting, the provision of depository and settlement services, and exchange settlement accounts.

The Group has identified as its principal goals for the period ahead:

- implementing a new treasury system and investigating leveraging off that investment by providing treasury services to other government agencies by late 2005;
- exiting the retail registry business by late 2004;
- negotiating a new five-year Funding Agreement to apply from July 2005;
- developing an operational capacity to settle New Zealand dollar foreign exchange transactions using CLS Bank by late 2004; and
- amending the Bank's financial reporting to adopt international financial reporting standards before July 2007.

## Internal Services

Within the Reserve Bank, the following operational units provide internal services, as required:

- The Knowledge Services Group is responsible for the Bank's IT functions, information management systems and data processing.
- The Human Resources Team is responsible for providing human resource strategic advice and operational services.
- The Corporate Affairs Department is responsible for managing the Reserve Bank's external communications and helping conserve and build the Bank's reputational capital.
- The Risk Assessment and Assurance Department is responsible for the Bank's internal audit function, risk monitoring and assessment, and performance audits. It provides risk management assessment and advice throughout the Bank, and undertakes reviews of problem areas, issues or incidents.

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## Capacity Building

The Reserve Bank is a small organisation, employing a little over 200 staff. The bulk of its work is conceptual or technical in nature, and in all its activities the Bank sets high standards, given that its reputation is critical to its effectiveness. Thus, the most crucial capacity-building issue for the Bank is the quality of its staff.

The Reserve Bank employs staff with the skills, knowledge and experience to perform a wide range of functions, often requiring high levels of technical expertise, judgement and credibility. The Bank uses a range of tools to manage human resource risks and build organisational capability. Every six months the Bank's senior management team undertakes a formal review of key person risk within the Bank and how it can be mitigated. This is important, as the sudden loss of even a small number of key staff can potentially expose gaps in the Bank's capacity to carry out its functions.

We seek to provide an environment which encourages staff to continue developing their skills and knowledge. This is recognised by an appraisal system that incorporates a development plan detailing individual training and development activities for each staff member. Examples include cross-training in different sections of the Bank, training on-the-job, and attendance of in-house and external programmes. We also use secondments as a way of developing skills among staff who wish to widen their work experience. To stimulate thinking within the Bank, a range of networks and relationships are maintained with other central banks and a professorial fellowship programme brings external experts to the Bank to enhance policy development. Two part-time external advisers contribute to the Bank's monetary policy deliberations.

Every 18 months or so, the Bank undertakes an extensive staff survey to assess overall staff satisfaction. The feedback received is used to improve the Bank's human resource procedures.

The Reserve Bank's effectiveness also depends on the robustness of its systems and controls. The Bank's functions require the ability to collect, process, analyse, and publish a wide range of complex financial and economic data. This requires high quality and reliable IT systems, economic models, research capacities, and information and data processed and integrated into policy to the highest possible standard.

The two policy departments, Economics and Financial Stability, employ respectively 32 and 47 staff, most of whom are economists highly proficient in macroeconomic modelling, statistical analysis, banking regulation, financial market dealing and the like.

The Economics Department expects that its staff numbers will remain at about present levels, while the Financial Stability Department expects that in the medium term it will employ up to five extra full-time staff.

The Reserve Bank's operational departments — Currency and Building, Financial Services, Knowledge Services, Human Resources, Corporate Affairs, and Risk Assessment and Assurance — employ approximately 120 staff. These departments' plans also identify the enhancement and optimal utilisation of human capital as fundamental. Among their initiatives are:

- if required, the employment of additional staff for upcoming projects, including the treasury systems project, electronic data management systems (EDMS), the enhancement of the Website, and to undertake specific work in other departments;
- exploring the merits of a formal trainee and/or graduate scheme for non-policy departments to provide a long-term staffing strategy;

- encouragement of multi-skilling among staff through job swaps; and
- for currency processing staff, meeting seasonal peak workloads through adjusting hours of work, such as longer hours balanced by four day weeks.

Other impending developments include:

- automating securities processing;
- internally developed applications being ported to the new systems architecture; and
- a new project management function to support project managers in terms of project management methodology.

## Monitoring the Bank's Performance

The Reserve Bank formally assesses its performance or is externally assessed in the following ways.

The Reserve Bank's Board of Directors reviews all aspects of the Bank's performance and the discharge of its statutory obligations. In addition to providing the Governor with advice and feedback, the Board is also required to report annually on the Bank's performance. The Board's report is published in the Bank's *Annual Report*.

The Reserve Bank's *Annual Report* includes a detailed assessment of the performance of the Bank's various functions in terms of the both the day-to-day responsibilities and progress against priorities set previously.

Parliament's Finance and Expenditure Committee reviews each quarterly *Monetary Policy Statement* and the Bank's *Annual Report*. Every six months the Reserve Bank assesses public perceptions of the Bank by commissioning specific questions within a generic public opinion poll.

