
Reserve Bank of New Zealand

Statement of Intent

For the period 1 July 2011 to 30 June 2014

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Introduction

Under section 162A of the Reserve Bank of New Zealand Act 1989 (the Act), the Reserve Bank must, in each financial year, provide to the Minister a *Statement of Intent (SOI)* for the Bank for that financial year and at least the next two financial years. Section 162B requires the *SOI* to contain the following information for the full period to which it relates:

- a) key background information about the Bank and its operating environment;
- b) the nature and scope of the Bank's functions and its principal areas of operation;
- c) the specific impacts, outcomes, or objectives that the Bank seeks to achieve or contribute to;
- d) how the Bank intends to perform its functions and conduct its operations to achieve those impacts, outcomes, or objectives;
- da) if a direction has been given under section 68B, how the Bank has had regard to the direction;
- e) the proposed strategies for managing the organisational health and capability of the Bank;
- f) a statement of the projected income and expenditure for the first financial year in the period to which the *SOI* relates;
- g) a statement of the principles in accordance with which the Bank must determine the amount it recommends to the Minister as appropriately payable by the Bank to the Crown as an annual dividend;
- h) the main financial and non-financial measures and standards by which the future performance of the Bank may be judged;
- i) the matters on which the Bank will consult or notify the Minister before making a decision, the matters on which it will report to its Minister, and the frequency of reporting;
- j) any other matters that are reasonably necessary to achieve an understanding of the Bank's intentions and direction.

What we do

The Reserve Bank of New Zealand is the nation's central bank, established by an Act of Parliament, the Reserve Bank of New Zealand Act. The Bank has three main functions, which are designed to promote a sound and dynamic monetary and financial system and meet the goal of improving New Zealand's economic performance. These functions are: (1) the management of monetary policy to maintain overall price stability; (2) the maintenance of a sound and efficient financial system; and (3) the supply of legal tender to meet the currency needs of the public.

The functions and operations that the Bank performs to achieve these objectives are described in the following pages. In performing them, the Bank ensures that it works effectively with Ministers, the Treasury, other relevant government departments and the private sector on all matters where there is a shared interest.

Vision

We promote a sound and dynamic monetary and financial system.

Values

Integrity – Being professional and exercising sound judgement

Innovation – Actively improving what we do

Inclusion – Working together for a more effective Bank

Foreword

The theme of 'recovery', albeit with an additional set of events, continues to be at the forefront of New Zealand's economic challenges. The Bank's primary challenge is to balance the appropriate responses and use the necessary tools to maintain price stability in the context of a robust and growing economy.

The Christchurch earthquake in February 2011 resulted in significant loss and trauma, compounding the effects of the September 2010 earthquake and subsequent aftershocks. In addition to the considerable impact on people's lives and immediate economic disruption, the earthquake will have a considerable impact on the New Zealand economy for years to come.

The economic impacts of such events are complex and significant. Understanding the inflation implications and designing monetary policy appropriate for the scale of rebuilding required in Christchurch will be especially challenging. The earthquake does not appear to have impacted bank balance sheets much, but it has stressed one significant insurance company (AMI) and we will continue to monitor this sector closely through the new regulatory framework that the Bank is currently putting in place.

Internationally, much of the world is still in recovery from the Global Financial Crisis. That is posing problems for some heavily indebted countries and sovereign debt markets. The ability of major economies – the US, the UK and Japan particularly – to recover domestically and address their own debt issues will be crucial for us.

At the same time, we expect the New Zealand economy to be driven by continued growth in our East Asia and Australian trading partners. Related to this, high commodity prices have become an important engine of growth, but we expect price volatility will pose challenges for monetary policy. Oil and food price rises fuelled by international political instability, along with global demand growth and supply disruptions, are starting to cause significant international inflation concerns.

Domestically, New Zealand households and businesses are behaving much more cautiously than before the Global Financial Crisis. This is slowing recovery, but is laying the groundwork for a more resilient economy for the future.

With the earthquake and fragile international sovereign debt markets, the government's fiscal burden is significantly tougher and that may have implications for monetary policy.

On a broader canvas, again coloured by experiences of the Global Financial Crisis, we will be considering the inter-relationship between monetary policy and potential macro-prudential policy tools to promote greater financial and macro stability. In particular, we need to understand the impact of such policies in mitigating credit booms and increasing the resilience of the financial system. Our experiences during the crisis, and changes to the financial market environment since, have also led us to review how we might improve the management of our foreign reserves, including introducing new improved benchmarks for our reserves portfolios.

The slower domestic recovery is assisting financial stability, by gradually improving New Zealand's significant external and financial imbalances. Banks' balance sheets have recovered, although funding conditions are still challenging.

Our prudential supervisory teams have a lot to do calibrating and fine-tuning regulatory requirements from Basel III,¹ open bank resolution, capital levels for agricultural lending, and liquidity requirements. This will include trans-Tasman stress tests. We are also looking into bank efficiency in New Zealand and comparisons with overseas.

¹ This is a new global regulatory standard on bank capital adequacy and liquidity agreed by the members of the Basel Committee on Banking Supervision.

Non-bank deposit takers have been a declining sector, but we hope to see some healthy growth in a more regulated form to help meet New Zealand's development needs. We will also be commencing a licensing regime for New Zealand's insurance industry.

The post-Global Financial Crisis environment has provided lessons for the way we manage the Bank's foreign reserves and payment systems. To help us manage our foreign reserves more effectively, we will use a new approach for asset allocation and performance benchmarking.

The banking industry is changing retail payments processing by introducing 'Settlement Before Interchange'. Associated changes required by the Bank will assist in the management of retail settlement risk should a payments system participant default. Development of wholesale payment and settlement systems will help bolster the resilience of our financial system. Our regulatory oversight will cover several major systems, including the NZX's new central counterparty clearing system.

Our systems are being reinforced in the event of an emergency by bringing the new Auckland office into operation.

The next few years will see the development of a new series of banknotes designed to take advantage of new high-tech security features.

Our staff's capability makes a critical contribution to the Bank's overall success in fulfilling its full range of expanded functions. We will be using a variety of tools to develop our staff's cross-functional capabilities and knowledge.

This *SOI* appears at the start of the second year of a five-year Funding Agreement between the Bank and the government, extending from 2010–11 to 2014–15. The agreement was developed in an environment where central government expected its agencies to have strong expenditure control and to minimise growth in operating costs. The Bank's budget for 2011–12 shows net operating expenditure of \$48.8 million, \$1.4 million less than the amount specified in the Bank's funding agreement for that year.

This budget will enable us to focus on finalising implementation of our new regulatory and supervision areas, completing information technology upgrades and the initial work on the introduction of a new series of bank notes, although much of this latter cost will fall after 2015.

We operate in an ever-changing and challenging environment. A year ago, we were emerging from the worst financial crisis in more than 70 years. We could not foresee that, a year later, New Zealand would be rebuilding from its worst natural disaster in 80 years. The Bank, a feature of our economic landscape for 76 years, is committed to making its contribution to the economic and financial stability necessary for recovery and prosperity.

