Briefing for the Incoming Minister on the Reserve Bank of New Zealand – October 2017

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Overview of the Reserve Bank of New Zealand

Roles and accountability

The Reserve Bank’s key responsibilities are to manage monetary policy to maintain price stability, promote the maintenance of a sound and efficient financial system, and supply New Zealand banknotes and coins that meet the needs of the public.

The Reserve Bank of New Zealand is the nation’s central bank. A statutory agency, the Bank performs functions derived from several pieces of legislation:

- the Reserve Bank of New Zealand Act 1989 (RBNZ Act), which specifies the Bank’s and the Governor’s capacity, functions and powers, as well as its monetary policy and banking supervision functions;
- the Insurance (Prudential Supervision) Act 2010 (IPSA), which provides for the Bank’s role as prudential supervisor of the insurance sector;
- the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML Act), which confers responsibility on the Bank as an Anti-Money Laundering/Countering Financing of Terrorism (AML/CFT) supervisor; and
- the Non-bank Deposit Takers Act 2013 (NBDT Act), which establishes the Bank as a prudential regulatory and licensing authority for non-bank deposit takers (NBDTs).

To achieve its purposes, the Bank’s functions cover: monetary policy formulation; financial market operations; macro-financial stability; prudential supervision; settlement services; and currency operations. These functions, the outcomes that the Bank targets, and the measures used to evaluate performance are described in the Bank’s Statement of Intent and Annual Report.

Appendix 1 details the significant powers and responsibilities of the Minister of Finance, the Reserve Bank, and the Reserve Bank Board, under each of the Acts listed above.

The RBNZ Act confers considerable day-to-day operational autonomy on the Bank, an important role for the Minister of Finance in various key decisions, and a robust accountability structure in which the Bank’s Board, the Minister and Parliament all have formal roles. The Bank publishes a range of accountability documents, including the Monetary Policy Statement (MPS), Financial Stability Report (FSR), a Statement of Intent (SOI) and an Annual Report. The Bank’s activities are examined by Parliament’s Finance and Expenditure Committee. Typically, select committee hearings are held covering the quarterly MPSs, the six-monthly FSRs and the Bank’s annual financial performance.

The Reserve Bank keeps the Minister and the Treasury informed on the economic outlook, policy developments and other significant matters affecting the Bank. We provide regular briefings on the economy ahead of each MPS. Recent practice has also included a scheduled meeting with the Minister and the Treasury approximately once every six weeks to discuss financial sector developments and provide updates on prudential policy matters. Other meetings are arranged as required to provide information and seek the Minister’s input, on particular regulatory policy issues.

Under the Memorandum of Understanding on Macro-Prudential Policy (MOU) the Bank commits to keep the Minister and Treasury informed about its thinking on macro-prudential policy developments, and to consult the Minister prior to any decision to deploy macro-prudential policy instruments.

The Bank’s accountability includes an extensive external engagement and public speech
programme. In 2017, it has delivered 127 presentations around New Zealand, of which nine have been on-the-record speeches. We provide copies of our on-the-record speeches to your office 1-2 days prior to delivery and inform you confidentially (by telephone) of our OCR decision and accompanying statement an hour before it is released. In 2018, the Bank plans to conduct its second External Stakeholder Engagement Survey. Its first such survey in 2014-15 covered general public and specific stakeholder groups (financial markets, regulated industry, business, educators/researchers).

**Role of the Minister**

The Minister of Finance has the following functions and powers under the RBNZ Act, IPSA and the NBDT Act:

- appointing the Governor on the recommendation of the Board;
- advising the Governor-General to remove the Governor from office, either on the recommendation of the Board or because statutory criteria for removal are made out;
- agreeing with the Governor the PTA and any variations to it;
- agreeing with the Governor a five-year funding agreement and any variations to it;
- various powers under Part 5 of the RBNZ Act, such as consent to the deregistration of or a direction to a registered bank, and advising the Governor-General to place a registered Bank into statutory management; and
- various powers under IPSA empowering statutory management of an insurer, and under the NBDT Act relating to approval of specific regulations.

Subject to procedures intended to ensure public transparency, the Minister of Finance can also:

- put in place an alternative monetary policy objective;
- direct the Bank to intervene in the foreign exchange market or deal in foreign exchange within fixed exchange rate bands; and
- direct the Bank to have regard to government policies relating to the Bank’s prudential functions under the RBNZ Act, IPSA and the NBDT Act.

The Minister provides an annual Letter of Expectations to the Governor (see Appendix 4 for the current Letter). The expectations are reflected in the Bank’s Statement of Intent. The Letter is posted on the Bank’s website when the SOI is published.

The Minister agreed with the Bank a *Memorandum of Understanding on Macro-prudential policy and operating guidelines* that is to be reviewed in 2018.

**Role of the Board of Directors**

Section 53 of the RBNZ Act specifies the duties of the Board, among other things, as being to:

(a) keep under constant review the performance of the Bank in carrying out—
   i. its primary function [monetary policy]; and 
   ii. its functions relating to promoting the maintenance of a sound and efficient financial system; and
   iii. its other functions under this Act or any other enactment:
(b) keep under constant review the performance of the Governor in discharging the responsibilities of that office:
(c) keep under constant review the performance of the Governor in ensuring that the Bank achieves the policy targets agreed to with the Minister [the *Policy Targets*...
Agreement:
(d) determine whether policy statements made pursuant to section 15 [MPSs] are consistent with the Bank’s primary function and the policy targets agreed to with the Minister:
(e) keep under constant review the use of the Bank’s resources.

Section 53 also specifies that the Board may provide advice to the Governor on any matter relating to the performance of the Bank’s functions and the exercise of its powers.

In November 2015, the Board received a Letter of Expectations from the Minister for the first time, setting out the Minister’s expectations of the Board’s activities (Appendix 5). As well as its longstanding framework for assessing the Bank’s monetary policy performance, the Board has developed particular frameworks to assist its monitoring of the Bank’s performance in relation to financial system soundness and efficiency and regulatory policy processes; and its important stakeholder relationships. These assessments, and advice offered by the Board, are provided on a continuous basis.

The Board’s Audit Committee reviews the Bank’s financial statements and internal and external audit activities. 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.

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. The Board appoints the Deputy Governors on the Governor’s recommendation.

The Board typically meets nine times a year, with provision for additional meetings. The Board currently has six non-executive directors, with one vacancy to be filled, following Dr Rod Carr’s retirement from the Board in July 2017. Board members are appointed for five-year terms and are eligible for reappointment.

Board of Directors

<table>
<thead>
<tr>
<th>Board Member</th>
<th>Appointed</th>
<th>Term-end date</th>
<th>Region</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-executive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chair: Prof Neil Quigley</td>
<td>1 February 2010</td>
<td>31 January 2020</td>
<td>Hamilton</td>
</tr>
<tr>
<td>Deputy Chair: Kerrin Vautier CMG</td>
<td>9 February 2010</td>
<td>8 February 2020</td>
<td>Auckland</td>
</tr>
<tr>
<td>Vacancy</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bridget Coates</td>
<td>1 October 2013</td>
<td>12 March 2022</td>
<td>Auckland</td>
</tr>
<tr>
<td>Jonathan Ross</td>
<td>12 August 2013</td>
<td>11 August 2018</td>
<td>Auckland</td>
</tr>
<tr>
<td>Keith Taylor ONZM</td>
<td>1 July 2009</td>
<td>30 June 2019</td>
<td>Wellington</td>
</tr>
<tr>
<td>Tania Simpson</td>
<td>16 July 2014</td>
<td>15 July 2019</td>
<td>Hamilton</td>
</tr>
<tr>
<td>Executive</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grant Spencer Governor</td>
<td>26 March 2018</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Policy Targets Agreement

Under the RBNZ Act, the Bank exercises its authority through the Governor and is subject to the Policy Targets Agreement (PTA), a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve.

Section 9 of the Act requires the responsible Minister, before appointing any person as Governor, to agree with that person policy targets for the carrying out the Reserve Bank’s primary function. Deputy Governor Grant Spencer has been appointed as acting Governor on the retirement of Graeme Wheeler, for a term of six months commencing 27 September 2017, and the terms of the existing (2012) PTA (Appendix 2) will carry over for this period.

The Minister and Governor may “from time to time” review or alter the PTA. Any alterations must be recorded, tabled at the Board, and gazetted.
Economic environment

- The Bank will release its latest assessment of the economic and inflation outlook in the Monetary Policy Statement on November 9.

- Appendix 7 provides a copy of a speech delivered on 30 August 2017 by the previous Governor, Graeme Wheeler, covering the Bank’s most recent view of the New Zealand economy and implications for monetary and financial stability policies.

- In many respects, the economy continues to perform well. The economic expansion is in its ninth year. Our August 2017 Monetary Policy Statement forecasts show annual real GDP growth of around 3.4 percent over the next 18 months, with inflation at the midpoint of the target band, the unemployment rate continuing to decline, and the current account deficit remaining within manageable levels. Headline inflation is likely to decline in coming quarters as the effects of higher fuel and food prices dissipate. The outlook for tradables inflation remains weak. Non-tradables inflation remains moderate but is expected to increase gradually as capacity pressure increases, bringing headline inflation to the midpoint of the target range over the medium term. Longer-term annual inflation expectations remain well anchored at around 2 percent.

- House price inflation in Auckland have moderated substantially over the past year, but it is uncertain whether this will be sustained. House price inflation in other regions has also slowed in recent months. House price to income ratios and debt to income ratios remain at historically high levels. There is a significant risk of further upward pressure on house prices so long as the imbalance between housing demand and supply remains.

- Economic activity continues to be supported by accommodative monetary policy and strong population growth. The outlook for domestic demand is also supported by additional fiscal stimulus and the high terms of trade.

- The greatest threat to the expansion lies in possible international political and economic developments and their implications for the global trading environment. The main domestic risk – and one that could be triggered by developments offshore – is a significant correction in the housing market.

- The Bank maintained the Official Cash Rate at an historic low of 1.75 percent at the September 2017 OCR review and indicated that monetary policy will continue to be accommodative for a considerable period. As has been the case in several other countries, monetary policy has been made more challenging by low global inflation and zero or negative policy rates in several major economies. This has put downward pressure on our interest rate structure and contributed to asset price inflation and upward pressure on the New Zealand dollar. This trend may turn as advanced economy central banks begin to reduce the degree of monetary stimulus in their economies. The US in particular has started to increase its policy rates and has announced plans to begin running off its debt holdings acquired under QE.
Regulatory policy programme

Background
The Bank provides the Minister with regular six-monthly reviews of its planned regulatory policy work programme. These reports provide information on ongoing work priorities, with a view to identifying any areas for further discussion, or where a ‘chew’ session would be helpful

Major regulatory Initiatives
Below is a table summarising the Bank’s current regulatory initiatives and their relative level of priority. These are elaborated in Appendix 3. The two projects at the top of the list have particular priority.

The IMF FSAP project refers to the work underway at the Reserve Bank to assess the recommendations in the recent Financial Sector Assessment Programme (FSAP). This was a thorough and comprehensive review that included a benchmarking of New Zealand’s financial regulatory regimes against international standards. A key recommendation was that the Reserve Bank should increase resources, both because current resource levels appear inadequate for the current model and to develop the supervisory model in certain areas to be more effective. We expect to discuss with you shortly a proposal for a modest increase in resources.

The capital review is the Bank’s most extensive externally-facing project. It is a comprehensive review of our capital adequacy framework for banks, a fundamental building block of the prudential regime. We have held two consultations so far and banks are highly engaged. Final decisions are expected to be taken in H1 2018, following two further consultation papers, which we will share and discuss with you.

<table>
<thead>
<tr>
<th>Project</th>
<th>Sector</th>
<th>Development Stage</th>
<th>MoF engagement and role</th>
<th>Priority to RBNZ</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Financial Market Infrastructures Bill</td>
<td>FMIs</td>
<td>Advanced</td>
<td>Action</td>
<td>High</td>
</tr>
<tr>
<td>2 OTC derivatives</td>
<td>Banks</td>
<td>In progress</td>
<td>Action</td>
<td>High</td>
</tr>
<tr>
<td>3 IMF FSAP</td>
<td>All</td>
<td>Advanced</td>
<td>Decision</td>
<td>High</td>
</tr>
<tr>
<td>4 Capital Review</td>
<td>Banks</td>
<td>In progress</td>
<td>Consult</td>
<td>High</td>
</tr>
<tr>
<td>5 Dashboard</td>
<td>Banks</td>
<td>Advanced</td>
<td>Inform</td>
<td>High</td>
</tr>
<tr>
<td>6 IPSA review</td>
<td>Insurers</td>
<td>In progress</td>
<td>Consult</td>
<td>Medium</td>
</tr>
<tr>
<td>7 Depositor protection/De Minimis</td>
<td>Banks</td>
<td>Advanced</td>
<td>Decision</td>
<td>Medium</td>
</tr>
<tr>
<td>8 Macroprudential Policy Review</td>
<td>Banks</td>
<td>In progress</td>
<td>Consult</td>
<td>Medium</td>
</tr>
<tr>
<td>9 Stress Testing</td>
<td>Banks</td>
<td>Advanced</td>
<td>Inform</td>
<td>Medium</td>
</tr>
<tr>
<td>10 Attestation Review</td>
<td>Banks</td>
<td>Advanced</td>
<td>Inform</td>
<td>Medium</td>
</tr>
</tbody>
</table>

1 Note that this list does not include business-as-usual supervisory activities, model approvals, minor, technical or low priority initiatives, or our engagement with other government agencies.
Next Steps and Follow-up

Please let us know if you would like additional information about any of these regulatory policy initiatives.