The Reserve Bank's financial statements are audited by an external auditor who is the agent of the Controller and Auditor-General. The Audit Committee of the Board reviews those financial statements and provides advice to the Governor before the Governor and Deputy Governor sign the related management statement. The critical payment

systems operated by the Reserve Bank are subject to review by external auditors, quarterly in respect of the Austraclear depository system and annually in respect of the exchange settlement account system.

From time to time, the Reserve Bank engages experts to assess the Bank's processes, research and technical performance. In the past, assessments have been provided in the fields of monetary policy development, forecasting processes, bank failure management, computer systems and network security, management, and leadership assessment and development. Also, two external advisers provide additional advice to the Governor regarding his interest rate decisions.

The Reserve Bank's performance is also subject to international scrutiny. Every 12 to 18 months, the International Monetary Fund undertakes an "Article IV" assessment of the New Zealand economy, which includes sections on monetary policy and financial system stability. The resultant report is made public. Likewise, every two years the OECD undertakes a similar assessment, which is also published. The recent IMF FSAP investigation is expected to be repeated in New Zealand every six or seven years.

The Bank communicates its thinking through:

- regular OCR announcements and quarterly *Monetary Policy Statements*;
- the Bank's *Annual Report* and financial statements;
- the quarterly *Bulletin*;
- occasional publications, such as issue-specific brochures; and
- addresses given by the Governor and other senior Bank staff.

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# Projected Income and Expenditure

## For the Year to 30 June 2005

The following outlines the Reserve Bank's projected financial performance for 2004/05.

The projected financial performance has been prepared using the accounting policies used in the preparation of the Bank's financial statements for the year ended 30 June 2003. Those accounting policies are disclosed on pages 53 to 57 of the Bank's 2003 *Annual Report*.

The Governor and the Minister of Finance are required to agree to a five-year Funding Agreement for the Reserve Bank. The current Funding Agreement expires on 30 June 2005. The Agreement allows for an agreed level of the Reserve Bank's income to be applied towards the cost of operating the Bank. These funding arrangements are an important part of governance arrangements designed to ensure the Bank's operational independence. To the extent that expenditure in any given year exceeds the agreed level of expenditure for that year under the Funding Agreement, that excess is to be funded from the Bank's reserves. Conversely, any underspending against the agreed Funding Agreement level for a particular year will result in the amount underspent being added to the Bank's reserves. Capital expenditure is funded by the Bank from its own resources, with depreciation being included in annual operating expenditure.

In addition to defining medium-term funding arrangements, the Reserve Bank undertakes an annual planning and budgeting process. The key assumptions underlying the budget for the year ended 30 June 2005 are that:

- the Bank's current functions will continue;
- activity in the Foreign Reserves Management and Market Operations functions will be similar to the previous year;
- interest and exchange rates will be those prevailing as at 31 March 2004;
- the Bank has no material open foreign currency positions during the year; and

- the Bank will receive a capital injection of \$1 billion in July 2004, which will be invested in a portfolio of New Zealand government securities.

Key expectations for the Reserve Bank's financial performance in 2004/2005 are:

- increased income, mainly due to the capital injection;
- increased personnel costs, as a result of more staff employed in the Financial Stability Department, Financial Services Group and Knowledge Services Group; and
- increased currency costs, as a result of more currency in circulation and lower stocks of coins available for reissue than in the previous year.

Significant resources will be devoted to project work over the next year, including the implementation of a new treasury system and a new electronic data management system. Costs related to these and other major projects will be capitalised and depreciated in accordance with the Bank's accounting policies. Capital expenditure for 2004/05 is forecast to be \$7.9m, with approval for a further \$2.7m, subject to a business case being made, to be developed during the year. This is principally for development of new systems and the purchase of a new note processing machine.

Increased personnel expenses, in the table on page 18, reflect additional activity that the Bank is undertaking in its oversight of the financial system and in providing additional payment system services. For determining net expenditure under the Funding Agreement we have assumed that the Funding Agreement and relevant notional surplus income are calculated with reference to the Bank's operating expenditure only.

## Projected financial performance 2004 – 2005

For the year ended 30 June	2004/05 \$m Forecast	2003/04 \$m Estimated Actual*	2003/04 \$000 Budget†
<b>Operating Income:</b>			
Foreign Currency Investment Margin	4.3	1.4	1.4
Local Currency Investment Margin	276.4	223.9	224.8
Net Investment Income	280.7	225.3	226.2
Other Income	8.3	9.1	9.0
<b>Total Operating Income</b>	<b>289.0</b>	<b>234.4</b>	<b>235.2</b>
<b>Operating Expenses:</b>			
Personnel	18.3	16.7	16.8
Asset Management	3.8	3.4	3.7
New Currency Issued	6.0	5.4	6.4
Administration	1.2	1.3	1.3
Other	9.2	9.0	9.5
<b>Total Operating Expenses</b>	<b>38.5</b>	<b>35.8</b>	<b>37.7</b>
<b>Operating Surplus</b>	<b>250.5</b>	<b>198.6</b>	<b>197.5</b>
<b>Funding Agreement Under Expenditure</b>	<b>2.9</b>	<b>4.3</b>	<b>2.5</b>
<b>Surplus for Appropriation</b>			
Transfers to Equity	2.9	4.3	2.5
Payment to Crown	247.6	194.3	195.0

\* Estimated actual expenditure for 2003/04 incorporates actual results to 31 March 2004 together with a revised estimate of results for the three months ended 30 June 2004.