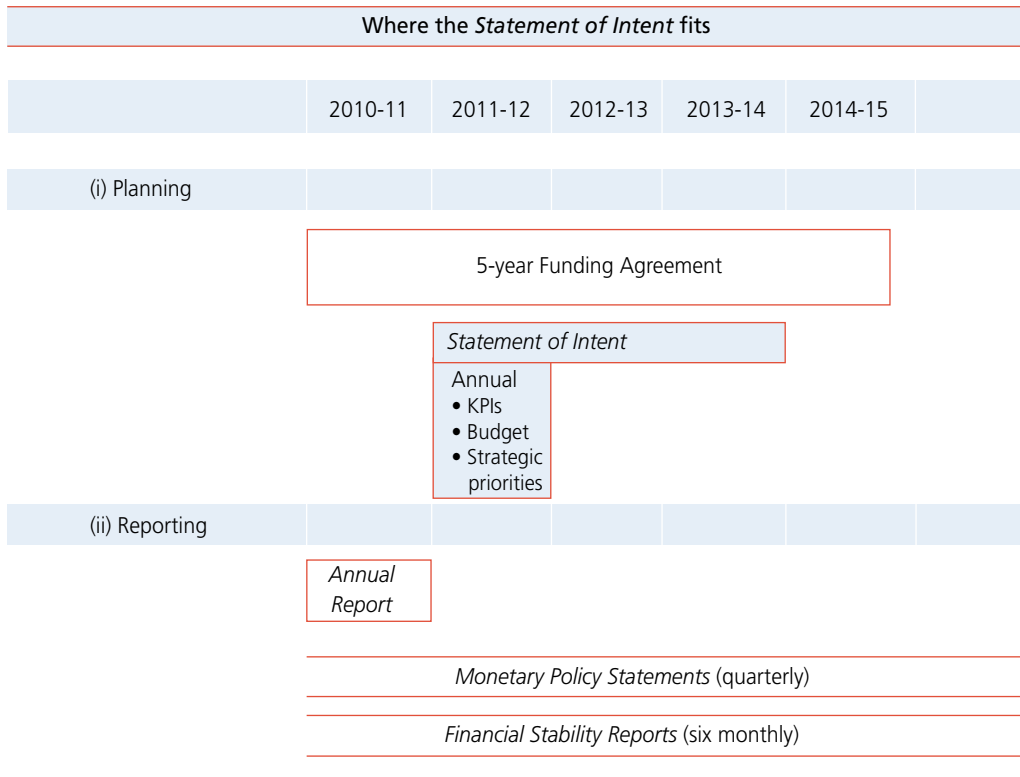


Alan Bollard
Governor



Grant Spencer
Deputy Governor

Planning and reporting framework



Our *SOI*, which traverses three years, is set in the context of our longer-term planning and funding. The Bank is funded through a five-year funding agreement between the Governor and the Minister of Finance, which is ratified by Parliament. The funding agreement specifies how much of the Bank's income can be retained by the Bank to meet its operating costs.

This *SOI* covers three years of the Funding Agreement, 2011/12–2013/14.

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.	Economics
2	Develop an implementation framework for macro-prudential policy tools in New Zealand and consider the inter-relationship with monetary policy.	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.	Prudential Supervision
4	Develop a plan for the implementation of Basel III prudential requirements for banks, suitably adapted for New Zealand conditions.	Prudential Supervision

Reserve Bank Strategic Priorities for 2011-12

Priority	Explanation	Department
5	Develop cross-functional capabilities among our staff to support the Bank's wider range of responsibilities.	Human Resources Bank-wide
6	Implement a new asset allocation and performance benchmarking framework for foreign reserves.	Financial Markets Financial Services Group Knowledge Services Group
7	Undertake initial planning and consultation for a new (Series 7) issue of bank notes.	Currency

Strategic Priorities over time

THEME	2007/08	2008/09
Economics		
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.	
Economics/Knowledge Services		
STATISTICS		Financial Sector Information System (FSIS) development: Design and build an integrated computer application.
Financial Markets		
BANK LIQUIDITY		Prudential liquidity policy: Develop and implement a prudential liquidity policy for registered banks.
FOREIGN RESERVES MANAGEMENT		
MACRO-PRUDENTIAL POLICY		
Prudential Supervision		
BANK REGULATION	Basel II implementation: Develop and implement policy on bank capital requirements under Basel II.	
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 non-bank deposit-takers and develop a prudential regime for the insurance sector.
INSURANCE		
Currency		
CURRENCY		
Bank-wide		
HUMAN RESOURCE DEVELOPMENT	Enable managers to continually develop leadership and management competencies.	Support management in further developing their values-based leadership competencies.
BUSINESS CONTINUITY		

2009/10	2010/11	2011/12
Economics		
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.
Economics/Knowledge Services		
Implement our Financial Sector Information System (FSIS), significantly improving the management of statistics and enabling new prudential data collections.		
Financial Markets		
Ensure the banking system has sufficient liquidity to meet its ongoing funding needs.		
		Implement a new asset allocation and performance benchmarking framework for foreign reserves.
	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.
Prudential Supervision		
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.
Introduce a prudential regime for the insurance sector, and implement new regulatory arrangements for NBDTs.	Advance the implementation of the new Non-Bank Deposit Taker regime.	
	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.
Bank-wide		
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 cross-functional capabilities among our staff to support the Bank's wider range of responsibilities.
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.	

Governance and structure

The Minister

The Reserve Bank Act provides considerable day-to-day operational autonomy to the Bank, an important role for the Minister of Finance in some key decisions, and a robust accountability structure in which the Bank's Board, the Minister, and Parliament all have formal roles. Transparency is an important feature of the overall framework.

The Minister of Finance has responsibility for: agreeing with the Governor on the monetary policy target; agreeing on changes to the scope of the supervisory regime; approval of any decision to place a failing bank into statutory management or to give directions to a registered bank; and approval of Orders-in-Council in relation to bank, non-bank deposit taker and insurance regulation. The Minister can also direct the Bank to intervene in the foreign exchange market or to impose, for a limited period, an alternative monetary policy target. In these cases, transparent procedures are set out in the Act.

The Bank keeps the Minister regularly informed on its thinking on significant policy developments, especially where Cabinet decisions and legislation may be required. In terms of the 2011-14 *SOI*, this would include developments in prudential and macro-prudential policy, implementation of the non-bank deposit taker and insurance regulatory regimes, the application of Basel III capital and liquidity reforms to New Zealand, and mechanisms to resolve bank failure.

Board of Directors

The Reserve Bank has a Board of Directors whose primary function is to review the performance of the Governor and the Bank. The Board holds regular meetings at which it receives extensive briefings on the Bank's activities, decisions and policies. At these meetings, the Board also provides advice to the Governor on a range of Bank functions.