Other key Reserve Bank initiatives

- The Bank operates payment and settlement systems that require significant investment and substantial upgrades over the next few years. Following a strategic review, the Bank decided that it must continue to own and operate a Real-Time Gross Settlement System (RTGS), as it is central to the financial system and the Bank’s statutory functions. The Bank investigated divesting NZ Clear, its Central Securities Depository (CSD) system, but opted to retain the business after a divestment process unearthed no compelling commercial bids. The Bank is currently working with SIA Perago to develop replacement solutions for the RTGS and CSD systems, in consultation with the banking and securities-trading industry users of the systems. The Bank is also working with Datacom who are building and will support the related infrastructure on which the new software will operate.

- The Bank is reviewing its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future. The review is considering a number of options for the custody and distribution of currency. The Bank will consult and collaborate with key stakeholders during 2017-18 to ensure that the review’s recommendations are understood, supported and developed to viable implementation plans.

- The Bank’s treasury systems support two key policy functions: foreign reserves management (including currency intervention), and the implementation of monetary policy (liquidity management). Systems requirements have evolved significantly since the GFC and the Bank is currently updating key functionality. The Bank will complete implementation of a new Trade Valuation Solution partnering with Numerix Risk Solutions. This will improve the valuation of the Bank’s assets and liabilities and deliver the benefits of market-standard pricing, enhanced risk measurement, improved position and trade management, and increased business agility.
Governance issues and decision making

Appendix 6 briefly summarises the Reserve Bank’s current decision-making approach, and discusses some alternative approaches.

The Reserve Bank’s decision-making approach has continued to evolve since inflation targeting was first introduced in 1990. This has partly been in response to a widening of the Reserve Bank’s policy functions to include prudential supervision and macro-financial policy. It also reflects the Reserve Bank incorporating developments in international thinking on decision making, in particular by introducing the Governing Committee in 2014.

The Governing Committee currently comprises the Governor, Deputy Governor and Assistant Governor/Head of Economics, and is chaired by the Governor. It is responsible for all major economic and financial policy decisions taken by the Reserve Bank. The Committee receives information and proposals from separate advisory committees for monetary policy, macro-prudential policy, and prudential regulation.

During 2017, the Reserve Bank and the Treasury have discussed whether there are opportunities to enhance the decision-making process further. The Reserve Bank believes that its decision-making approach is sufficiently flexible to enable further evolution to occur as appropriate.

You have indicated your desire to review and reform the Act to broaden the Bank’s mandate to include an employment objective, and to adjust the Reserve Bank’s monetary policy decision-making structures, introducing external members into the committee. The governance model outlined in the Labour Party policy statement has a number of important properties to maintain integrity and independence of decision-making, which the Bank endorses. These include a majority of internal members and appointment of external members by the Governor following consultation with the Minister of Finance.

The Reserve Bank considers that some evolution in its decision-making approach may be appropriate. We recommend that the review of the RBNZ Act be limited to your stated change objectives. We consider a review along these lines could be completed reasonably quickly and we would be happy to prepare a draft terms of reference, in consultation with the Treasury. A variety of arrangements are possible and these are discussed, alongside the rationale for the Bank’s preferred model, in Appendix 6.

Other legislative changes that may be desirable over time include:

- Creating separate decision-making committees for monetary and financial policy.
- Clarifying the role of the Minister of Finance in macro-prudential policy decision making.
- Clarifying the role of the Minister of Finance in the management of a failing financial institution.

There are also a number of more minor technical amendments that would be useful to tidy up. We are happy to discuss with you the scope of possible RBNZ Act amendments and a schedule for their introduction.

Administration of RBNZ Act

The Reserve Bank is responsible for administering the RBNZ Act 1989, the Insurance (Prudential Supervision) Act 2010 and the Non-bank Deposit Takers Act 2013, along with associated regulations. The RBNZ Act establishes the Reserve Bank as New Zealand’s
central bank with the primary function of achieving price stability. Together, these pieces of legislation, along with the proposed Financial Markets Infrastructure Bill, comprise an integrated suite of legislated measures aimed at promoting a sound and efficient financial system.

In response to an independent submission, the previous Minister of Finance has sought advice on the appropriate responsibility for administering the RBNZ Act. An argument has been made that the Bank is not a government department and should not administer its own legislation. The Bank does not consider that administration of the Act should be transferred. The Bank is directly responsible to the Minister of Finance and legislative amendments are decided by Cabinet. The Bank notes that a recent review of the administration of the framework for secondary legislation by James Every-Palmer QC commissioned by the Treasury stated that “prudential provisions in legislation are highly technical and in my view should be prepared by the Reserve Bank”.2

Governance roles

- Graeme Wheeler’s term as Governor expired on 26 September 2017. Grant Spencer has been appointed Governor for the six months from 27 September 2017 to 26 March 2018. Mr Spencer will retire from the Bank on completion of his term.

- A recruitment process has begun to enable the Board to recommend a suitable candidate to you to appoint as Governor from 27 March 2018. The Chair, Professor Neil Quigley, will communicate with you separately on progress.

- A vacancy exists on the Board of Directors since Dr Rod Carr stepped down after completing his term in July 2017. A recruitment process has identified potential candidates for you. It is important that this position be filled to ensure that the Board has the appropriate balance of skills among its membership to support its review of the Bank’s performance in carrying out monetary policy and other functions.

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2 Every-Palmer QC, Dr James (2017) ‘Reserve Bank Prudential Regulation of Banks’:

“Recommendation #2: The prudential requirements should be drafted and made by RBNZ

“The prudential requirements are highly technical and in my view should be prepared by the Reserve Bank rather than by Parliamentary Counsel’s Office.

“For similar reasons, subject to the restriction set out in recommendation #9, I consider that the prudential requirements should be made by the Reserve Bank, rather than by a Ministerial decision or by the Governor General through an Order in Council.”
Operational matters and organisational structure

Funding

The Bank’s operational budget is subject to a Five-year Funding Agreement with Government. The current Funding Agreement covers the five-year period ending 30 June 2020, and provides funding of $66.3 million for 2017/18. [RBNZ Acts ss159-161]

Organisation

The Bank’s functions are generally conducted within departments, although a number of functions are managed across different departments, either by committees or through cross-department project management. The main committees are:

- **Governing Committee**

  The Governing Committee is responsible for all major economic and financial policy decisions taken by the Reserve Bank. The committee currently comprises the Governor, Deputy Governor, and Assistant Governor/Head of Economics, and is chaired by the Governor.

  **Membership**

  - Grant Spencer – Governor
  - Geoff Bascand – Deputy Governor and Head of Financial Stability
  - Dr John McDermott – Assistant Governor and Head of Economics

- **Senior Management Group**

  The Senior Management Group provides leadership to the organisation, oversees the operational policy and direction of the organisation, and ensures there is co-ordination between the policy and support departments.

  **Membership**

  Governing Committee plus
  - Sean Mills – Assistant Governor, Head of Operations (starts 13 November)

  and
  - Toby Fiennes – Head of Prudential Supervision
  - Stephen Gordon – Head of Currency, Property and Security
  - Mike Hannah – Head of Communications, Board Secretary
  - Bernard Hodggets – Head of Macro-Financial Stability
  - Patrick Hoerler – Head of Risk Assessment & Assurance
  - Lindsay Jenkin – Head of Human Resources
  - Mark Perry – Head of Financial Markets
  - Klarissa Plimmer – Chief Information Officer
  - Mike Wolyncewicz – Chief Financial Officer

- **Monetary Policy Committee**

  The Monetary Policy Committee assesses economic conditions and issues relating to the formulation and implementation of monetary policy. It advises the Governing
Committee on setting the OCR, and on currency intervention. It oversees delivery of the Bank's Monetary Policy Statement. There are 10 RBNZ staff members and two external members (Tony Caughey and Conor English) on the MPC.

- **Macro-Financial Committee**


- **Financial System Oversight Committee**

  The Financial System Oversight Committee oversees the development of policies related to the regulation and supervision of the financial system. It also analyses the efficiency of the financial system, having regard to financial system soundness and efficiency.

- **Assets and Liabilities Committee**

  The Assets and Liabilities Committee oversees the management and development of the Bank's balance sheet, including foreign reserves, capital, funding, and liquidity management, including the underlying risk management systems and processes.

- **Communications Committee**

  The Communications Committee agrees on the Bank's Communications Strategy, monitors its progress, identifies key stakeholders, agrees key messages, and confirms major engagements. It agrees content and timing for public communications, other than the MPS and FSR, which are determined in other committees.

Please see the latest *Statement of Intent* for further details of governance and organisational structure.
### Significant Powers and Functions under the Reserve Bank of New Zealand Act 1989

<table>
<thead>
<tr>
<th>Section</th>
<th>Powers</th>
<th>Governor</th>
<th>Board</th>
<th>Minister</th>
<th>Cabinet (Order in Council)</th>
<th>Other Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>Powers of Natural Person</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Determine Policy Targets</td>
<td>Agree</td>
<td></td>
<td>Agree</td>
<td></td>
<td>Gazette and tabled in House</td>
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<tr>
<td>12</td>
<td>Change Monetary Policy Objective</td>
<td></td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td>Gazette and tabled in House</td>
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<tr>
<td>16</td>
<td>Dealing in Foreign Exchange</td>
<td>✓</td>
<td></td>
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<tr>
<td>17</td>
<td>Direct Foreign Exchange Intervention</td>
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<tr>
<td>18/20</td>
<td>Fix Foreign Exchange Rates</td>
<td>May refuse</td>
<td>Decide</td>
<td>Required</td>
<td></td>
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<tr>
<td>22</td>
<td>Suspend Foreign Exchange Trading</td>
<td>✓</td>
<td></td>
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<td>To be advised</td>
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<td>24</td>
<td>Level of Foreign Reserves</td>
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<td></td>
<td>Determine</td>
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<td>25</td>
<td>Issue Currency</td>
<td>✓</td>
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<tr>
<td>26</td>
<td>Call in Currency</td>
<td>✓</td>
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<td>Consent</td>
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<td>32</td>
<td>Settlement Account Services</td>
<td>✓</td>
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<tr>
<td>34</td>
<td>Government Banking</td>
<td>Agree</td>
<td></td>
<td>Agree</td>
<td></td>
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<tr>
<td>35</td>
<td>Registry Services</td>
<td>✓</td>
<td></td>
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<tr>
<td>39</td>
<td>Various other Powers</td>
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<td>40</td>
<td>Appointment of Governor</td>
<td></td>
<td>Recommend</td>
<td>Appoint</td>
<td></td>
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<tr>
<td>43/45</td>
<td>Appointment/Removal of Deputy Governor</td>
<td>Recommend</td>
<td>Appoint/Remove</td>
<td></td>
<td></td>
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<tr>
<td>49</td>
<td>Removal of Governor</td>
<td></td>
<td>May Recommend</td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>63</td>
<td>Fees &amp; Expenses of Directors</td>
<td></td>
<td>May Recommend</td>
<td>Decide</td>
<td></td>
<td></td>
</tr>
<tr>
<td>73</td>
<td>Register Banks</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Gazette</td>
</tr>
<tr>
<td>SECTION</td>
<td>POWERS</td>
<td>GOVERNOR</td>
<td>BOARD</td>
<td>MINISTER</td>
<td>CABINET (ORDER IN COUNCIL)</td>
<td>OTHER PROCEDURES</td>
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</tr>
<tr>
<td>74</td>
<td>Conditions of Registration</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>77</td>
<td>Deregister Banks</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td></td>
<td>Gazette</td>
</tr>
<tr>
<td>81</td>
<td>Public Disclosure Statements</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>99</td>
<td>Bank may appoint Investigator</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>113</td>
<td>Give Directions to Banks</td>
<td></td>
<td></td>
<td></td>
<td>Consent</td>
<td></td>
</tr>
<tr>
<td>116</td>
<td>Approve sale of registered bank’s business to third party, bypassing need for regulatory consent</td>
<td>✓</td>
<td></td>
<td>Consent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>117</td>
<td>Statutory Management</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>119</td>
<td>Advisory Committee</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td></td>
<td>Gazette</td>
</tr>
<tr>
<td>123</td>
<td>Vest assets and liabilities of branch bank in newly incorporated company.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>132</td>
<td>Statutory manager may transfer bank in statutory management’s assets to a newly incorporated company.</td>
<td>Receive consultation</td>
<td></td>
<td>Consent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>144</td>
<td>Terminate Statutory Management</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>149</td>
<td>Advance to Statutory Management</td>
<td></td>
<td></td>
<td>Consent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>156ZA</td>
<td>Bank may decide application for designation by payments system.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td>Co-Regulator with FMA</td>
</tr>
<tr>
<td>156ZC</td>
<td>Bank may disallow proposed amendment to rules of a designated settlement system.</td>
<td>✓</td>
<td></td>
<td></td>
<td>Co-Regulator with FMA</td>
<td></td>
</tr>
<tr>
<td>156ZH</td>
<td>Bank may independently begin review of settlement system.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>159/160</td>
<td>Determine funding for the Bank.</td>
<td>Agree</td>
<td></td>
<td>Agree</td>
<td></td>
<td>Parliament ratifies</td>
</tr>
<tr>
<td>162</td>
<td>Surplus Income (Dividend).</td>
<td>Recommend</td>
<td>Advise</td>
<td>Decide</td>
<td></td>
<td>Tabled in House</td>
</tr>
<tr>
<td>167</td>
<td>Require performance audit.</td>
<td></td>
<td></td>
<td>Decide</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Significant Powers and Functions under the Anti-Money Laundering and Countering Finance of Terrorism Act 2009