† The budget published in the 2003 *Annual Report* has been restated for the reclassification of expenses previously netted against Net Investment Income.

### Outlook for Expenditure Projections

For many years the Bank has managed to achieve considerable cost savings through continually reviewing the scope of services offered by the Bank, and processes and structures used for delivering these services. More recently, the Bank has commenced a programme of building its capability in certain areas. In particular, the Bank has recruited a number of staff for its financial system surveillance function, and supporting its market operations and foreign reserve management activities. A significant capital expenditure programme is underway which will ensure appropriate systems capability is in place that services the Bank's complex business needs and minimises operational risk.

This capability-building and delivery of new outputs will result in a reversal of the trend, over the previous decade, of cost reductions achieved by the Bank actively down-sizing or reconfiguring its operations. The significant capital expenditure to be undertaken over the next year or so is expected to increase the Bank's depreciation charge in the order of \$2 million per year for five years commencing July 2005.

## Appendix A

### Key document references

Title	Purpose	Location
Reserve Bank of New Zealand Act 1989	Reserve Bank's statutory authority	<a href="http://www.legislation.govt.nz">www.legislation.govt.nz</a>
Policy Targets Agreement	Agreement between the Governor and the Minister of Finance specifying in detail the inflation target	<a href="http://www.rbnz.govt.nz/monpol/pta">www.rbnz.govt.nz/monpol/pta</a>
Funding Agreement	Basis of Bank's funding, setting how much of the Bank's revenues can be retained by the Bank	<a href="http://www.rbnz.govt.nz/about/whatwedo/0090769.html">www.rbnz.govt.nz/about/whatwedo/0090769.html</a>
Mission Statement and Values	Expression of the Bank's modus operandi	Inside front cover of <i>Annual Report</i>
<i>Annual Report*</i>	Key accountability document, plus presentation of financial statements	<a href="http://www.rbnz.govt.nz/about/whatwedo/0094054.html">www.rbnz.govt.nz/about/whatwedo/0094054.html</a>
Board of Directors' Annual Report	Board of Directors' report on the Bank's performance	Reproduced in Bank's <i>Annual Report</i>
<i>Briefing on the Reserve Bank of New Zealand*</i>	Description of the role and functions of the Reserve Bank prepared for an incoming government	<a href="http://www.rbnz.govt.nz/about/whatwedo/0122541.html">www.rbnz.govt.nz/about/whatwedo/0122541.html</a>
Statement of Principles*	Explanation of the Reserve Bank's approach to bank registration and supervision	<a href="http://www.rbnz.govt.nz/banking/regulation/bs1.pdf">http://www.rbnz.govt.nz/banking/regulation/bs1.pdf</a>
<i>Monetary Policy Statement*</i>	Quarterly publication of the Bank's view of the state of the economy, including extensive economic projections	<a href="http://www.rbnz.govt.nz/monpol/statements/index.html">www.rbnz.govt.nz/monpol/statements/index.html</a>
<i>Reserve Bank Bulletin*</i>	Quarterly publication of articles relevant to central banking in New Zealand	<a href="http://www.rbnz.govt.nz/research/bulletin/index.html">www.rbnz.govt.nz/research/bulletin/index.html</a>
Letter to Minister of Finance on foreign exchange market intervention policy	Description of how the Bank may intervene in the foreign exchange market under section 16 of the Reserve Bank Act to influence the exchange rate	<a href="http://www.rbnz.govt.nz/foreignreserves/intervention/0148214.html">http://www.rbnz.govt.nz/foreignreserves/intervention/0148214.html</a>
Letter from Minister of Finance to the Bank on foreign exchange intervention	Provision of delegated authority for the Bank to intervene in the foreign exchange market under section 17 of the Reserve Bank Act, should that market become dysfunctional	<a href="http://www.rbnz.govt.nz/foreignreserves/intervention/0148293.html">www.rbnz.govt.nz/foreignreserves/intervention/0148293.html</a>
<i>This is the Reserve Bank*</i>	Introductory brochure about the Reserve Bank	<a href="http://www.rbnz.govt.nz/about/whatwedo/0109157.html">www.rbnz.govt.nz/about/whatwedo/0109157.html</a>
<i>Central Banking in New Zealand*</i>	Brochure about the Reserve Bank and its governance arrangements	<a href="http://www.rbnz.govt.nz/publications/index.html">www.rbnz.govt.nz/publications/index.html</a>

\* Also available in print from: The Librarian, Reserve Bank of New Zealand, PO Box 2498, Wellington, New Zealand. [knowledge@rbnz.govt.nz](mailto:knowledge@rbnz.govt.nz)