The Board, through its Audit Committee, reviews the Bank's financial statements and internal audit activity. Each year, the Board writes an assessment of the Bank's and the Governor'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 on the appointment or reappointment of the Governor. The Minister can only appoint a Governor recommended by the Board. The Board can recommend to the Minister that the Governor be dismissed if the Board believes that the Governor's performance or conduct has been 'inadequate' or inappropriate in any one of various respects. The Board appoints the Deputy Governor on the Governor's recommendation.

The Board typically meets formally nine times a year, with provision for additional meetings. The current Board members are Dr Arthur Grimes (Chair); Mr Hugh Fletcher (Deputy Chair, and Chair of the Board's Audit Committee); Dr Chris Eichbaum; Professor Neil Quigley; Ms Sue Sheldon CNZM; Mr Keith Taylor; Ms Kerrin Vautier CMG; and Dr Alan Bollard (Governor). Board members are appointed for five-year terms and are eligible for reappointment.

Management structure

Under the Act, the Governor – who is also the Bank’s Chief Executive – is accountable for the Bank’s actions. In monetary policy, and in many other matters, decision-making authority resides with the Governor alone, although in practice he receives widespread advice, and takes monetary policy decisions based on the formal advice of the Official Cash Rate Advisory Group.² The Governor is appointed for a five-year term and can also be reappointed for further terms of up to five years. The Act sets specific procedures for the appointment, reappointment and dismissal of the Governor.

The Reserve Bank’s senior management team is made up of the Governor, the Deputy Governor/Deputy Chief Executive, two Assistant Governors and the heads of the Bank’s various departments, as outlined below. The positions of Governor and Deputy Governor are required, and their roles defined, by statute. Currently, the Deputy Governor is also the Head of Financial Stability. The two current Assistant Governors are the Head of Operations and the Head of Economics. The Governor receives advice from a number of internal committees within the Bank.

² This group includes key economic advisers within the Bank and two external monetary policy advisers.

Reserve Bank organisational structure

Governors	Department/Heads	Functions	Internal services	
Governor <i>Alan Bollard</i>	Assistant Governor/ Head of Economics <i>John McDermott</i>	Economics	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability <i>Grant Spencer</i>	Financial markets <i>Simon Tyler</i>	Domestic market operations Foreign reserves management Macro-financial stability	
		Prudential supervision <i>Toby Fiennes</i>	Financial system surveillance and policy	
		Currency and building services <i>Alan Boaden</i>	Currency operations	Property management Security
	Financial services <i>Mike Wolyncewicz</i>	Settlement services	Accounting services Treasury services	
	Knowledge services <i>Tanya Harris</i>		Library services Technology services Project management Web publishing	
	Assistant Governor/ Head of Operations <i>Don Abel</i>	Human resources <i>Lindsay Jenkin</i>		Human resources strategy and services
		Communications/ Board secretary <i>Mike Hannah</i>		Communications strategy and services Reputation management Board secretariat
		Risk assessment and assurance <i>Steve Anderson</i>		Risk assessment and assurance Audit services Legal services

Functions and operations

Monetary policy formulation

Outcome

Stability in the general level of prices.

Objective statement

To achieve and maintain stability in the general level of prices. The current Policy Targets Agreement (PTA)³ 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.”

Environment

- New Zealand economic activity has been soft, due to weak domestic demand by cautious households and businesses. Households have continued to reduce high debt levels, prompted by soft labour and housing markets. Businesses, faced with weaker-than-expected final demand and limited profit growth, were reluctant to invest.
- The Canterbury earthquakes will significantly reduce near-term economic activity. However, the resulting reconstruction spending will provide a significant boost to activity, thus eliminating excess capacity in the economy.
- Stronger activity in major trading partner economies has partially offset weak domestic demand. Conditions have improved in Western economies though vulnerabilities remain (particularly in some European economies). These developments have supported higher agricultural export prices.
- Inflation pressures have increased in many regions, including New Zealand, driven mainly by commodity prices. This has prompted central banks, particularly in Asia, to increasingly focus on the appropriate timing of the removal of policy stimulus.

Scope of operations

- Setting an Official Cash Rate (OCR) eight times a year, or as required, with the aim of keeping inflation within the target band.
- Publishing the Bank’s quarterly *Monetary Policy Statements (MPSs)* at the same time as four of the OCR decisions. The *MPSs* set out the Bank’s views on the economy and inflationary pressures, and the basis for the OCR decision.
- Announcing the other four OCR decisions approximately halfway between each *MPS*.
- Intervening in the foreign exchange market, where appropriate and feasible, to influence the level of the exchange rate, consistent with the objectives of the PTA.

Issues

- A prolonged and varied economic adjustment is expected to the Canterbury earthquakes, affecting construction activity, investment, private wealth, household consumption, the government’s fiscal position, and monetary policy settings.

³ The PTA specifies the monetary policy target agreed by the Governor and the Minister of Finance.

-
- New Zealand continues to be affected by developments in the international economic environment, including movements in commodity prices, risk sentiment and the exchange rate.
 - In New Zealand and many other countries, households and governments are looking to consolidate their balance sheets, with consequent implications for aggregate demand, inflationary pressure and hence monetary policy.
 - The Global Financial Crisis has prompted many countries to reassess their policy frameworks, both the objectives set for policy-makers and the choice of policy instruments. We will need to continue to learn from international experience, to ensure that monetary and macro-prudential policies are framed appropriately.

Initiatives and strategies

- Provide up-to-date, comprehensive analysis of economic events to inform monetary policy deliberations.
- Investigate and understand the economic impacts of the Canterbury earthquakes: the size of recovery expenditure, the near-term negative impacts on economic growth, the ability of the construction sector to meet reconstruction demand, and the impact on household and Crown balance sheets.
- Develop and improve the analytical frameworks used to guide monetary and macro-prudential policies. Improve analysis of the exchange rate, the terms of trade, and wage and price setting.
- Investigate the feasibility of developing flow-of-funds and sectoral financial accounts and balance sheets for New Zealand, in order to provide new statistics on wealth, help improve the quality of existing saving statistics and provide an analytical link between the financial sector and the real economy.

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 remain within the target range.
- Unnecessary instability in output, interest rates and the exchange rate should be avoided.
- *Monetary Policy Statements* assess the Bank's performance in meeting the objectives of the Policy Targets Agreement.
- The quality of the *MPSs* attracts net positive comment from monetary policy experts.

Domestic market operations

Foreign reserves management

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.

Objective statement

To support the implementation of monetary policy; to assist in the efficient functioning of the New Zealand financial system; to manage official foreign reserves; to implement the Bank's foreign exchange market intervention policy; to manage the Crown's financial liquidity; and to maintain crisis intervention capability.

Environment

- Market conditions continue to mean that the Bank's liquidity management operations will continue to be focused towards operations in the foreign exchange swaps market.
- Relatively low interest rates in the major markets are reducing the earnings on un-hedged foreign reserves.
- Although banks have been able to improve levels of liquidity and raise term funds over the past year, sovereign debt concerns in parts of Europe are continuing to affect the cost and availability of funds.
- Global regulatory standards are changing with the move to the new Basel III bank liquidity and capital regime.