<table>
<thead>
<tr>
<th>Section</th>
<th>Powers</th>
<th>Governor</th>
<th>Board</th>
<th>Minister</th>
<th>Cabinet (Order in Council)</th>
<th>Other Procedures</th>
</tr>
</thead>
</table>
| 131/132 | Monitor and assess the level of risk of money laundering and the financing of terrorism across all of the reporting entities that it supervises:  
Monitor the reporting entities that it supervises for compliance with this Act and regulations, and for this purpose to develop and implement a supervisory programme:  
Provide guidance to the reporting entities it supervises in order to assist those entities to comply with this Act and regulations:  
Investigate the reporting entities it supervises and enforce compliance with this Act and regulations:  
Co-operate through the AML/CFT Co-ordination Committee (or any other mechanism that may be appropriate) with domestic and international counterparts to ensure the consistent, effective and efficient implementation of this Act.  
The Bank has powers as necessary to carry out the above functions. | ✅ | | | | | |
# Significant Powers and Functions under the Insurance (Prudential Supervision) Act 2010

<table>
<thead>
<tr>
<th>Section</th>
<th>Powers</th>
<th>Governor</th>
<th>Board</th>
<th>Minister</th>
<th>Cabinet (Order in Council)</th>
<th>Other Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>Bank may grant a licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21(2)</td>
<td>Conditions of licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Cancel a licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>Issue fit and proper standards.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Gazetted and tabled in House</td>
</tr>
<tr>
<td>38</td>
<td>Bank may remove directors or relevant officers from appointment.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>49</td>
<td>Approve or refuse any amalgamation or portfolio transfer.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>55</td>
<td>Issue solvency standards.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td>Gazetted and tabled in House</td>
</tr>
<tr>
<td>108</td>
<td>Bank may bring High Court action to recover losses for policyholders.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>121</td>
<td>Require insurer to supply information.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>130</td>
<td>Bank may appoint investigator.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>143</td>
<td>Bank may give directions to insurer or associated person.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>151</td>
<td>Apply to High Court for liquidation.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>152</td>
<td>Apply to High Court to reduce value of contracts of insurance.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>153</td>
<td>Apply to High Court for voluntary administration.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>154</td>
<td>Approve appointment of voluntary liquidator.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>155-168</td>
<td>Participate in the liquidation of an insurer.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>170</td>
<td>Statutory Management.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>183</td>
<td>Sales of insurer business by statutory manager require approval.</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>SECTION</td>
<td>POWERS</td>
<td>GOVERNOR</td>
<td>BOARD</td>
<td>MINISTER</td>
<td>CABINET (ORDER IN COUNCIL)</td>
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</tr>
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</tr>
<tr>
<td>185</td>
<td>Vest assets and liabilities of branch insurer into newly formed company.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>191</td>
<td>Values of contracts of insurance may be reduced.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>197</td>
<td>Termination of Statutory Management.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
<tr>
<td>237/238</td>
<td>Recommend making of regulations, including the jurisdictions being prescribed for exemptions available under certain provisions.</td>
<td>Recommend</td>
<td></td>
<td>Decide</td>
<td>Required</td>
<td></td>
</tr>
</tbody>
</table>
## Significant Powers and Functions under the Non-Bank Deposit Takers Act 2013

<table>
<thead>
<tr>
<th>Section</th>
<th>Powers</th>
<th>Governor</th>
<th>Board</th>
<th>Minister</th>
<th>Cabinet (Order in Council)</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>14</td>
<td>Bank may grant a licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Conditions of licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Cancel a licence.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>43</td>
<td>Consent to change of ownership.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>44</td>
<td>Require trustee to attest to licensed NBDT's compliance.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>47</td>
<td>Require information from licenced NBDT.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>48</td>
<td>Require information from associated person.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>49</td>
<td>Require reports for investigatory purposes.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>50</td>
<td>Require trustee to provide information about licensed NBDTs.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>51</td>
<td>Production and search powers when offence suspected.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>56</td>
<td>Bank may direct licensed NBDTs or associated persons.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>57</td>
<td>Bank may direct trustees.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>60</td>
<td>Bank may appoint or remove directors of licensed NBDTs.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>70</td>
<td>Bank may exempt NBDTs from requirements under the Act or regulations.</td>
<td>✓</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>73</td>
<td>Recommend regulations for capital, liquidity, related party and credit ratings.</td>
<td>Recommend</td>
<td>Decide</td>
<td>Required</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX 2 CURRENT POLICY TARGETS AGREEMENT

Policy Targets Agreement (2017)
This agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand (the Bank) is made under section 9 of the Reserve Bank of New Zealand Act 1989 (the Act). The Minister and the Governor agree as follows:

1. Price stability
   a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.
   b) The Government's economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

2. Policy target
   a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.
   b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

3. Inflation variations around target
   a) For a variety of reasons, the actual annual rate of CPI inflation will vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.
   b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

4. Communication, implementation and accountability
   a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.
   b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate.
   c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.
APPENDIX 3 REGULATORY POLICY PROGRAMME

Project 1: Financial Market Infrastructures Bill

Ministerial role – action

The Reserve Bank and Treasury will provide advice on four specific areas of Cabinet report back in November. Subject to your approval, an exposure draft of the proposed Bill will be sought thereafter.

Problem definition

Financial Market Infrastructures (FMIs) can be subject to a number of market failures:

- **Negative externalities**: The scale of transactions handled by FMIs and their inherent interconnectedness with the financial system makes the potential knock-on effects of failure large and far reaching\(^1\). As an FMI does not bear all of the costs of its own failure, it may have insufficient incentive to appropriately manage the risks;
- **Co-ordination issues**: FMIs will focus on their own costs and benefits, potentially producing sub-optimal outcomes from a broader public interest perspective. For example, cost constraints at individual institutions may result in underinvestment in common technology or shared resources; and
- **Anti-competitive practices**: FMIs will often have quasi-monopolistic characteristics, potentially giving rise to club behaviour such as restricting system access.

The impact of market failure will be greatest for systemically important FMIs (SIFMs), whose disruption or failure could disrupt the operation of the financial system, and create solvency and liquidity problems for market participants.

In the event of a systemically important bank or other institution failing, FMIs can also act as the mechanism by which contagion risk is transmitted through the wider financial system.

Planned / completed consultations

Three rounds of public consultation were undertaken over 2013-16 on a proposed new oversight framework for FMIs, focusing on the regulation of FMIs that are systemically important to New Zealand.

Cabinet approved the adoption of a new legislative framework for the regulation of FMIs in April 2017. A Bill giving effect to this decision is currently being drafted. We anticipate an exposure draft of the Bill should be ready for public consultation within Q1 2018, although this timing is somewhat uncertain around the general election. Concurrently, policy work on several outstanding aspects of the framework the Agencies undertook to return to Cabinet for approval is progressing, and will be reflected in the exposure draft.

Draft advice on the four additional matters to be reported back to Cabinet will be shared with the Minister in November, and Minister’s approval to publish the exposure draft will be sought in due course.

Objectives

The immediate objectives of the Bill are to promote the maintenance of a sound and efficient

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\(^1\) New Zealand’s retail payment system, SBI, handles c$4 billion transactions per day, while the interbank payment system, ESAS, handles c$25 billion transactions per day.
financial system, and to avoid significant damage to the financial system that could result from the failure of an FMI or one of its participants.

Many of the powers under the Bill will be jointly exercised by the Financial Markets Authority, whose objectives will be to promote the confident and informed participation of businesses, investors, and consumers in financial markets, and promote and facilitate the development of fair, efficient, and transparent financial markets.

Policy proposal

In summary, the new legislative framework agreed by Cabinet will have the following features:

- The Reserve Bank and FMA would have information gathering power for all FMIs (not just payment systems) to identify potential systemic risks;
- An FMI that is identified as being systemically important would be required to be designated under a revised Designation Regime;
- The Reserve Bank and FMA would have enhanced oversight powers for designated FMIs, including powers related to setting regulatory requirements, overseeing FMIs’ rules, investigative and enforcement powers;
- Reflecting the diversity of the sector, and in order to keep compliance costs low, the proposed powers under the revised Designation Regime would be applied differently for different FMIs, depending on their level of systemic importance, level of New Zealand presence and their legal form;
- The currently designated payment and settlement systems that have voluntarily opted into the regime could continue to seek legal protection for netting and settlement under the revised Designation regime. Other new non-systemically important FMIs would also be able to opt-in to the designation regime for these purposes.
- There would be a crisis management regime for FMIs in serious difficulties, including compulsory directions from the regulators and, ultimately, the ability to place a FMI in statutory management.

Further Cabinet decisions will also be sought on four discrete technical issues: whether Ministerial consent should be required before the joint regulators can issue a direction to a designated FMI; whether regulatory requirements should be imposed via standards or conditions; whether there should be a statutory stay on termination rights; and appropriate safeguards around the power of a statutory manager to depart from the ranking of creditors.

Efficiency and innovation impacts

The new framework is designed to avoid adverse impacts on efficiency and innovation by ensuring that regulatory interventions are proportionate (by being focused on systemic FMIs), and compliance costs minimised (through the use of principles-based requirements that allow individual FMIs to design the most efficient means of compliance). The framework may also promote financial system efficiency by giving the joint regulators stronger powers to encourage wider access arrangements and support co-ordination initiatives in shared infrastructure or technology.

Likely stakeholder reactions

There is a high level of support for a more robust legislative framework for FMI regulation. Industry is likely to have an ongoing concern about minimising compliance costs as the framework is implemented.
Project 2: OTC derivatives

Ministerial role – action

The Reserve Bank and MBIE will summarise the responses to the recent consultation and make recommendations to you and the Minister of Commerce as to next steps. It is highly likely that legislative change will be recommended, so Cabinet will need to give approval. We expect to report to you on this matter before Christmas.

Problem definition

New G20 rules require significant derivative market participants to exchange collateral, or ‘margin’, on transactions not executed through a centralised exchange nor cleared through a central clearinghouse (‘uncleared OTC derivatives’) to protect against current and potential future credit exposures arising from a counterparty’s default. Although derivative margin requirements are not planned for NZ at this stage, other jurisdictions’ rules have a wide cross-border reach, capturing New Zealand entities either directly as part of a foreign-owned banking group, or indirectly where they trade with a covered foreign counterpart. We expect all big 4 NZ banks to be captured by foreign margin requirements in 2018.2

However, certain features in NZ law may prevent NZ entities complying with foreign rules and emerging market practice around derivative margin exchange. In particular, statutory moratoria on creditor rights in liquidation, administration, or statutory management3 could prevent collateral being promptly available in the event of a default, at the same time as established creditor priority regimes4 could subordinate derivatives counterparties and compromise their claim to any pledged collateral.

Without prompt and certain access to margin, foreign participants may be unwilling or unable to transact with NZ banks, cutting off access to important financial products and threatening the viability of foreign funding programmes that rely on uncleared ‘basis swaps’ to hedge associated currency risks5. More broadly, restricted NZ access to deep liquidity pools in key foreign markets like the US and EU may place upward pressure on the cost of domestic credit, and adversely impact the efficiency and soundness of NZ’s financial sector.

Planned / completed consultations

Since late 2016, the Reserve Bank and MBIE, in collaboration with Treasury, have been engaging with industry and official stakeholders to assess the likely domestic impact of foreign margin requirements. In July the Reserve Bank and MBIE released a joint consultation document exploring the need and scope for targeted legislative amendments to support margin arrangements in line with international requirements and expectations. Submissions closed on 24 August. Six submissions were received, representing a wide cross-sector of stakeholders including the banking, financial market, insolvency, and legal sectors. The Reserve Bank and MBIE are currently considering responses, as well as engaging with stakeholders to further explore several issues raised through the process.

Based on the outcomes of the consultation and ongoing discussions with affected stakeholders, a draft final policy proposal and Regulatory Impact Statement will be prepared.

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2 ANZ NZ was captured from September 2017. ASB, BNZ and WNZL will likely be captured from September 2018. Domestically-owned NZ banks fall below de minimis thresholds to be covered by the rules, based on current activity.
3 As set out in the Corporations (Investigation and Management Act) 1989, the Reserve Bank of New Zealand Act 1989, and the Companies Act 1993.
4 As set out in the (Personal Property Securities Act 1999 (PPSA) and the Companies Act 1993.
5 These programmes currently make up around 15 per cent of banking sector non-equity funding, with around NZ$50bn of non-NZD offshore funding outstanding.
for Cabinet’s approval. We expect this to be completed by end 2017.

Objectives

The Reserve Bank and MBIE recognise the importance of supporting NZ entities’ ability to enter into robust and compliant margin arrangements with their foreign derivative counterparties. At the same time, the Reserve Bank and MBIE are cognisant that altering the treatment of NZ entities’ derivative counterparties in order to facilitate margin compliance will have implications for the rights of other stakeholders: deviating from existing and established preference arrangements and insolvency processes for a particular class of creditors may have wider unintended knock-on consequences. In light of this, the consultation explored the specific areas of New Zealand law that might impede the prompt and certain enforcement of derivatives margin, considered legislative changes that may be necessary to address these impediments, and sought stakeholders’ views on how any such legislative changes should be designed to minimise unintended circumstances or knock-on consequences for other laws and policies.

Policy options

The consultation document considered two broad options:

- **Option A – Status Quo**: NZ banks do comply with (or have been given a waiver from) margin rules in certain jurisdictions absent legislative change, most notably Australia. However, NZ entities face significant market-based barriers in many key trading jurisdictions, including the US and EU.

- **Option B – Targeted legislative change**: Pre-consultation stakeholder engagement identified several specific impediments in NZ law to margin arrangements, in particular statutory moratoria, Companies Act preferential claims and other priority rules in the PPSA. Views were sought on whether addressing these, or any other, issues was necessary and sufficient to achieve compliant margin arrangements.

Efficiency and innovation impacts

NZ banks’ inability to comply with the margin rules could lead to reduced access to offshore derivatives products and counterparts, and increased concentration risks, hedging complexities, and funding costs. Ensuring NZ banks can comply with the margin requirements and expectations of their foreign counterparts will protect the competitiveness of NZ banks within the global financial system, bolster the efficiency of our financial markets, assist in the effective mitigation of risks, and promote the soundness and stability of the financial system as a whole.

Likely Stakeholder reactions

Respondents to the consultation were strongly supportive of a policy response to address legal impediments to margin exchange and enforceability, whilst raising some specific concerns over the scope (narrowly capturing uncleared OTC derivatives transactions subject to margin requirements, rather than a broader range of collateralised transactions) and form of the proposed legislative amendments (targeted amendments to existing legislation, rather than through separate, standalone legislation). Stakeholder engagement to further explore these issues is ongoing, and will feed into the final policy proposal.

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6 Personal Property Securities Act 1999 (PPSA).
Project 3: IMF’s 2016 Financial Sector Assessment Programme (FSAP)

Ministerial role – decision

The Reserve Bank will shortly advise you of the proposed modifications to its supervisory model as a result of the FSAP recommendations, the business rationale for these and the resource adjustments sought.

Background

Over the course of 2016 the IMF undertook its FSAP review of the New Zealand financial system – in the form of two ‘missions’ conducted in August and November. An FSAP is a key part of the IMF’s surveillance of individual member countries and involves an evaluation of financial sector resilience, an assessment of the quality of the regulatory and supervisory framework, and an evaluation of the capacity to manage and resolve financial crises.

New Zealand has had one previous FSAP in 2003/04. The 2016 FSAP was therefore a timely opportunity for New Zealand to be benchmarked against international standards, particularly in light of the significant changes in New Zealand’s regulatory landscape since 2004. These changes – some of which can be traced to recommendations from the previous FSAP and others to factors such as the Global Financial Crisis (GFC) – have included the expansion of the perimeter of prudential regulation to include insurance and non-bank lending institutions, the development and implementation of a bank resolution framework, the implementation of new solvency and liquidity standards for banks, and the operationalisation of macro-prudential policy.

Cabinet paper

In April this year a Cabinet paper from the inter-agency FSAP Steering Group (comprising the FMA, MBIE, Reserve Bank and the Treasury) summarising the results of the two FSAP missions was discussed at the Cabinet Economic Growth and Infrastructure (EGI).

The Cabinet paper noted each agency’s initial response to what were then draft and unpublished recommendations, and that agencies will report on a quarterly basis to you and the Minister of Commerce and Consumer Affairs on progress in the consideration and implementation of the FSAP recommendations.

IMF publishes the outcomes of the New Zealand FSAP

The IMF released the findings and recommendations in the second week of May – the main report, and accompanying IMF press statement, was released on 9 May (NZ time) and the 7 individual FSAP reports were released 2 days later. Publication by the IMF followed discussion at their Executive Board meeting on the 3rd of May, alongside the annual Article IV report for New Zealand. Your office, together with the Reserve Bank and the FMA, coordinated the release of press statements in response to the publication of the main FSAP report on 9 May. The Treasury was also involved in this coordination, but did not release a statement.

Subsequent media coverage focussed on a number of the FSAP’s findings, including the extended de minimis proposition as an alternative to deposit insurance; the recommendations around strengthening the macro-prudential regime; more intensive supervision to support the Reserve Bank’s three-pillar approach to regulation and supervision; and gaps in New Zealand’s approach to insurance conduct regulation.

The Reserve Bank released a Bulletin article in July explaining the FSAP findings in more
detail and outlining the Reserve Bank’s initial reaction. Agencies prepared the regular quarterly reporting on post-FSAP work as outlined in the FSAP Cabinet paper discussed at EGI on 12 April. However, with the timing of the election this report will now be submitted at a later date.

**Next steps**

The Reserve Bank will report to you in Q4 with a business case for modest increased resourcing in response to the FSAP findings. This will set out options and the business rationale for any increase. It should be noted that the likely proposed increased resources, while manageable within the current Reserve Bank Funding Agreement, have implications for the future Funding Agreement. We would be coming to you to give you full line of sight, and to ensure that you are comfortable with the supervisory model, and associated resourcing, given that it is proposed for the long term.
Project 4: Review of capital requirements for banks

Ministerial role – consultation

The Reserve Bank will provide public consultation papers to you two weeks ahead of proposed release for your feedback.

Problem definition

Given developments both internationally and domestically we are reviewing whether the capital regime we administer ensures banks in aggregate and individually hold an adequate level of capital given the risks they are exposed to.

Planned / completed consultations

On 1 May the Reserve Bank released the first consultation paper of the review, a high-level issues paper that proposed a set of issues to be considered in the review and outlined some of the arguments that could be made about each issue. Submissions on the document closed on 9 June. We are currently analysing the submissions.

The issues paper divided the review into three parts, dealing with the definition of capital (the ‘numerator’ aspect, given that capital is the numerator in the capital ratio calculation), the measurement of risk (the ‘denominator’ aspect), and the ratio itself. A second consultation paper, outlining issues and reform options relating to the definition of capital (the numerator), was published on 14 July. Submissions closed on 8 September.

The numerator paper will be followed by a denominator paper, and then a capital ratio paper, later in the year. As a set, these documents will provide detailed analysis of key issues and present concrete options for change.

Once the general direction of reform, if any, has been confirmed following public consultation, further discussion documents, addressing detailed design issues, will be published.

Consultation documents will be provided to the Minister for comment, in advance of publication (we expect the next document will be provided in November). We expect to conclude the review in the first half of 2018. The Reserve Bank will advise the Minister before final policy decisions are taken.

Objectives

The aim of the review is to identify, and calibrate, the most appropriate framework for setting capital requirements for New Zealand banks, taking into account how the current framework has operated, international developments in bank capital requirements, and the impact that any changes will have on soundness and efficiency.

Policy options

For the parts of the review dealing with the denominator and the overall capital ratio, no specific options have been proposed at this stage. However, the 1 May issues paper did say that the Reserve Bank would look at:

- the extent to which the four largest banks should continue to use their own models to determine the risks they face, and whether or not there should be restrictions on model inputs or outputs;
whether or not the standardised approach for determining risk, used by all banks except the four largest banks, could be made more sensitive;
whether or not the internal model and standardised approaches are producing outcomes which are similar enough;
whether current minimum capital ratios are sufficiently conservative, and whether the mix of different kinds of capital (e.g. common equity vs. convertible debt) is appropriate; and
whether the minimum capital ratios, which are risk-weighted ratios, should be supported by other requirements such as a simple (not risk-weighted) leverage ratio requirement or additional layers of loss-absorbent funding.

Convertible instruments

The Reserve Bank currently recognises convertible instruments as capital. Specific options for reform in this area were canvassed in the second paper released on 14 July. Options include:

- retaining the current definition of capital but recognising only the after-tax value of convertible instruments, either requiring a mandatory reduction for tax, or requiring a reduction if a comprehensive tax ruling indicates there will be a tax charge (current requirements include a tax ruling but in practice the scope of rulings appear not always to have been comprehensive);
- recognising only those convertible instruments that are written off in a crisis but not those that have the added feature of compensating for write off with newly issued shares;
- not recognising any convertible instruments as capital but allowing vanilla subordinated debt instruments to qualify as tier 2 capital (this is our preferred option); and
- not recognising any subordinated debt (convertible or otherwise) as capital (i.e. an ‘equity-only’ regime).

The Reserve Bank stated that its preferred option was to simplify the regime by excluding from capital all capital instruments except ordinary shares, perpetual non-convertible preference shares, and subordinated non-convertible debt.

Efficiency and innovation impacts

In setting capital requirements the Reserve Bank recognises the need to balance the benefits of higher capital against the costs. It is expected that a higher level of capital would reduce the probability and severity of bank failures and would smooth out credit cycles. But banks typically argue that capital is a costly source of funding and that if they had to seek more of it they would need to pass on costs to customers, leading to reduced investment and growth. The review will seek to properly balance these impacts.

Stakeholder views

In consultation to date, banks have argued against options that limit the recognition of convertible instruments as capital for regulatory purposes. They see convertible instruments as a cheaper and therefore more efficient form of capital funding than common equity (interest rates on these instruments are closer to interest rates on debt than typical equity returns).

The largest banks have also argued against restrictions on the use of internal models for determining risk (in general, the use of internal models has led to lower capital requirements).

Banks have urged the Reserve Bank to be cautious about increasing minimum capital
requirements, arguing that New Zealand’s rules are already conservative by international standards.
Project 5: Dashboard approach to quarterly disclosure

Ministerial role – inform

The project is in the technical implementation phase and the Reserve Bank will inform you of progress.

Problem definition

Late in 2015 the Reserve Bank completed its regulatory stocktake of the prudential requirements for banks and non-bank deposit takers. The aim of the stocktake was to improve the efficiency, clarity and consistency of the prudential requirements for banks and NBDTs. As part of the stocktake, the Bank looked closely at the disclosure requirements for banks. Effective disclosure is critical to market discipline, which is a key pillar in the Reserve Bank’s approach to prudential regulation.

The Bank found that while public disclosures made by banks under the prudential regime largely achieve their objective, some of these disclosures could be made in a more timely, accessible and comparable manner, which in turn would enhance market discipline. The Bank believes that a new ‘Dashboard’ approach to quarterly disclosure will provide these benefits, and possibly at a lower cost to banks.

Policy options and proposal

The Dashboard is our preferred high level option for changing the existing disclosure regime. While there are a number of different options around the specific design and content, the proposed Dashboard is envisioned to provide a side-by-side comparison of locally incorporated banks according to key metrics (such as credit ratings) hosted on the Reserve Bank’s website and updated quarterly with a reduced time lag compared to when disclosure statement information is currently published.

An alternative high level option for changing the existing disclosure regime was to scale back the content of off-quarter disclosure statements to summary capital and asset quality disclosure along the lines of that specified for off-quarters in Pillar 3 of the Basel framework.

Planned / completed consultations

We released a public consultation document on the two policy options in late 2016, and published a summary of submissions on this consultation in February this year. Based on our consideration of submissions and further analysis, we concluded that the Dashboard remained our preferred option (as it better promoted market discipline and provided additional efficiency gains). However, we also acknowledged a number of issues raised by submitters which required further analysis. These included how to ensure banks retain some control of published data, timeframes for publishing data on the Dashboard, and various matters around the specific content of the Dashboard.

We held workshops with banks in May and August to discuss these matters. These workshops have allowed us to finalise precisely how the Dashboard will operate and the specific data that it will contain. We published the final policy decisions on the Dashboard approach for quarterly disclosures on 21 September.

We are also undertaking preliminary work on a project to operationalise the Dashboard (this will include the design of the underlying IT infrastructure and administrative process, and the Dashboard webpages themselves). This project is likely to involve further engagement with
potential Dashboard users, and trials of the Dashboard publication process with banks. The target date for the first publication of the Dashboard is end-May 2018.

**Efficiency and innovation impacts**

The Dashboard is likely to have positive efficiency and innovation impacts, especially from the perspective of the consumer. In particular, it could encourage greater analysis of disclosures made by banks, and encourage new ways of carrying out this analysis and presenting it to depositors and the broader market. Compliance costs would be kept to a minimum as the Reserve Bank proposes to draw to a large extent on information that banks already prepare or will have to report to us privately.

**Likely stakeholder reactions**

Based on the feedback received to date, there is a high level consensus amongst stakeholders that improving the effectiveness of the disclosure regime is an appropriate objective.

Banks are supportive of the overall Dashboard concept, but concerned to ensure that the design of the Dashboard minimises compliance costs, and that there are reasonable timeframes set for implementation.

Other stakeholders are generally highly supportive of the Dashboard.
Project 6: IPSA review

Ministerial role – decisions

The Reserve Bank intends to issue a series of consultations over the next 18 months, aimed at improving the Insurance (Prudential Supervision) Act 2010 (IPSA). We will fully engage with you, and you will be asked to approve each consultation paper, given that it is primary legislation under consideration. Following consultation, you will need to seek Cabinet approval for any proposed changes.

Problem definition

The Reserve Bank has initiated a comprehensive review of IPSA. The Terms of Reference were released in April 2016. We consider that the current legislative purposes of IPSA remain appropriate. However:

- there are a number of areas where the legislative framework could be reviewed with a view to enhancing cost effective regulation and supervision, and minimising compliance costs whilst maintaining, or enhancing, the soundness and competitiveness of the insurance sector;
- the IMF FSAP assessment of New Zealand’s insurance regulatory framework makes a set of recommendations to improve the alignment of the regulatory framework and supervisory approach with current international standards that should be assessed;
- industry participants have raised areas of concern with the current legislative framework or its application; and
- the Reserve Bank has previously advised Cabinet that it would undertake a comprehensive review of IPSA once operational experience had been gained with the Act.

Planned / completed consultations

The Review will be undertaken in 3 phases and each phase will include extensive stakeholder consultation:

Phase 1: Issues Paper released for consultation

The Bank released an Issues Paper on 30 March 2017 for consultation. The paper sets out 11 broad areas the Reserve Bank has identified that may warrant further consideration during phase 2 of the Review. These areas reflect the comprehensive nature of the Review and include the:

- scope of business and entities subject to regulation and supervision;
- regulation and supervision of overseas insurers operating in the New Zealand market;
- framework for statutory funds and other policyholder protection mechanisms;
- requirements and expectations of key role holders and functions within insurance firms;
- enforcement regime and distress management powers;
- framework related to requirements for minimum financial resources (solvency framework);

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7 Following consideration by Cabinet (EGI-16-MIN-0018 and CAB-16-MIN-0072 refer).
8 Advice to Cabinet Economic Growth and Infrastructure Committee on 27 June 2012.
• supervisory processes including the appropriateness of regulatory approval regimes; and
• disclosure and financial strength rating requirements.