Scope of operations

- Providing advice on financial market developments and issues for the formulation of monetary policy
- Implementing monetary policy through market operations that ensure market interest rates are consistent with the OCR.
- Managing official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes.
- Managing liquidity in the banking system.
- Providing and managing the Crown Settlement Account.
- Acting as lender of last resort to the financial system if necessary, as well as assisting in the resolution of any financial market or banking crisis.

Issues

- Ensuring the Bank's liquidity facilities can cope with post-crisis 'normal' conditions and changes to global liquidity regulatory standards inherent in Basel III.
- Continuing to develop the Bank's foreign exchange intervention capability to enhance the implementation of monetary policy and the maintenance of orderly foreign exchange markets.
- Implementing the liquidity management regime so that the payments system continues to operate, the banking system has adequate liquidity, and risks (both to the Bank and the market) are balanced appropriately.

Initiatives and strategies

- Implement the recent review of foreign reserves asset allocation and management approach, including the implementation of independent benchmarks for the foreign reserves assets.⁴
- Review the Bank's liquidity facilities and eligible collateral categories such that facilities can meet the financial system's needs in the new Basel III environment.

Key performance indicators

- Short-term wholesale interest rates are maintained at levels close to the OCR.
- No evidence of payment disruptions due to a shortage of settlement cash in the system, e.g. persistent accessing of the ORRF facility.
- Over the medium term, domestic market operations generate a positive return.
- Foreign reserves are maintained at target levels, with liquidity and credit standards met throughout.
- The Foreign Reserves Management portfolio yields a net return that meets or exceeds the benchmark portfolio.⁵
- The foreign exchange open position is managed such that: a) the bulk of active foreign exchange purchases (sales) are undertaken around peaks (troughs) in the exchange rate cycle; and b) the net return on the non-core open foreign exchange position is positive over the cycle.

⁴ See Initiatives in Knowledge services (page 24) and Internal financial services (page 25).

⁵ The Bank is developing a new benchmark portfolio, which would include an open exchange position of 1 billion SDRs.

Macro-financial stability

Outcomes

A sound and efficient financial system that supports the functioning of the economy.

Objective statement

To promote a sound and efficient financial system that facilitates the performance of the economy. Where possible, to reduce or manage risks to the financial system arising from extremes in the credit cycle, or developments in liquidity conditions and global funding markets. To analyse and report on the soundness and efficiency of the financial system.

Environment

- Debt among households, farms and other businesses has increased substantially over the past decade in an environment of rapid credit growth and rising asset prices.
- Despite weak private sector credit growth over the past three years and a lift in private savings, outstanding debt levels remain elevated and government debt levels have been rising.
- New Zealand's net financial liabilities remain high by international standards, reflecting a sustained period of current account deficits financed by borrowing channeled primarily through the banking system.
- Volatility in global credit market conditions continues to pose an ongoing source of risk to the financial system through its effect on the cost and availability of offshore funding.
- New Zealand's financial system is heavily reliant on the four major Australasian banking groups.

Scope of operations

- Monitoring and reporting on the risks facing the financial system, including those arising from the credit cycle, high indebtedness or external sector imbalances.
- Publishing regular *Financial Stability Reports (FSRs)* assessing the soundness and efficiency of the New Zealand financial system.
- Conducting research into the effectiveness of macro-prudential instruments and their associated costs and benefits.
- Advising on the deployment of macro-prudential instruments and the macro-financial implications of other Bank policies.

Issues

- The Global Financial Crisis has prompted worldwide interest in the use of various macro-prudential instruments to reduce financial system risk, but there remains limited consensus around their use.
- The capacity for macro-prudential instruments to directly moderate the credit cycle may be limited, and could vary considerably depending on financial market conditions.
- Some macro-prudential instruments may result in economic distortions and other costs, including financial sector disintermediation.

Initiatives and strategies

- Continue research into the effectiveness of macro-prudential instruments identified as having a potential role to play in New Zealand.
- Develop an implementation framework for macro-prudential policy tools in New Zealand, including a system of indicators of financial risks and imbalances.

Key performance indicators

- The Bank maintains, publishes and monitors a comprehensive set of indicators to assess risks and imbalances in the financial system.
- Any measures taken to reduce financial system risks, including the use of macro-prudential instruments, are explained and assessed in the *FSR* and their net benefits for financial system stability are demonstrated.
- The quality of the *FSRs* attracts net positive comment from financial system experts.

Prudential supervision

Outcomes

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

Objective statement

To register and supervise banks, license and supervise insurers, regulate non-bank deposit takers, oversee payment and settlement systems, and undertake policy development in all these areas. These actions are for the purpose of promoting a sound and efficient New Zealand financial system, and for limiting damage to the financial system that could arise from bank, non-bank deposit taker, or insurer failure, or other financial system distress. This will be 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.

Environment

- Given the slow and uneven recovery in the global economy, and shocks to the domestic economy from the Canterbury earthquakes, there remain relatively high risks to the balance sheets of banks, non-bank deposit takers and insurers.
- Governments and international regulators are seeking prompt resolution frameworks that prevent failing financial institutions from destabilising the financial system and exposing the taxpayer to risk of loss.
- International regulators are promoting more robust financial market infrastructure through revised international standards, and use of central counterparties to clear certain financial instruments.
- The Basel III reforms of bank capital and liquidity requirements were endorsed by G20 leaders in November 2010.
- Non-bank deposit takers are now required to comply with risk management, credit ratings, capital, liquidity, and governance standards, and restrictions on related-party exposures.
- Legislation is expected to be introduced in 2011 providing non-bank deposit taker licensing requirements and distress and failure management powers for the Reserve Bank.
- Insurers are now subject to the Reserve Bank regulatory and supervisory regime.
- The Bank is engaging with banks, life insurers and non-bank deposit takers that it will supervise for anti-money laundering and countering financing of terrorism (AML/CFT) purposes to gauge progress prior to full implementation of the AML/CFT statutory requirements.

Scope of operations

- Setting and applying prudential criteria for bank registration.
- Monitoring banks' adherence to prudential standards.
- Strengthening the Bank's capacity to respond in times of financial crisis.
- Setting and overseeing criteria for designation of payment and settlement systems.
- Progressively developing and implementing the prudential regulatory framework for non-bank deposit takers and insurers, throughout 2011 and 2012.
- Undertaking further development of the AML/CFT supervisory framework, throughout 2011 and 2012.