The paper sought stakeholders’ views on these areas and asked if there were any other areas that should be considered within the Review. Consultation on the Issues Paper closed on 30 June 2017.

Discussion forum

Discussion forums on the Issues Paper were held during May 2017 in Auckland and Wellington. In total, around 200 people registered to attend the sessions. Attendees appreciated and supported the consultative approach and provided us with a good feel for some of the matters they were likely to raise in submissions – there was a focus on the legislation’s coverage, and in particular the place of overseas insurers.

Consultation Feedback

Forty-two submissions were received in response to the Issues Paper. In broad terms, stakeholders consider that IPSA and the Bank’s prudential supervision have improved the soundness of the insurance sector and does not impose inappropriate compliance costs or unduly restrict competition and innovation. However, stakeholders also broadly agree that there are opportunities to improve the framework’s effectiveness and, in some areas, reduce compliance costs. Stakeholders therefore support the review and the 3 phased consultative approach adopted.

Stakeholder comments largely focused on the legislation’s coverage and in particular the ability to adapt to technological developments and new business models, the treatment of overseas insurers, the disclosure framework and the Bank’s approach to supervision, with some support expressed for the IMF’s recommendations.10

Phase 2 analysis and consultation

Phase 2 of the Review will include more detailed consideration of the issues identified, as informed by the submissions made on the Issues Paper, to ensure that any policy concerns are understood. This phase will also consider the relevant recommendations of the IMF FSAP assessment where appropriate. Options to address any policy concerns identified will be developed during this phase.

It is expected that Phase 2 will take place over the next 12 to 18 months with a series of consultations to ensure that potential policy concerns are understood and that options to address them are well targeted. We will consult you as we go through the process.

Policy options / policy proposal

As noted above, Phase 1 of the Review is focused on the identification of potential concerns for consideration during Phase 2. During Phase 2, any identified policy concerns will be considered and options and proposals to address these concerns developed. This work will be supported by stakeholder consultation. No options have been proposed at this stage.

10 Stakeholder submissions have been published on the Reserve Bank website unless confidentiality was requested.

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Efficiency and innovation impacts

The Review will enable consideration of ways in which the legislative framework may be amended to reduce unnecessary compliance and administrative costs and avoid inappropriate barriers to innovation, whilst maintaining or enhancing an appropriate balance with the policy objectives of a sound and efficient insurance sector and public confidence in the insurance sector.

Likely Stakeholder reactions

At this stage of the Review, stakeholder feedback has expressed interest in and support of the Review process and the consultative approach undertaken to date.

As noted above, feedback on the Issues Paper has particular commentary on the legislation’s scope and the treatment of overseas insurers. Stakeholders note a need for the framework to recognise and adapt to the changing nature of the insurance sector from technological applications and the potential for new business models, the continued or enhanced support to the participation of reinsurance firms in the New Zealand market, and providing appropriate protections for New Zealand interests where overseas firms are in difficulty. There are wide ranging views on how these objectives are best achieved. No proposals have been put forward at this stage, and the issues will be considered more fully in Phase 2 of the Review.
Project 7: Depositor protection/De Minimis

Ministerial role – decision

The Reserve Bank and Treasury will seek final decisions from you on depositor protection and changes to the crisis governance framework in legislation.

Problem definition

The current regulatory and supervisory framework is based around a non-zero but low probability failure event. However, bank failures, particularly systemic failures, can significantly affect not just the stability of the financial system, but also of the real economy and the fiscal position. The Open Bank Resolution (OBR) policy enables authorities to manage the failure of a large bank and to impose the losses on shareholders and creditors in the first instance. As such, it is a key tool in limiting fiscal risk caused by a bank failure by providing a credible alternative to taxpayer-funded bailouts. The current base policy settings for OBR anticipate that all unsecured creditors would incur losses proportionate to the size of their deposit, but that small depositors up to a certain de minimis level (currently unspecified) will be protected from losses.

Policy proposal

Work is underway to develop an enhancement to the level of protection by pre-announcing a de minimis at $10k per depositor. This limit would provide full protection to around 80% of depositors. The enhanced de minimis model seeks to address potential concerns around the willingness of a government to use OBR by allowing a higher proportion of depositors to be fully protected from losses. Under this model, all depositors benefit from the de minimis allowance, but in practice, the (full) protection for small depositors is funded through the imposition of marginally higher losses on the largest creditors. As a result, no direct fiscal exposure is created.

Objectives

The Reserve Bank registers and supervises banks for the purposes of promoting the maintenance of a sound and efficient financial system; or avoiding significant damage to the financial system that could result from the failure of a registered bank. Depositors’ interests are recognised indirectly through enhanced stability, rather than through an explicit depositor protection objective, whilst recognising that there are political challenges associated with imposing losses on depositors. Thus, the arguments for revisiting existing settings are mainly around (a) the uncertainty of depositor protection arrangements, i.e. an unspecified amount for the de minimis and (b) the political palatability of imposing losses on depositors. Work is being undertaken to provide clarity as to the trade-offs in adopting an enhanced de minimis of up to $10k per depositor and the potential distortions that may result from the announcement of a de minimis threshold for OBR banks only, and how those distortions may be best addressed. Whilst the IMF continues to view large scale deposit insurance as a first best solution, they were supportive of the enhanced de minimis model as an alternative.

Efficiency and innovation impacts

Limiting depositor protection avoids inefficiency in the financial system by maintaining strong incentives on stakeholders and mitigating moral hazard. The final design features of the enhanced de minimis mechanism will largely determine the costs banks may incur in adapting their systems to deliver the enhanced de minimis functionality.
Planned consultation

Consultation on the cost and benefits of the enhanced *de minimis* as the preferred model to deliver deposit protection, having regard to the current regulatory framework and the concentrated nature of the banking system, will be undertaken. The matter of ‘why not deposit insurance’ will be explained by way of assessing against parameters such as (i) enhancing the political palatability for OBR; (ii) incentives on depositors/effects on market discipline; (iii) potential increase in fiscal risk; (iv) upfront costs to the banks to introduce and maintain the functionality; (v) BAU costs on consumers, etc. A paper is currently being drafted to seek Cabinet approval for the Reserve Bank to commence consultation on the model. A draft of this paper is expected to be shared with the Minister early in Q4 2017.

Likely stakeholder reactions

The proposals would be sufficient to ensure that around 80% of New Zealanders are fully protected from the effects of bank failure, based on a high-level analysis of existing deposit holdings. However, it is expected that the public reaction would be driven by wealthier depositors who tend to hold large bank deposits, and would prefer the introduction of full scale deposit insurance as it has the potential to deliver much higher coverage limits. In practice, higher levels of protection would be available under the *de minimis* model to any depositor who proactively manages their exposure to the banking sector (i.e. splitting funds across more than one bank).

Meanwhile providing clarity on the level of protection compared to the status quo enhances the credibility of the regime and would be welcomed by creditors and markets, in general. Because no premiums will be collected, banks would likely be more open to the scheme, despite the potential costs that may be incurred to accommodate the enhanced *de minimis* functionality. Some small banks can be expected to campaign for inclusion in the scheme, as could NBDTs, should it be decided that the *de minimis* arrangements will not be extended to NBDTs.
Project 8: Macro-prudential Policy

Ministerial role – consult

The Reserve Bank will consult with you on the outcome of the recent consultation on the possible inclusion of a DTI instrument in the macro-prudential toolkit. The Bank and the Treasury will discuss a draft terms of reference for the review of macro-prudential policy required under the Memorandum of Understanding.

Meanwhile, the Bank will continue to administer the existing MoU and report on LVR settings as part of the November Financial Stability Report.

Problem definition

The global financial crisis showed that lenders do not always have the incentives to take into account all of the risks to the wider economy generated by their lending. One example is that a boom-bust cycle in mortgage lending can lead to a costly economic downturn, even if the losses to most individual mortgage lenders are manageable.

Objectives

Macro-prudential policy in New Zealand is conducted to achieve objectives set out in a memorandum of understanding (MoU) between the Reserve Bank and the Minister of Finance, which was signed in May 2013. The MoU establishes the objectives, processes and instruments for macro-prudential policy. While the Reserve Bank has the existing legal powers to use prudential tools in a cyclical fashion, it was considered appropriate to set out the framework in a public document given the new nature of this form of prudential policy, which has become prominent following the GFC. The MoU establishes that the Reserve Bank initiates any macro-prudential policy action, but only after consultation with the Treasury and Minister.

Macro-prudential policy (quoting from the MOU) aims to “increase the resilience of the domestic financial system and counter instability in the domestic financial system arising from credit, asset price or liquidity shocks”.

Policy options

LVR restrictions have been in place since 2013 and are expected to be retained until there has been a sustained stabilisation in house prices and credit. The policy has reduced the accumulation of risky loans on bank balance sheets. The housing market has slowed over 2017 and new lending volumes have declined, partly reflecting the tightening of restrictions on investors in October 2016. However, loans are still being made at elevated debt to income ratios (DTIs). The RBNZ has suggested that limits on DTIs could be a useful option in the macro-prudential toolkit. The Bank has not proposed that DTIs be used in the near term, even if added to the MoU. In the meantime, we are continuing to work with the banks to improve DTI data, and could consider the use of a DTI tool in the future if DTIs remain stretched and the housing market re-accelerates.

Planned / completed consultations

A consultation paper on the possible inclusion of a DTI instrument in the macro-prudential toolkit was released in June and submissions closed in August. The Bank is currently analysing responses, and will report to you on the summary of submissions before releasing it to the public. Given additional work that is required on the nature of a possible DTI instrument, the Bank proposes deferring its consideration for inclusion in the toolkit until the
MOU review.

Further out, the MOU stipulates that a review of the overall framework be undertaken in 2018 (five years after the signing of the agreement). We have been discussing a possible terms of reference for the review with the Treasury and would expect to discuss a draft terms of reference with you in due course.

Efficiency and innovation impacts

While macro-prudential tools are designed to enhance financial system resilience, they can impose efficiency costs on the financial system. One form of inefficiency is that instruments such as LVR or DTI restrictions can restrict home purchases by owner occupiers, including first home buyers. These instruments can lead to greater borrowing from non-bank sources although this lending market is very small in New Zealand (despite the ongoing LVR restrictions). The efficiency costs must be weighed carefully against the benefits to financial resilience when proposing and calibrating the use of such instruments.

Likely Stakeholder reactions

Banks have emphasised their internal risk management policies, which limit the LVR of borrowers and test the adequacy of their income to service the loan (even if interest rates rise somewhat from current levels), and question the need for additional controls. If a DTI policy was introduced, it could also be controversial with affected borrowers, although our sense (from experience with LVRs) is that many people understand the need for prudent mortgage origination.
Project 9: Stress testing

Ministerial role – inform

The Reserve Bank will keep you informed via our regular FSI meetings and briefings of findings from this round of bank stress tests.

Problem definition

Banks are required to consider how their institution would handle severe macroeconomic downturns (‘stress testing’) as part of determining that they are adequately capitalised. The Reserve Bank emphasises bank-run tests (other regulators obtain very detailed data from banks and place more emphasis on the results they calculate themselves).

In late 2014, The Reserve Bank investigated the methodologies major banks use to do stress-testing and identified a range of areas for improvement. These areas included the processes used to govern the stress tests, the quality of models and a range of technical issues. A challenge for New Zealand stress testing is that the stability of our banking system in recent years makes it more difficult for banks to model how they could be affected by systemic stress.

Objectives

Our key objectives in this area are to promote good stress testing practices, raise the stress testing capability of the NZ banks, develop insights into potential systemic risks, and thereby help maintain confidence in the banking system.

Our focus in recent years has been on the major banks, but we aim to work more with the smaller banks when resources permit.

Policy options and proposal

The Reserve Bank has published a stress-testing guide after consulting the major banks. We will now monitor progress and continue to ask the major banks to run stress tests based on scenarios we design at least annually. Focused tests of key portfolios (like the recent dairy lending test) have also provided valuable information and have promoted best-practice model development.

The Reserve Bank typically conducts a stress tests of the major banks annually. Recently, the Bank has worked with the IMF FSAP team to conduct additional model-based stress tests of the New Zealand banking system. The results of the stress tests generally indicate that solvency and liquidity of the banking system can withstand adverse and severe macroeconomic shocks. Tests are discussed with the Treasury and your office as part of discussions on risks to the financial system, and results for the banking system as a whole are generally published.

Stress tests will be used in the capital review, but the system withstanding a macroeconomic stress event does not prove that all banks are adequately capitalised. Capital must also be held to withstand bank-specific adverse shocks.

Efficiency and innovation impacts

Stress testing has resource costs. The Reserve Bank aims to mitigate these by working where possible in conjunction with APRA (since APRA requires stress testing of NZ assets when the parents are tested), and by encouraging banks to use analytical tools for stress
testing that also give them useful business and risk management intelligence, rather than treating it as a 'compliance activity'.
Project 10: Thematic Review of Bank Directors’ Attestation Regime

Ministerial role – inform

The Reserve Bank will keep you informed via FSI meetings and briefings of its responses to the review of the bank directors’ attestation regime, with a possible report in Q4 2017. There is likely to be some implication for the Bank’s response to the FSAP review.

Background

The Reserve Bank’s approach to regulation and supervision of registered banks emphasises the role of directors in managing their bank’s risks (self-discipline) and in ensuring that market participants have the appropriate information, incentives, and mechanisms to influence the banks’ behaviours in a way that contributes to a sound and efficient banking sector (market discipline). The directors’ attestation regime is a key mechanism used by the Reserve Bank to promote self-discipline and market discipline. Currently, directors are required to attest in their quarterly published disclosure statements that after due enquiry, they believe that:

i) the disclosure statement contains all the required information and is accurate;
ii) all of the bank’s conditions of registration have been complied with;
iii) credit exposures to connected persons were not contrary to the interests of the bank; and
iv) the bank had systems in place to monitor and control adequately the material risks of the banking group and that those systems were being properly applied.

In the IMF’s 2017 New Zealand Financial Sector Assessment Programme (FSAP) report, the IMF noted the Reserve Bank’s significant reliance on directors’ attestations, to ensure that the bank has adequate risk management systems in place. The IMF also pointed out that although the first three attestation statements above (i-iii) are supported by detailed policy guidance, the Reserve Bank has issued limited guidance regarding what constitutes adequate risk management arrangements. In the absence of guidance, there is a risk that across the banking system, directors may be attesting to different standards.

Objectives and Methodology of the Review

The Reserve Bank decided to undertake a review of the bank directors’ attestation regime, commencing in April 2017, to assess the regime’s effectiveness, improve understanding of banks’ approaches to governance, and gain further insights on some of the concerns that the IMF raised in the 2017 FSAP review.

The Reserve Bank sub-contracted Deloitte Consulting to assist with the review. The review is now finished and was conducted in four parts: 1. a survey of all directors of the 15 locally-incorporated banks, 2. a desk-based documentation review for 11 selected banks, 3. interviews of directors, senior managers, and auditors of the 11 selected banks, and 4. workshops attended by directors and senior managers of all 15 locally-incorporated banks, which served as a forum to discuss Deloitte’s initial findings.

Outcomes of the Review

Deloitte has assessed the directors’ attestation regime to be ‘largely effective’, based on their assessment of the 11 selected banks’ attestation systems and processes against Deloitte’s effectiveness criteria, (with most weight given to the arrangements in place in the 4 largest banks). However, given the individual bank weaknesses identified by Deloitte and the number of recommendations proposed, further work is under consideration by the Reserve Bank to enhance the overall effectiveness of the regime. Deloitte noted three particular
areas that could threaten the effectiveness of the regime: 1. the reliance on high quality directors on bank boards, 2. the importance of an open and honest bank culture, and 3. the role of the Reserve Bank in ensuring the integrity of the regime, including the nature and extent of verification undertaken by the Reserve Bank.

Bank directors and senior management have engaged very constructively through the review and workshop process, and broadly supported the review findings. It is expected that the Reserve Bank will provide written feedback to banks on their individual findings during September / October 2017, and complete its own assessment of the options to enhance the effectiveness of the directors’ attestation regime by end-November 2017. We anticipate that the Reserve Bank will take the opportunity through an on the record speech in Q4 2017 or Q1 2018 to explain the findings of the attestation review, and to outline the Reserve Bank’s proposed response to the review findings.
Dear Graeme,

This letter continues the convention of recent years of the Minister of Finance providing you with their expectations for engagement with the Reserve Bank and to inform the development of the Bank’s Statement of Intent.

A high-performing Reserve Bank plays a crucial role in New Zealand’s economic performance. The Reserve Bank undertakes a number of key roles relating to price and financial stability, the provision of currency, regulation and supervision of financial entities, oversight and operation of payment systems and anti-money laundering supervision. The roles and functions undertaken by the Bank are specified in the Reserve Bank Act 1989, the Insurance (Prudential Supervision) Act 2010, the Non-bank Deposit Takers Act 2013 and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

The Government continues to take a consistent and deliberate approach to balance sheet management. The Reserve Bank has both direct and indirect impacts on the Crown’s balance sheet. This reflects the Bank’s own balance sheet management as well as the important impacts stemming from a growing and stable macroeconomy. I remain interested in the balance sheet implications associated with managing financial stability, including how potential risks are managed.

I continue to envisage ongoing constructive engagement, including through our regular financial systems meetings, briefings on Monetary Policy Statements and our other regular discussions.

I expect that the Bank will engage with my office to:

- provide me with substantive information on policies that are in the development phase and well ahead of public consultation;
- inform me in advance of speeches and major communications in preparation for any enquiries that I may receive;
- provide me with final consultation documents on material policy issues at least two weeks prior to their intended release in order to allow sufficient time to raise any final queries;
- advise me as soon as practicable if any significant institution regulated by the Reserve Bank faces a material risk of financial difficulty;
inform me in a timely manner of any risk to financial institutions where there is a material likelihood that you may need to recommend that I exercise any of my powers within a month.

As the Bank progresses work across a number of policy areas, I expect the Bank to continue to proactively communicate key information and policy changes to the public.

Areas of Particular Interest for 2017/18

Looking ahead to 2017/18, I am particularly interested in the following areas:

Macroeconomic developments

I remain interested in the Bank's understanding of how key relationships and behaviours may have changed in the economy as well as likely future changes and the implications of such changes for the operation of monetary policy. As you are aware a new Policy Targets Agreement is required to be put in place next year. I would appreciate the Bank’s views on how the Policy Targets Agreement has been working in practice and whether changes in the economic environment have implications for the Policy Targets Agreement.

Financial stability

I expect the Bank to keep me regularly informed of its assessment of the risks to financial system stability:

Macro-prudential policy

I am pleased that the Bank is continuing to improve its analytical base for macro-prudential policy. I look forward to the Bank’s consultation and cost-benefit analysis on the case for introducing a debt-to-income tool to the Memorandum of Understanding on Macro-prudential Policy.

I expect the Bank to regularly review the effectiveness and need for macro-prudential tools.

Prudential regulation

I recognise the Bank's overall purpose of promoting the maintenance of a sound and efficient financial system and that the Bank's approach towards prudential supervision continues to rest on the three pillars of supervision (self-discipline, market discipline and regulatory discipline). In the coming year, I will be particularly interested in:

- progress with the review of the Insurance (Prudential Supervision) Act;
- the ongoing suitability of policies to reduce the likelihood of the failure of financial institutions in New Zealand. I look forward to being kept informed about progress with the Bank's capital review. Capital settings can play an important role in avoiding the significant damage, including to depositors and the Crown, that could result from the failure of a registered bank;
progress from the Bank in responding to the recommendations from the IMF’s Financial Sector Assessment Programme. I will expect to see careful analysis of the various recommendations addressed to the Bank, and a description of the proposed action to be taken in response, or the reasons as to why you think specific recommendations should not be taken forward.

Regulatory practice

The Government continues to have a strong interest in improving the quality and effectiveness of regulation, and I recognise the changes that the Bank has put in place in support of this. Where you intend to adopt policies under the powers provided in your legislation, I continue to expect to receive your assessments of the expected regulatory impacts of these policies in advance, and at appropriate intervals thereafter, in accordance with section 162AB of the Reserve Bank of New Zealand Act. Please agree with the Treasury a framework for deciding whether a policy is of a minor or technical nature.

I am particularly interested in analysis that considers the impact of policy proposals on New Zealand’s wider economic performance. I expect the Statement of Intent to refer to the Bank’s plans to take forward its regulatory stewardship responsibilities over the coming years.

I hope this provides you with a clear sense of my expectations for the coming year. I look forward to seeing a draft Statement of Intent that captures the areas of interest above, and having the opportunity to provide comments. In addition, I welcome your suggestions on other areas of engagement that may be important to New Zealand’s macroeconomic and financial stability.

The Board’s function is to keep the performance of the Reserve Bank and the Governor under constant review. In fulfilling this role, the Board should be aware of my expectations. As such, I am copying this letter to the Chair of the Board and I will also directly engage the Chair of the Board on relevant issues.

Yours sincerely

Steven Joyce
Minister of Finance

cc: Professor Neil Quigley, Chair, Reserve Bank of New Zealand Board of Directors
APPENDIX 5  LETTER OF EXPECTATIONS TO THE BOARD

Office of Hon Bill English
Deputy Prime Minister
Minister of Finance
Minister Responsible for HNZC

23 NOV 2015

Dr Rod Carr
Chair
Reserve Bank of New Zealand
PO Box 2498
WELLINGTON 6140

Dear Rod,

I am writing this letter to set out my expectations for the Board of the Reserve Bank of New Zealand (“the Bank”). The Board has a critical role in the accountability arrangements that support strong performance by the Bank. I wish to extend my appreciation for the work of the Board.

As you know, the Board’s role is different from that of other statutory entities. The board of a crown entity under the Crown Entities Act 2004 is the ‘governing body’, with authority to ‘exercise the powers and perform the functions of the entity’. In contrast, a key ongoing function of the Board under the Reserve Bank of New Zealand Act 1989 (“the Act”) is to act on my behalf in monitoring the Bank – by keeping the performance of the Bank and the Governor under constant review.

The purpose of this letter is to provide greater clarity about my specific expectations and interests as Minister of Finance with respect to the Board’s activities. It is intended to help inform the Board’s focus and future engagements with me. It is not intended in any way to proscribe or limit the Board’s duties, as set out in Sections 53 and 53A of the Act.

Fundamentally, I rely on the Board to advise me whether the Bank has been successful in meeting its responsibilities under the Reserve Bank Act. My specific interests for this monitoring role are:

- **Monitoring the performance of monetary policy with respect to the Policy Targets Agreement (PTA).** I expect the Board to provide me with a clear sense of its judgements and the basis for them in assessing performance in meeting the PTA, recognising that the policy targets have evolved to be flexible and forward looking.

- **Assessing the performance of the Bank in promoting the maintenance of a sound and efficient financial system.** I expect the Board to articulate how it judges performance with respect to this statutory objective. I am particularly interested in how the objectives of soundness and efficiency are promoted and balanced.
• **Monitoring the Bank’s regulatory policy processes.** The Bank has important regulatory responsibilities. I expect the Board to take a close interest in the robustness of regulatory policy development and to articulate how it judges performance with respect to this function. In particular, the Board should:
  - Keep under review how the Bank’s regulatory policy is developed in light of the Government’s response to the Productivity Commission’s report on regulatory institutions and practices, and how these changes improve regulatory practice.
  - Test the Bank’s thinking on regulatory policy developments and be satisfied that the Bank has reasonably addressed any alternative perspectives from other relevant parties (e.g., the Government, the Treasury, the Council of Financial Regulators, Australian stakeholders, the financial sector and the wider public through consultation).

• **Monitoring the Bank’s relationships.** The Bank has a number of important stakeholder relationships—with me, with the Treasury, with regulated entities and with other agencies. I would expect the Board to keep under review how these relationships are operating in practice.

• **Monitoring of operational functions.** The Bank has a range of operational functions, including those related to payment systems and currency. I expect the Board to monitor the Bank’s operational performance and risk, particularly with regard to the use of the Crown’s resources and wider economic efficiency.

• **Organisational strategy and financial management.** The Bank is a complex organisation with a large balance sheet. I expect the Board to take a strong interest in the Bank’s strategy and financial management. The Board should closely monitor the Bank’s performance against the Statement of Intent (SOI).

The duties of the Board include keeping under review the performance of the Governor. I would expect to discuss your assessment of the Governor’s performance from time to time. I would not expect you to limit your communications on the performance of the Governor or the Bank to the narrow criteria set out in section 53(3), as I hope those circumstances would apply rarely if ever.

The annual Board report, as required under the Act, is the formal document that sets out the Board’s assessment of performance. I expect this to provide enough detail to enable me and the wider public to understand how the Board has undertaken its review role.

Greater visibility of the Board’s activities throughout the year would also be welcome and I would be interested in any suggestions you have to facilitate that. In addition, I will ask my office to establish six-monthly meetings with me. In advance of those meetings, I invite you to share any other documents regarding the Bank’s performance which would support the discussion.

Yours sincerely

Hon Bill English
Minister of Finance
APPENDIX 6  

The Reserve Bank’s decision-making process

Introduction

This Appendix briefly summarises the Reserve Bank’s current decision-making approach and assesses possible modifications. A more detailed version of this paper is available that compares the Reserve Bank’s approach with developments in international research into decision making, and global central bank practice.

The Reserve Bank’s decision-making approach has continued to evolve since inflation targeting was first introduced in 1990. This has partly been in response to increased prudential regulatory activity, including under the Insurance (Prudential Supervision) Act 2010, the Non-bank Deposit Takers Act 2013, and the development of macro-prudential policy. It also reflects the Reserve Bank incorporating developments in international thinking on decision making, in particular, which influenced the formation of the Governing Committee in 2014.

The Reserve Bank considers its current decision-making arrangements work well. In the primary function – monetary policy – the Reserve Bank is highly regarded internationally. Decision making for financial policy (encompassing macro-prudential and prudential regulatory policy) is less easy to evaluate, but there has been considerable international interest in the development of New Zealand’s macro-prudential policy approach.

During 2017, the Reserve Bank and the Treasury discussed whether there are opportunities to enhance the decision process further. The Reserve Bank’s decision-making approach has varied over time and is sufficiently flexible to enable further evolution as appropriate. Changes that may be desirable include:

- Formalising the committee structure that has evolved by incorporating it in the Reserve Bank Act.
- Creating separate decision-making committees for monetary and financial policy.
- Clarifying the role of macro-prudential policy within Part V of the Reserve Bank Act.
- Clarifying the role of the Minister of Finance in the management of a failing financial institution.

You have previously outlined proposals to adjust the Reserve Bank’s monetary policy decision-making structures, introducing external members into the policy committee. Such a model is feasible and is in line with arrangements in some other countries. While not addressing directly the model outlined in the Labour Party policy statement, this appendix discusses the relative merits of different arrangements and what is important for their effectiveness.

Current Reserve Bank decision making model

1 The most recent qualitative assessment of the Reserve Bank’s monetary policy decision process was by Philip Turner (Turner, 2017). A recent quantitative assessment of the Reserve Bank’s performance with regard to inflation targeting found that the Reserve Bank and the Swiss central bank were the outstanding performers with respect to the lowest volatility of the inflation/output trade-off (Farvaque, Stanek, & Vigeant, 2013). With regard to transparency, the Reserve Bank is rated as the third most transparent central bank, as measured by the Dincer and Eichengreen transparency index (Eichengreen & Dincer, 2014).