Issues

- Ensuring that banks maintain adequate capital in relation to risks in their business, including close monitoring of asset quality and prompt supervisory responses.
- Developing and implementing prudential policy initiatives, including policies relating to banks' significant acquisitions and covered bond issuance.
- Implementing the Non-Bank Deposit Takers Bill (when enacted), and enforcing the regulatory regime for the non-bank deposit taker sector.
- Implementing the Insurance (Prudential Supervision) Act 2010, including setting minimum solvency standards for insurers.
- Refining our bank capital and liquidity frameworks to reflect New Zealand circumstances, having regard to international developments.
- International re-examination of macroeconomic stabilisation policy and of how modifications to prudential policy may support and interact with monetary policy.
- Coordinating with other AML/CFT supervisors to ensure consistency in approach and guidance during implementation of the regime.

Initiatives and strategies

- Enhance the Bank's monitoring of risks to bank balance sheets and profitability.
- Consult with banks on pre-positioning for the Open Bank Resolution initiative, and work towards full implementation.
- Continue implementing regulations for the non-bank deposit taker sector, and review the effectiveness of these by the end of 2012.
- Implement Basel III capital and liquidity standards, in a way that is fit for New Zealand conditions.
- Refine our crisis preparedness, focusing on trans-Tasman coordination.
- Develop the supervisory framework for the insurance sector.
- Process insurers' provisional and full licence applications so all insurers are licensed by March 2012.
- Develop and implement the AML/CFT 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.

Key performance indicators

- The bank, non-bank deposit taker and insurance regulatory regimes, and in particular the regulatory changes implemented during the year, promote the soundness and efficiency of the financial system in a cost-effective manner.
- The prudential oversight function for banks, NBDTs, insurance companies and payment systems shows: vigilance in its monitoring activities; is capable of identifying emerging financial stresses; and is prepared to effectively resolve institutional failures in conjunction with government.
- The Bank demonstrates a consultative and transparent approach to its supervision of the financial system, supported by robust analysis that is accepted by supervised institutions and stakeholders.
- Develop and implement the new data collections required to fulfil the Bank's regulatory responsibilities.
- The *FSRs* provide a comprehensive assessment of the health of the New Zealand financial system.

Currency operations

Outcomes

Legal tender that meets the currency needs of the public.

Objective statement

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.

Environment

- The demand for notes and coins continues to grow each year. Cash remains an important means of making payments in New Zealand.
- The Bank's new management information system for its cash operations offers new opportunities to support more efficient and secure management of cash processes.
- The rate of counterfeiting in New Zealand is very low by international standards. However, rapid technical innovation means we cannot be complacent.
- Surveys of the general public and of notes in circulation have shown that the quality of most denominations is very good, but the quality of many \$5 notes in circulation does not meet the public's expectations.
- The recent earthquakes in Canterbury make it timely to review the levels and locations of contingency reserves.

Scope of operations

- Procuring, storing, processing and issuing bank notes and coins to the banking system.
- Maintaining the quality, and verifying the authenticity of, currency in circulation.
- Issuing legal tender collectors' currency through an outsourcing arrangement.

Issues

- The cash-handling operations can be managed more effectively by utilising the new management information system for cash operations.
- The current polymer bank note series is 12 years old and the security features are due for modernisation.
- The quality of \$5 notes in circulation is below the desired standard.

Initiatives and strategies

- Further develop and fully utilise the new management information system for the cash operations.
- Undertake planning for the development of a new bank note series and make decisions regarding suppliers.
- Lift the quality of \$5 notes in circulation through a 'swap' programme.
- Review the levels and location of currency reserves held for contingency purposes.

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 will be fewer than ten per million notes in circulation.

Settlement services

Outcomes

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

Objective statement

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

Environment

- The upgraded Exchange Settlement Account System (ESAS)/NZClear system is allowing the Bank to deliver functional enhancements to users.
- International standards for system performance and resilience are being lifted.
- The Reserve Bank and NZX Limited are working together to improve operation of New Zealand's clearing and settlement infrastructure.

Scope of operations

Operating the ESAS and NZClear systems, including the infrastructure required for settlement of foreign exchange transactions through Continuous Linked Settlement (CLS) Bank.

Issues

- Enhancing ESAS and NZClear system functionality.
- Improving business continuity planning and disaster recovery capabilities.
- Responding to higher international operating standards.
- Facilitating the industry decision to move to 'Settlement Before Interchange' for intra-day bilateral settlement and interchange of retail transactions.

Initiatives and strategies

- Continue to enhance NZClear and ESAS as agreed with industry.
- Complete establishment of the Bank's Auckland office and its disaster recovery capability.
- Implement 'Settlement Before Interchange' functionality within ESAS to replace the retail settlement function performed by Interchange Settlement Limited, so reducing payment settlement risk.
- Working together with NZX Limited via a joint industry council to improve the operation of New Zealand's clearing and settlement infrastructure.

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 external audits for ESAS and NZClear.
- International standards for payment and settlement systems (CPSS and IOSCO)⁶ are complied with, subject to variations for local New Zealand conditions.

⁶ Committee on Payment and Settlement Systems; and the International Organisation of Securities Commissions.

Organisational health and capabilities

Human resources

Objective statement

To provide strategic human resource advice and support services.

Environment

The Bank's role has expanded and staff capability is critical to contributing to the Bank's overall success in fulfilling its full range of functions. Through a programme of cross-skilling, rotations and staff development, we can provide a challenging work environment and continuously grow the skills and knowledge of our staff.

Scope of operations

- Providing strategic human resource advice and support to senior management.
- Organising specific bank-wide training and development programmes, key-role risk planning, succession planning and secondment arrangements.
- Assisting departments with change management, recruitment, employee development, contract negotiation, employment relations, legislative advice and terminations.
- Facilitating the annual remuneration review and performance management programme.

Issues

- Staff will be both motivated and challenged by the Bank's changing role. Support and leadership are required, as well as opportunities for staff to extend themselves.
- Identifying areas where skills can be enhanced and developed to meet current and future business requirements.

Initiatives and strategies

- Develop our staff capability across the Bank's full range of 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.
- Enrich the Bank's training and development programme.
- Support staff to perform at their best.
- Ensure the Bank values of integrity, innovation and inclusion are central to all staff initiatives.
- The biennial staff satisfaction survey will be completed in 2011.
- Ensure the Auckland office is fully operational and that core Bank operations can be maintained in the event of a major catastrophe.

Knowledge services

Objective statement

To provide knowledge management and information technology services, direction and support.

Environment

To perform its functions effectively, the Bank requires technology platforms that provide a high level of uninterrupted service, functionality and security, as well as easy access to a broad range of relevant information sources.

Scope of operations

- Developing and maintaining the Bank's core technology infrastructure.
- Providing business analysis tools and applications development.
- Delivering help desk and web support.
- Maintaining library, museum, information and records management services.
- Providing project and programme management, and business continuity planning services.
- Providing payments systems network support.

Issues

Managing capital expenditure to:

- maintain and upgrade information technology, information management and applications;
- provide efficient payments systems services;
- enhance data management and reporting systems; and
- improve business continuity.

Initiatives and strategies

- In conjunction with the Bank's Financial Services Group, provide a system to give effect to changes to foreign reserves asset management.⁷
- Continue the implementation of the Financial Sector Information System project integrating the Bank's statistical data.
- Implement a common platform to support supervisory functions across the insurance, non-bank deposit taker and banking sectors, and for our role across these sectors in anti-money laundering and countering financing of terrorism.
- Develop systems to make the management of the IT environment more efficient.
- Ensure the Bank's IT security systems are maintained at industry best practice and are capable to respond to an increasing threat from external sources.
- Enhance the electronic delivery of information to the Bank through collaborative tools.
- Improve management and archival processes around document, email, network drive files and physical records in accordance with the Public Records Act.
- Develop museum services as part of a wider public education programme.
- Enhance the Bank's business continuity infrastructure for critical functions.

⁷ See Initiatives in Foreign reserves management (page 16) and Internal financial services (page 25).

Internal financial services

Objective statement

To provide support services for the Bank's key financial operations, including financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

Environment

The Bank's financial systems must be of a high standard to enable management of a very large and complex balance sheet.

Scope of operations

- Settling transactions, treasury accounting and compliance reporting in support of the Bank's domestic market operations, foreign reserves functions and currency operations.
- Preparing financial statements, and monthly management and Board reports.
- Facilitating the Bank's planning and annual budgeting processes.
- Delivering financial support services and balance sheet management advice.
- Liaising with external auditors.

Issues

- Ensuring systems are developed to meet changes to the Bank's financial operations and environment.
- Maximising efficiency through process and systems improvements.

Initiatives and strategies

- Continue to enhance workflows, reports and processes for financial operations, currency operations and securities transactions.
- In conjunction with the Bank's Knowledge Services Group, revise reporting for financial market operations to give effect to portfolio management changes, including implementing a new asset allocation and performance benchmarking framework.⁸
- Replace the Bank's own financial management information system during 2011.

⁸ See Initiatives in Foreign reserves management (page 16) and Knowledge services (page 24).

Communications

Objective statement

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

Environment

- The Bank's messages and actions across its policy functions require broad public understanding to be most effective.
- This will be particularly so in the Bank's contribution to the financial and economic recovery, particularly after the Canterbury earthquakes; the consideration of any new macro-prudential policy tools; its expanding prudential supervision powers; and the introduction of new Series 7 banknotes.
- The economic and financial environment places a premium on financial literacy.
- Emerging media technologies may provide new opportunities as well as risks that require management.

Scope of operations

- Supporting the Bank's functions with communication and relationship strategies.
- Editing and publishing Bank statements and documents.
- Sponsoring financial literacy and education initiatives.
- Coordinating responses to Official Information Act requests, ministerial correspondence, parliamentary questions and public inquiries.
- Providing Board secretariat and administrative services.

Issues

- Ensuring the Bank's messages are informed, easily understood, timely and delivered to target audiences through the most appropriate channels.
- Maintaining the Bank's preparedness by monitoring developments, news and commentaries, and liaising with other agencies.
- Improving New Zealanders' financial literacy.
- Further enhancing internal communications, inclusive of a new Auckland office.

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 roles in regulating and supervising non-bank financial institutions, the insurance sector, and anti-money laundering and countering financing of terrorism.
- Provide and implement a communications strategy for the new Series 7 banknotes.
- Enhance financial literacy through support for relevant programmes.
- Refresh the Internal Communications Strategy with the introduction of new channels and activities.

Risk assessment and assurance

Objective statement

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

Environment

The Bank's financial exposure from changes in its balance sheet structure and regulatory exposure from changes in its regulatory responsibilities increase overall risks faced by the Bank.

Scope of operations

- Assisting management to identify and analyse sources of risk.
- Assisting management to design risk management systems and processes.
- Monitoring risk management implementation and providing risk management advice to Governors and the Board.
- Providing ongoing internal audit review and evaluation of the Bank's operations and control systems.
- Providing legal advice and services.

Issues

- Ensuring risks are being managed in a proactive, coordinated, prioritised and cost-effective manner.
- Identifying and managing the increased exposure to implementation risks from the expanded prudential regulatory regimes.

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.

Property management Security

Objective statement

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

Environment

- The infrastructure of the Bank's building must be maintained at a level that promotes efficiency, soundness, effectiveness and security.
- For security reasons, the Bank needs a modern, reliable security access and control system.
- For efficiency and environmental reasons, the Bank needs to maintain and extend energy-saving and recycling programmes.

Scope of operations

- Maintaining the Bank-owned building at 2 The Terrace, and managing leases on eight of the 14 floors.
- Maintaining a secure working environment and the safe custody of currency reserves.
- Maintaining business continuity sites in Wellington and in Auckland.

Issues

- Some of the infrastructure of the Bank's primary building will need replacement soon.

Initiatives and strategies

- Replace the Bank building's lift control systems and cooling towers.
- Implement cost-effective measures to further enhance energy efficiency.

Financial management

Financial structure

Balance sheet overview and funding of the Bank's operations

The Reserve Bank is both a statutory agency and a financial institution. It receives no direct funding through the central government budgetary process. Instead, the Bank's main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the Bank's equity. Currency in circulation is a liability on which no interest expense is incurred. The funds received when currency is issued are invested and earn interest income, which is known as seigniorage.

The nature and extent of the Bank's principal activities impacting on its balance sheet are described in the *Annual Report 2009–2010* (pages 70–71). Foreign reserves management, New Zealand dollar liquidity management and currency operations materially impact the size and structure of the Bank's balance sheet.

Under the Reserve Bank Act, the Minister 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 operating 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. This contrasts with the arrangements for government departments, which are funded on an annual basis. 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.

Annual distributions paid by the Bank

Under the Reserve Bank of New Zealand Amendment Act, the Bank's annual dividend is determined using the principles listed below in the *Statement of dividend principles*. The Bank applies the dividend principles and makes a recommendation to the Minister of Finance of the amount to be paid. The Minister then 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.

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.

In 2010, the Governor and the Minister of Finance signed a Funding Agreement for the five-year period 1 July 2010–30 June 2015. The 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, and completing unfinished work upgrading information technology, business continuity and building infrastructure, in particular, establishing the Auckland office.

The new agreement was developed in an environment where central government expected its agencies to have strong expenditure control and to minimise growth in operating costs. The Bank has carefully prioritised its expenditure proposals and minimised increases in costs, without undermining the ability to deliver on the Bank's existing and new responsibilities over the term of the new Funding Agreement.

The introduction of a new series of bank notes is potentially a large project for the Funding Agreement, with a considerable cost attached to it. However, at this stage, much of the cost will fall into the subsequent five-year funding agreement period (i.e., from 1 July 2015 onwards).

Drivers of the Bank's financial performance and financial position

The principal drivers of the Bank's financial performance are:

- *The value of currency in circulation.*

Currency in circulation is a non-interest-bearing liability. Trading banks are charged for currency issued to them and the Bank earns interest on investment of these amounts paid by trading banks.

At 30 April 2011, currency in circulation was \$4.34 billion.