2 The Reserve Bank was recognised as ‘central bank of the year’ in 2015 by centralbanking.com, in part because of its “joined-up approach to monetary and macro-prudential policy”, and its excellence in communication and governance. See Central Banking (2015). A comprehensive review of the Reserve Bank’s financial policy was carried out by the IMF in 2017. See International Monetary Fund (2017).
The objective of decision-making design is to create a system that leads to rigorous decision making. The four key components of decision-making systems are: optimal institutional design, high quality inputs, genuine deliberation, and accountability for decisions (figure 1)\(^3\). The elements are intrinsically inter-related: the institutional design will determine the inputs that are required, how deliberation takes place, and the mechanisms for accountability. The components cannot be looked at in isolation, but rather how they operate as a whole.

**Figure 1: Key ingredients to sound decision making**

The main components of the Reserve Bank’s decision-making system are:

1) **Institutional design**

The Reserve Bank operates similar decision-making models for each of its three main policy areas of monetary, macro-financial and prudential policy, with differences specific to the nature of each policy decision (see Attachment 1).

The decision-making powers of the Reserve Bank are defined in the Reserve Bank Act. Policy objectives are agreed with the government of the day through the Policy Targets Agreement (PTA) for monetary policy, and the Memorandum of Understanding (MoU) for macro-financial policy. Prudential policy strategic priorities are set out in the *Statement of Intent*, and the Minister of Finance’s annual letter of expectations sets out a range of operational and policy priorities. A summary of the Reserve Bank’s regulatory policy-making processes, including consultation, regulatory impact analysis, timelines and principles are described in the Reserve Bank’s *Statement of Policy Making Approach*.

Monetary policy and key financial policy decisions are made by the Governing Committee, which currently comprises the Governor, the Deputy Governor and the Assistant Governor/Head of Economics. The Committee operates by consensus. Once a decision has been finalised, each member of the Committee adopts that decision, ensuring a consistent message and a unified Bank voice on monetary and financial policy in the interests of market

\(^3\) Based on Warsh (2016)
certainty and stability⁴. The Governor retains accountability for decisions of the Committee.

The Governing Committee receives information and proposals from separate advisory committees for monetary policy, macro-financial policy, and prudential supervision. The majority of policy decisions are taken in the various policy committees, each chaired by a governor, with all governors present.

2) High quality inputs

Decision making at the Reserve Bank is supported by a broad range of high quality inputs. Each advisory committee receives analysis prepared by the relevant teams from the Economics, Financial Markets, Macro-Financial and Prudential Supervision departments⁵.

Significant external input from the business and financial community is a critical ingredient into the Reserve Bank’s policy decision-making. Such input is obtained in a variety of ways:

- Two external advisors on the Monetary Policy Committee (MPC) provide insights from their engagement in economic sectors of interest.
- The Bank engages with the domestic business and financial market communities. It makes around 150 business visits and approximately 140 off-the-record speeches each by year.
- The Bank participates actively in the international financial and economic communities, and gathers significant intelligence through for a hosted by other central banks.
- The Bank uses a wide range of survey data, produced by itself and other parties.

In respect of financial policy, the Reserve Bank has developed clear policy-making processes that include extensive public and industry consultation, regulatory impact analysis, and the development of underlying principles that inform the approach.

Economic forecasts are integral to the monetary and macro-financial decision making process. However, policy decisions are model assisted, not totally model-dependent.

Policy decisions for monetary and financial policy follow a risk based approach. In monetary policy, a risk survey of MPC members is carefully analysed to assess the degree of uncertainty about the forecasts of key economic variables, and the balance of risks. Prudential policy also takes a risk based approach, where the scale of regulatory actions is proportional to the risk each sector poses to financial stability. Such an approach helps ensure that policy resources are devoted to areas most likely to have the greatest impact.

The Reserve Bank regularly assesses the quality of the inputs to its decision-making process. With respect to monetary policy, the Reserve Bank periodically invites overseas experts to attend and report on the process⁶. The Bank of International Settlements reports that over the past 18 years the Reserve Bank has initiated more external reviews of policy than any other central bank⁷. With respect to financial policy, the Reserve Bank is subject to the periodic IMF Financial Stability Assessment Programme (FSAP)⁸.

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⁴ See Dr John McDermott (2016).
⁵ In the case of the Monetary Policy Committee, this is described in some detail in Richardson (2016)
⁶ The most recent review was in February 2017 by Philip Turner (Turner, 2017). He concluded that that “the written materials provided … covered comprehensively the many aspects that could be relevant for the central bank’s broad mandate. Much thoughtful analysis and research had clearly gone into its preparation, and it was clearly presented”.
⁸ The most recent was conducted in 2016/17. See International Monetary Fund (2017).
3) **Genuine deliberation**

The Governing Committee deliberates on key policy decisions in two phases:

- In the advisory committees (each chaired by a governor), where information and analysis is presented, wider discussion takes place, and recommendations made.
- In the Governing Committee, where final policy decision are made. In the case of monetary policy decisions, the Governing Committee receives written advice from each MPC member. In the case of Macro-Financial and Prudential decisions, the Governors normally receive specific policy recommendations at the relevant advisory committee.

The process is designed to ensure that decision making is based on extensive information, and that in-depth discussion is facilitated. This ensures that a broad range of perspectives are considered and helps avoid group think. The objective is to build towards a consensus that allows for differences of individual opinions, but reaches a joint position that all Governing Committee members can agree to.

4) **Accountability**

The RBNZ is accountable to the Minister and to Parliament, and ultimately to the New Zealand public, for the decisions it makes. Two main decision review procedures exist:

- The constant review of the performance of the Governor and the Bank by the Reserve Bank Board as required by the Act, and as reported regularly to the Minister of Finance, and to the public through the Annual Report.
- The public review of decisions based on information that the Reserve Bank releases, and including the Bank’s media presentation and public presentation to the Finance and Expenditure Committee on the release of each Monetary Policy Statement, Financial Stability Report, SOI and Annual Report.

The RBNZ is seen as one of the most transparent central banks in the world in terms of monetary policy communications. In reviewing the MPC decisions, the Board has access to all the materials considered by the MPC, and the opportunity to question governors and staff. It sees the written advice provided by each member of the MPC, with the advice of the Deputy Governor and the Assistant Governor identified, though not by name. The Board discusses each decision extensively. A subset of this information is made available to the general public.

**Potential modifications to the current framework**

1) **Incorporation of current practice into legislation**

Updating the Reserve Bank legislation to reflect current practice would bring the Governing Committee into the Reserve Bank Act. If the Governing Committee was codified in its current form, it would:

- protect the committee decision-making process; and,
- increase the transparency of the Bank’s decision-making process.

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9 As measured by the Dincer and Eichengreen transparency index which is based on the communication of monetary policy (Eichengreen & Dincer, 2014). Amongst 120 world central banks, the RBNZ’s transparency score has only been exceeded by the Riksbank, and since 2011 by the Czech Republic’s central bank.
Ultimate accountability for policy decisions made by the Governing Committee would be retained by the Governor, who would be responsible for the manner in which the Governing Committee conducts itself. The Governor would remain the Chief Executive of the Bank.

2) Introduction of an employment objective for monetary policy

The Labour Party has stated it plans to add full employment to the Reserve Bank’s objectives\(^\text{10}\). Some inflation targeting central banks also have an employment objective, of which the closest comparison might be the United States Federal Reserve which has the “dual mandate” of maximum employment and stable prices\(^\text{11}\).

In the long run, conditions in the labour market are affected by supply factors that are mainly outside the Reserve Bank’s control including: the structure of the labour market; bargaining and contractual arrangements; and the education, skills and mobility of workers. There will be “natural rates” of employment and unemployment determined by these factors\(^\text{12}\). Achieving low and stable inflation in the long run is consistent with achieving the natural rate of employment.

Over shorter time periods, unemployment will vary due to fluctuations in demand factors in the economy. Attempts to achieve price stability over short time periods can result in unacceptable volatility in unemployment. The Reserve Bank already takes unemployment into account in its monetary policy decisions by seeking to avoid such volatility. The Policy Targets Agreement specifies that the Reserve Bank must avoid undue volatility in output, of which employment is an important component. In practice, this means that the Reserve Bank takes into account employment conditions (and other factors) in determining how tightly it manages inflation in relation to its target.

3) Clarify the objectives of financial policy

The objectives for monetary policy are clearly defined in the PTA. For financial policy the Bank relies on the high-level objective stated in Part V of the RBNZ Act (s68: To promote the maintenance of a sound and efficient financial system) and the MoU with the Minister on Macro-prudential policy. The role of the MoU will be reviewed in the planned 2018 review (jointly with Treasury) of Macro-prudential policy. There are some specific aspects of the prudential regime and decision-making processes and responsibilities that could be clarified.

4) Separate committees for monetary and financial policy

While the current Governing Committee has operated well across both the monetary policy and financial stability functions, there may be benefit in having a clearer separation of decision making through separate policy committees. They would each be chaired by the Governor, and likely have overlapping membership. Because monetary policy and financial stability policy each have their own primary objectives and policy instruments, separate committees would more transparently delineate decisions. It would also enable the composition of the Committees to be tailored to the different skill sets required for each policy area.

\(^{10}\) Robertson (2017)
\(^{11}\) The Federal Reserve also has an objective of moderate long term interest rates, but this will in effect occur under the price stability objective.
\(^{12}\) The natural rate of unemployment is also sometimes called the NAIRU, or “non-accelerating inflation rate of unemployment”. The NAIRU can also be defined as a shorter term concept. The NAIRU is not observable, and therefore must be estimated, and is time varying.
5) **Committee size**

International research into committee performance finds that committees of about five members are optimal, bringing the benefits of diversity of knowledge without incurring significant coordination costs. International evidence suggests that the average policy committee size is just under seven (Attachment 2). Consequently, there may be scope to modestly increase the size of the Governing Committee, for example to include additional expertise.

6) **External members**

The Labour Party has stated that it plans to consider adding external members to the monetary policy committee\(^ {13} \).

The extent to which policy committees benefit from external members depends on the nature and objectives of the committee and the conditions associated with the external members’ appointment. Policy committees which have to interpret political objectives or indeed establish goals to be achieved should benefit from having external members. In New Zealand, the objectives of monetary policy are clear in the Act, and through the PTA. For prudential policy, the objectives of soundness and efficiency are clear, but their interpretation requires complex judgement.

Committees may also include external members to access outside perspectives, when other avenues are costly or not feasible. Financial policy decision-making generally involves extensive public and key stakeholder consultation, while monetary policy decision-making involves less formal but frequent sectoral engagement. Policy making in monetary and financial policy often involves complex considerations based on multiple indicators, analytic models and competing economic theories. Full-time members with experience and expertise are likely to be better suited to this task than part-time external participants.

About two thirds of the monetary policy committees of inflation targeting central banks have external members (Attachment 2). There is a wide variety of ways this is put into practice depending on the size, culture and institutional structures of the individual countries. Careful consideration would be required of the best way to introduce externals to the Governing Committee if this option was adopted.

7) **Decision-making approach**

The Governing Committee makes decisions by consensus rather than voting. Research into decision-making practices finds that consensus is the preferred decision approach as it allows for more in-depth discussions, the frank exchange of views, more accurate judgement on average, and higher committee morale. However, as committee size increases it can become costly in time and effort to achieve consensus, and therefore larger committees typically use voting mechanisms.

Provided the Governing Committee remains relatively small, we believe it should continue to make decisions by consensus, with the Governor having the final decision if no consensus can be achieved.

8) **Appointment process**

Where policy committees have political considerations, member appointment tends to be

\(^{13}\) Robertson (2017)
made by the head of state or parliament. Even where political considerations are less relevant, external members are often appointed by the government.

In New Zealand, the Governing Committee is a “technical” committee created to carry out the purpose and objectives set out in the Act, the PTA and the MoU. The Reserve Bank is the government’s agent in carrying out its monetary, prudential and macro-prudential policy objectives, and we consider it critical that policy committee appointments be made by the Reserve Bank for their policy competence and not through a political body. The Governing Committee should continue to be appointed by the Governor, or by the Reserve Bank Board on the recommendation of the Governor.

9) Communicating how decisions are made

Some overseas central bank policy committees release minutes of their decision process, and voting records. Whether or not this supports rigorous decision-making depends on the nature of the committee. In a committee where members may publicly disagree, or that includes external members, the release of minutes and voting records may help explain the decision process. International practice shows that policy committees tend to release minutes and voting records when they have external members, and when decisions are arrived at by voting (Attachment 3).

We propose that the Governing Committee retains a consensus decision-making approach. Under that model, minutes would likely reflect Governing Committee consensus views, adding little to the transparency of judgements already expressed in the Monetary Policy Statements.

10) The role of the Board

The Board has three functions under the Act:

- Keep under constant review the performance of the Bank and the Governor.
- Recommend the Governor’s appointment, or dismissal, to the Minister of Finance, and make the Deputy Governors’ appointments on the recommendation of the Governor.
- May give advice to the Governor.

The role of the Board has been reinforced by the introduction of the Minister’s Letter of Expectations.

In pursuit of its functions the Board constantly reviews the performance of the Reserve Bank. It is responsible for agreeing the performance objectives of the Governor each year, and for undertaking a review of the Governor’s performance against those objectives at the end of the year. It receives, and may request, all relevant information to perform its role, and is able to question managers and staff within the organisation.