- *The size of the Bank's open foreign exchange position and related changes in foreign exchange rates.*

In 2007, the Bank changed its exposure to foreign exchange risk after concluding that it could better meet its statutory responsibilities by holding a portion of foreign currency reserves on an unhedged basis. The Bank established a benchmark holding of SDR 1.0 billion unhedged foreign reserves with the ability to hold more or less than the benchmark over the exchange rate cycle. The unhedged foreign reserves position is held in six currencies – US dollars, euro, Japanese yen, British pounds, Australian dollars and Canadian dollars.

Holding unhedged foreign reserves means that the Bank's net equity will fluctuate with changes in the exchange rate: foreign exchange losses may be incurred when the New Zealand dollar is strong, and gains may be recorded when the New Zealand dollar is weak. The unhedged position increases volatility in the Bank's financial performance and financial position.

At 30 April 2011, the Bank held an open foreign exchange position of SDR 1.15 billion (NZD 2.31 billion), down from SDR 1.33 billion (NZD 2.85 billion) at 30 June 2010.

- *Interest rates earned on the Bank's investment in government securities and other securities.*
Under the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), the Bank's holdings of New Zealand government securities are valued at market value, with unrealised gains and losses on those holdings booked to equity. Interest income is recognised in the Bank's Income Statement.
- *The size and performance of the Bank's foreign reserve management and market operations functions.*
The Bank holds foreign reserves that can be liquidated at short notice to support its functions, including monetary policy objectives and the maintenance of orderly markets. At 30 April 2011, the Bank had foreign reserve assets equivalent in value to NZD 9.09 billion, which provided the Bank with foreign currency intervention capacity.

In 2008, the Bank introduced a range of temporary measures to support New Zealand dollar liquidity in response to global market disruptions. Some of these measures were removed as market conditions improved during 2009 and early 2010 and the New Zealand banks gained improved access to funding.

- *Operating expenditure incurred by the Bank.*
As noted in the previous section about the Funding Agreement, the level of operating expenditure is expected to increase, reflecting further expansion of the Bank's financial system regulatory and supervision capacity, improvement of business continuity capabilities, commencement of changes to currency in circulation, and the renewal and replacement of systems.
- *The level of equity available for investment and the dividend paid by the Bank.*
The Bank requires equity to absorb any losses arising from carrying out its functions and equity is reviewed annually to assist in determining the Bank's annual dividend.

Dividends for the 2009-10 year totalled \$335 million, including \$45 million in surplus capital associated with the temporary liquidity facilities that were withdrawn after conditions in financial markets improved.

Principal financial risk management considerations

As a financial institution with more than \$20 billion in assets, the Bank faces a wide range of financial risks. These arise mainly because of the Bank's operations in the domestic financial system and because of the Bank's holdings of foreign exchange reserves. The risks include:

- credit risks and market risks associated with day-to-day dealings with financial institutions, in the process of managing liquidity in the financial system;
- risks associated with the Bank's holdings of foreign currency reserves, including credit risk, liquidity risk, interest rate risk and exchange rate risk; and
- operational risks in the transactions and processing areas of the Bank.

More detailed information on the Bank's approach to managing these risks is outlined on pages 83–95 in the *Annual Report 2008–2009*.

Financial projections

The following table outlines the Bank's budgeted income and expenditure for 2011–12. The budgeted income and expenditure have been prepared using the accounting policies used in the preparation of the Bank's financial statements for the year ended 30 June 2010.

The key assumptions underlying the budget for the year ended 30 June 2012 are that:

- the Bank's current functions will continue, with the Bank proceeding with prudential supervision of non-bank financial institutions and insurers;
- the Bank will maintain an open foreign currency position during the year equal to \$2.31 billion, being the position at 30 April 2011;
- interest and exchange rates will be those prevailing as at 30 April 2011;
- there will be no change in the credit worthiness of the Bank's counterparties; and
- there will be no material changes to the Bank's liquidity management operations.

The following table sets out projected income and expenditure for the Bank for the year ended 30 June 2012.⁹

Projected financial performance 2011 – 2012

	Budget
<i>For the year ended 30 June</i>	2011-12
	\$m
Operating income:	
Net investment income	307.5
Other income	7.6
Total operating income	315.1
Operating expenses:	
Personnel	29.2
Asset management	6.5
Net currency issued	5.3
Other	15.3
Total operating expenses	56.3
Operating surplus	258.8

The budget is based on the key assumptions outlined above. It is important to note that the Bank's assets and liabilities are sensitive to changes in interest rates and exchange rates, and that actual financial results could differ materially from those budgeted.

⁹ The Bank's accounting policies are disclosed in its *Annual Report 2009–2010* on pages 63–69.

At 30 April 2011, a 10 percent appreciation in the value of the New Zealand dollar would reduce the Bank's comprehensive income¹⁰ by \$210 million, and conversely a 10 percent depreciation in the value of the New Zealand dollar would add \$256 million to comprehensive income. A 1 percent across-the-board increase in interest rates would reduce comprehensive income by about \$148 million, and a 1 percent across-the-board reduction in interest rates would increase comprehensive income by about \$157 million.

Net expenditure by function

<i>For the year ended 30 June</i>	Net Expenditure ¹¹
	Budget
	2011-12
	\$000s
Functions:	
Monetary Policy Formulation	11,476
Domestic Market Operations	5,731
Macro-Financial Stability	3,643
Prudential Supervision	12,196
Foreign Reserves Management	6,527
Settlement Services	(331)
Currency Operations	9,514
Net expenditure	48,756
Net expenditure provided for in the Funding Agreement	50,200
Funding Agreement Under-Expenditure	1,444

¹⁰ Comprehensive income includes earnings booked to the Bank's Income Statement and also changes booked directly to equity. The majority of sensitivity to changes in foreign exchange rates is booked to the Income Statement, whereas the majority of interest rate sensitivity arises on the Bank's portfolio of New Zealand government securities and is booked directly to equity. Refer to page 88 of the *Bank's Annual Report 2009-2010* for a detailed sensitivity analysis as at 30 June 2010.

¹¹ Net Expenditure comprises operating expenses less income earned from certain Bank operations as specified in the Funding Agreement.

Regulatory scanning and planning

The Bank carries out a scan of its existing stock of regulation each year. The first of these was undertaken in 2010. It identified a number of minor redundant pieces of legislation, such as commencement orders relating to legislation that has been repealed. Work was initiated to have these revoked. No issues have been identified that need attention in the current period. This was not unexpected, given that the Bank is responsible for only a relatively small stock of legislation, and is generally in close contact with banks and other institutions it regulates.

In addition, the Bank prepares annual regulatory plans to help it prioritise its regulatory work. These plans are prepared in accordance with the overarching framework set out in the document 'Government Statement on Regulation: Better Regulation, Less Regulation'. Accordingly, the plans prioritise proposals that will deliver the biggest gains and, where feasible, result in regulatory simplification such as streamlining processes and increasing flexibility.

Last year, the Bank undertook a major review of disclosure requirements for registered banks with the aim of significantly reducing compliance costs for banks while at the same time making information more accessible for investors, depositors and analysts. The new requirements take full effect in September 2011, but a number of banks have decided to move to the new requirements before then to take advantage of the available compliance cost reductions.

This year, the regulatory plan focuses on bringing into effect the remaining aspects of the new prudential requirements for non-bank deposit takers and insurers, and on better aligning prudential requirements for banks with international standards promulgated by the Basel Committee on Banking Supervision.

Monitoring the Bank's performance

The Bank has been, and will continue to strive to be, a world leader in the openness and transparency of its processes and policies. Transparency assists the Bank to achieve its policy and operational goals effectively and efficiently, while allowing others to scrutinise the Bank's performance and to provide feedback, so helping the Bank improve the way it works.

The principal mechanisms for externally communicating the Bank's views each year include:

- eight OCR decisions, four of them in the quarterly *MPSs*;
- two *FSRs*;
- the Bank's *Statement of Intent*, *Annual Report* and financial statements;
- four *Bulletins*;
- the Bank's website (www.rbnz.govt.nz);
- addresses given by the Governor and other senior Bank staff; and
- occasional publications and issue-specific books and brochures.

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

The Board reviews the Bank's performance and the discharge of its statutory obligations. In addition to providing the Governor with ongoing 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*.¹²

¹² For example, see pages 6–9 in the *Annual Report 2009–2010*.

The Audit Committee of the Board reviews the Bank's financial statements and provides advice to the Governor before the Governor and Deputy Governor sign the related management statements. It also monitors the Bank's internal audit function.

The Bank publishes its *SOI* at the commencement of each financial year. The *SOI* sets out the Bank's principal functions, objectives, strategies and key performance indicators for the next three years; comments on strategies for managing organisational health and capability; sets out initiatives and projected income and expenditure for the first year of that three-year period; includes a statement of principles determining the annual dividend payable to the Minister; and outlines the Bank's Regulatory Plan for the year.

The Annual Report includes both the financial statements and an assessment of the performance of the Bank's various functions, in terms of both the day-to-day responsibilities and progress against priorities and key performance indicators published in the *SOI*. It is tabled in Parliament.

Parliament's Finance and Expenditure Committee reviews the quarterly *MPS*, the six-monthly *FSR* and the Bank's *Annual Report*, and can ask the Bank to appear before it on request.

Under section 167 of the Act, the Minister may, from time to time, initiate an assessment of the Bank's performance and how it has exercised its powers under the Act.

The Bank is subject to Cabinet's Regulatory Impact Analysis requirements, ensuring that proposals involving regulatory options are subject to careful and robust regulatory analysis, and that the Bank demonstrates that a regulatory solution is required in the public interest. The Bank undertakes extensive consultation on proposed legislation and regulation.

The Bank's financial statements are audited by external auditors, who are the agent of the Controller and Auditor-General. The critical payment systems operated by the Bank are subject to review by external auditors quarterly in respect of the NZClear depository system, and annually in respect of ESAS. An annual report is presented to NZClear members.

From time to time, the 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; financial system policy; forecasting processes; bank-failure management; computer systems and network security; management; and leadership assessment and development. The Bank funds a Professorial Fellowship in Monetary and Financial Economics at Victoria University of Wellington. Also, two external advisers assist in the provision of advice to the Governor regarding his interest rate decisions. Prior to the release of the *MPS*, these two advisers participate in the deliberations leading to the formulation of the *MPS*.

The Bank's performance is also subject to international scrutiny. Every 12 to 18 months, the International Monetary Fund (IMF) 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 Organisation for Economic Co-operation and Development undertakes a similar assessment, which is also published. The IMF is expected to undertake a Financial Sector Assessment Programme investigation every six or seven years; the last was in 2003.

Appendix A

Key document references

Title	Purpose	Location
Policy Targets Agreement	Agreement between the Governor and the Minister of Finance required under s9 of the Act, specifying the monetary policy target in detail	http://www.rbnz.govt.nz/monpol/pta/index.html
<i>Monetary Policy Statement*</i>	Quarterly publication of the Bank's view of how it proposes to meet its monetary policy targets, including extensive economic projections, required under s15 of the Act	http://www.rbnz.govt.nz/monpol/statements/
<i>Financial Stability Report*</i>	Six-monthly publication of the Bank's view on the soundness and efficiency of the New Zealand financial system, required under s165A of the Act	http://www.rbnz.govt.nz/finstab/fsreport/index.html
<i>Annual Report*</i>	Key accountability document, plus presentation of financial statements, required under ss163-165 of the Act	http://www.rbnz.govt.nz/about/whatwedo/0094054.html
Board of Directors' <i>Annual Report</i>	Board of Directors' report on the Bank's performance required under s53A of the Act	Reproduced in the Bank's Annual Report http://www.rbnz.govt.nz/about/whatwedo/0094054.html
Briefing on the Reserve Bank of New Zealand*	Description of the role and functions of the Reserve Bank, prepared for an incoming government	http://www.rbnz.govt.nz/about/whatwedo/0122541.html
Reserve Bank of New Zealand Act 1989	Reserve Bank's statutory authority	www.rbnz.govt.nz/about/ourlegislation/
Funding Agreement	Basis of Bank's funding, setting how much of the Bank's revenues can be retained by the Bank, in accordance with ss159-161 of the Act	http://www.rbnz.govt.nz/about/whatwedo/1845734.html
<i>Statement of Intent*</i>	A statement of what the Bank intends to achieve over the next three years, with forecast income and expenditure for one financial year, in accordance with ss162A-E of the Act	http://www.rbnz.govt.nz/about/whatwedo/1764296.html
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 Act to influence the exchange rate	http://www.rbnz.govt.nz/finmarkets/foreignreserves/intervention/0148214.html
Memorandum from the 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 Act, should that market become dysfunctional	http://www.rbnz.govt.nz/finmarkets/foreignreserves/intervention/0148293.html
Reserve Bank <i>Bulletin*</i>	Quarterly publication of articles relevant to central banking in New Zealand	http://www.rbnz.govt.nz/research/bulletin/
Statement of Principles	Explanation of the Reserve Bank's approach to bank registration and supervision under s75 of the Act	http://www.rbnz.govt.nz/finstab/banking/regulation/0094291.html
<i>Annual Report for the NZClear NZ System</i>	Accountability document on the performance of the NZClear NZ system	http://www.rbnz.govt.nz/payment/nzclear/index.html
Vision Statement and Values	Expression of the Bank's vision and culture	Inside front cover of <i>Annual Report</i> http://www.rbnz.govt.nz/about/whatwedo/0094054.html

* Also available in print from: the Knowledge Centre, Reserve Bank of New Zealand, PO Box 2498, Wellington, New Zealand 6140. knowledge@rbnz.govt.nz, www.rbnz.govt.nz