The Board’s role in monitoring the performance of policy decision-making is extensive. It has continued to adapt and improve its procedures in meeting the needs of the government and Minister of Finance to monitor the Bank’s performance.
Works Cited


### Attachment 1: Key institutional aspects of RBNZ decision-making framework

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Responsible</th>
<th>Monetary</th>
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<td>MoU</td>
<td>Derived from legislation</td>
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## Attachment 2: International Practice

### Scope, size, and composition of policy making committees

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Source: central bank websites and other published material
Attachment 3: International Practice

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Source: central bank websites and other published material.
Reflections on the stewardship of the Reserve Bank

A speech delivered to The Northern Club in Auckland

On 30 August 2017

By Graeme Wheeler, Governor
Thank you for the invitation to join you, it’s a pleasure to speak again at the Northern Club.

Today, I will offer thoughts on the stewardship of the Reserve Bank over the past five years in meeting its price stability and financial stability objectives, and discuss some policy challenges the Bank may face in the future. It’s been a remarkable five years, especially with the challenges thrown up by the global economy and an over-heated domestic housing market.

1. A challenging international and domestic environment

As a small open economy, developments beyond our shores have a large influence on New Zealand’s economic outcomes. The global expansion, which is about to enter its ninth year, is the weakest in 70 years. Until recently, output growth in the advanced economies has been below trend, and headline and core inflation continue to be low despite unprecedented monetary stimulus.

Several factors account for the weak recovery: corporate and household deleveraging following the Global Financial Crisis (GFC) has been more prolonged than expected – especially in the euro area; productivity and business investment in the advanced economies have been weak; and trade has been much less of a catalyst than normal. Increasingly, the gravitational centre for the global economy is shifting away from the US and Europe to the East Asia region.

Each five year window brings its own set of risks and challenges. Over the past five years on the international front we’ve seen:

- Increasing use of unconventional monetary policies (including negative interest rates and unprecedented amounts of quantitative easing) to deliver the cheapest financing the world has experienced. While aimed at stimulating spending, it also led to rapid increases in asset valuations (bonds, equities, and real estate) and a sharp compression in credit spreads and risk premia.
- The largest slowdown in global trade since the early 1980s, which has seen countries seeking to boost domestic growth through lower exchange rates.
- Sharp swings in commodity prices with peak to trough movements of 75 percent in oil and other commodities.
- A continued build up in global debt that is now at record highs relative to global output.

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1 The Reserve Bank is mandated by the Reserve Bank of New Zealand Act to contribute to New Zealand’s economic growth by maintaining stable prices, promoting financial systems soundness and efficiency, and meeting the currency demands of the public.

2 Major central banks in advanced economies have conducted around USD12 trillion of quantitative easing since 2008. Countries whose central banks currently have their main policy rate below ½ percent, account for around 1/3 of world output.

3 Merchandise trade growth over the 5 years to 2017 was the slowest period of 5 year growth since the early 1980s. Protectionist measures and trade disputes in 2016 were at their highest level since the GFC.

4 The price of Brent Crude averaged USD 115/barrel from early 2011 to mid-2014 and fell to USD 28/barrel in January 2016. Over the past 12 months it has averaged around USD 50/barrel.

5 Global non-financial sector debt was 220 percent of global GDP in 2016, up from 180 percent in 2007.
Unexpected political developments in Europe, the UK and the US that substantially increased uncertainty, although measures of financial market volatility remain close to 25 year lows.\(^6\)

Back home, New Zealand experienced:

- The strongest migration surge since the 1860s (equivalent to a 6 percent increase in the working-age population since 2012) and the labour force participation rate reached historically high levels.\(^7\)\(^8\)
- A long period of negative tradables inflation – probably the longest since the Great Depression.\(^9\)
- A 75 percent decline in dairy prices before recovering partially.\(^10\)
- A major switching of expenditure and production to the non-tradables sector, in part to free up resources for the Canterbury rebuild.\(^11\)
- Annual house price inflation that reached 30 percent in Auckland and spread rapidly throughout the country.

In a world of unconventional monetary policy and unprecedented liquidity, investors' bid up asset prices and, in doing so, compressed risk premia. In these settings, New Zealand, with its stronger output growth, higher interest rates, and impressive international rankings on numerous business and governance-related surveys attracted portfolio flows from the rest of the world.\(^12\)\(^13\) These flows put upward pressure on the exchange rate, and lowered long term interest rates.

The appreciating exchange rate made it more difficult for our exporters to compete on global markets (if not matched by rising export prices) and skewed growth away from the tradables sector. By lowering tradables inflation, it also increased the risk that headline inflation would remain low and feed through into falling long-term inflation expectations. Lower long term interest rates reduced the funding costs for New Zealand banks and led to historically low

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\(^6\) Financial market volatility remains close to historic lows in equity, bond and fx markets (as shown by the MOVE index of US Treasury options, the VIX index of S and P options and the CVIX index of FX options).

\(^7\) Net permanent long-term migration of working age entrants has totalled 220,000 since 2012. This is equivalent to a 6 percent increase in the working-age population.

\(^8\) The labour force participation rate currently stands at 70 percent. The participation rate over the past 25 years has averaged 67 percent.

\(^9\) Tradables inflation was negative over the period 2012 Q2 to 2016 Q4, and averaged minus 1.2 percent per annum during that time.

\(^10\) Whole milk powder prices fall from USD 5208 per metric tonne in October 2013 and fell to USD 1590 per metric tonne in August 2015. They have averaged around USD 3100 per metric tonne in 2017.

\(^11\) The cost of Canterbury reconstruction following the four earthquakes is expected to be around NZD 40 billion in 2015 dollars. The insurance payout, expected to be around NZD 36 to 40 billion, is the 5th largest global insurance payout.

\(^12\) Average daily foreign exchange turnover in the NZ dollar averaged USD105 billion in April 2016, of which USD 40 billion were spot transactions.

\(^13\) New Zealand is ranked number 1 on the following international surveys: World Bank Group ‘Doing Business Report’, Transparency International’s, ‘Corruption Perceptions Index’; and is number 2 on the Institute for Economics and Peace’s ‘Global Peace Index’.
mortgage rates. These, in conjunction with constraints on housing supply and strong population growth, stimulated rapid house price inflation—initially in Auckland and later across the country.

2. New Zealand’s Recent Macro-Economic Performance

Despite the difficult international backdrop, New Zealand’s economy has generally performed well over the past five years. As shown in table 1, compared to the period 1990 – 2012 (that is the 22 year period since flexible inflation targeting was first introduced) the five years from the beginning of 2013 have seen slightly faster GDP growth and much stronger employment growth. Over the past five years, headline CPI inflation has been weaker, our current account deficit has been smaller as a share of GDP, while the unemployment rate has been around its average for the period since the mid-1990s even with record increases in migration and labour force participation. Labour productivity has been disappointing, a challenge we share with many other advanced economies.14

Some of these outcomes lie well beyond the influence of the Reserve Bank’s policy levers. For example, monetary policy cannot directly influence the supply of labour, the productivity of labour and capital, the innovation that takes place within the economy, or the country’s external position.

Table 1: New Zealand Indicators (annual average percentage change)

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Source: Stats NZ, RBNZ estimates, IMF World Economic Outlook

Over the past five years, the Bank’s monetary policy has been an important driver behind the rate of output and employment growth, and the path of non-tradable inflation and inflation expectations. During this time monetary policy has been stimulatory, with the Official Cash Rate averaging 2-3 percentage points below the neutral interest rate (the interest rate at which monetary policy is neither stimulatory nor contractionary). Monetary policy isn’t however, the only driver of growth in output and employment – the pent up demand for investment in construction and infrastructure, the rise in the terms of trade and the rapid increase in population are also important factors.

Our low annual rate of headline inflation (1 percent over the past five years) has mainly been due to the 4½ years of negative tradables inflation experienced from mid-2012 until late-2016. Tradables inflation, much of which lies beyond the Bank’s control, averaged minus 1.2 percent during this period. Annual non-tradables inflation, which the Bank has considerable

14 Labour productivity growth (real GDP/total hours worked) has been flat for the period since the beginning of 2013.

15 From 1993 Q3 to 2012 Q4 the Reserve Bank’s sectoral factor model suggests annual core inflation was 2.2 percent.
influence over, averaged 2.3 percent since 2013 and core inflation averaged 1.4 percent and remained within the 1 to 3 percent target band established for headline inflation.\(^{16}\)

Looking at the key relative prices in the economy we would have preferred a lower exchange rate over this period. The TWI remains 4 percent higher than it was prior to the seven cuts in the Official Cash Rate that commenced in June 2015. To a large extent the high exchange rate reflects the favourable performance of the economy, the high terms of trade, and weakness in the US dollar. The appreciation in the exchange rate has been a headwind for the tradables sector and, by reducing already weak tradables inflation, made it more difficult to reach the Bank’s inflation goals. A lower New Zealand dollar is needed to increase tradables inflation and help deliver more balanced growth.

3. The impact of Macro-Prudential Policy

With low interest rates unable to constrain credit growth, rapid house price inflation was creating financial stability risks for the banking system and, given the very high levels of household debt, increasing the risk that a rapid fall in house prices could have a severe economic impact.

We were conscious that the introduction of LVR restrictions would make life difficult for the Bank, given the sensitivities around housing.

Loan-to-value ratio restrictions (LVRs) reduced the systemic risk to the banking system flowing from the rapid increase in house prices. Requiring new borrowers to have a greater equity contribution in their house purchases reduced the overall riskiness of banks’ mortgage portfolios.

When LVRs were introduced in October 2013, 21 percent of the stock of mortgage lending across the banking system was at LVRs of 80 percent or higher. With a third of new mortgage lending at that time taking place at LVRs of 80 percent or higher, the overall stock of high LVR mortgages was likely to approach 25 percent. As a result of the LVR restrictions, the stock of highly leveraged loans across the banks’ mortgage portfolios is now around 8 percent.

\(^{16}\) As measured by the Reserve Bank’s sectoral factor model. The target band is specified in terms of annual CPI inflation, not ‘core’ inflation.
Some commentators expected the LVR restrictions to fall heavily on first home borrowers. While some first home buyers wanting high LVR loans have been affected by the restrictions, banks have given priority to first home buyers within their 10 percent speed limit. Figure 3 shows that over the past 2½ years the share of first home buyers in real estate transactions has been around 21 percent—its level in early 2013. Over this period, first home buyers have taken out nearly $21 billion of mortgage loans from the banking system, with 28 percent of that lending at LVRs greater than 80 percent.
It’s encouraging that nation-wide annual house price inflation has fallen from its peak of 21 percent in August 2015 to 1 percent currently (figure 4). Several factors contributed to the slowdown including the tightening of investor LVRs in October 2016, more restrictive lending conditions by banks, the rise in mortgage rates in early 2017 and increasing concerns about housing affordability.

**Figure 3: Annual house price inflation**

![Figure 3: Annual house price inflation](source: REINZ)

LVR policy has been aimed at reducing financial stability risks as house prices became increasingly stretched. LVRs are not expected to be a permanent measure and the conditions for their removal would be: signs that financial stability risks have eased; and a degree of confidence that these risks won’t worsen again when LVRs are removed. On the former measure, the financial risk picture is improving. Banks are carrying a lower share of high LVR mortgages as a result of the LVR limits having been in place, and the slowdown in house price inflation is positive - although prices remain very elevated relative to incomes and rents.

However, the underlying drivers of housing demand (population growth, low interest rates) remain strong with housing demand still outstripping supply. There is a risk of a housing market resurgence (and a sharp lift in high LVR lending) if LVRs were removed at this time. The Bank will continue to review developments, bearing in mind that removal could be made in stages as a safeguard to a resurgent market.

**4. The outlook for the New Zealand Economy**

In the absence of major unanticipated shocks, prospects look promising for continued robust economic growth over the next two years. If this occurs, the current expansion would be the longest in 50 years. Our forecasts suggest that GDP growth will exceed the growth rate of potential output and be driven by continued accommodative monetary policy, population growth, high terms of trade and, in the outer period, by the budgetary stimulus announced in the 2017 Budget. A positive output gap is forecast with inflation gradually approaching the

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mid-point of the target band.\textsuperscript{18}

i) Domestic risks

The main domestic risks we face lie with migration and the housing market.

A sharp decline in net immigration

Since early 2012 net permanent and long-term working age immigration has totaled 220,000 – equivalent to a 6 percent increase in the working age population. Migrants have mainly been in the 15-29 year age group. This migration has increased the demand for housing and goods and services, while also increasing labour supply (and hence potential output). Migration has had a positive net demand effect, although its impact has been weaker than in previous migration cycles, and is one factor moderating wage outcomes.

Our forecasts assume net immigration of 140,000 people over the next three years – a further 3.5 percent boost to the working age population. A much sharper reduction in arrivals or increase in departures, absent an increase in global growth, would slow domestic economic growth by reducing employment and demand growth.

A resurgence in house price inflation

House price to income ratios are high in New Zealand, and especially in Auckland. Although house price inflation has slowed markedly, a further surge in house prices can’t be ruled out as mortgage rates are low, net migration flows are strong and large supply and demand imbalances remain in the housing market.

A strong resurgence in house price inflation would increase the risk of a subsequent future correction. With a debt to income ratio of 167 percent (up from the 2009 peak of 159 percent) households are already heavily exposed to the risk of rising interest rates or falling house prices. In addition, the share of high Debt-to-Income (DTI) lending to first home buyers, other owner occupiers and investors is high, making borrowers more vulnerable to rises in interest rates and/or reductions in income (e.g. associated with unemployment). This increases the risk of forced sales in a downturn leading to falls in house prices and flow-on effects on bank balance sheets and the broader economy. This is why we have been consulting on whether a DTI instrument should be included in the macro-prudential toolkit. We wouldn’t seek to use it while the housing market continues to moderate.

\textsuperscript{18} Potential output refers to the sustainable long term growth path of the economy when resources are fully employed and price stability is achieved. The output gap reflects the difference between the level of output in the economy and potential output and, as such, indicates the degree of excess capacity or capacity constraints in the economy and the implications for inflationary pressures. We regard the neutral interest rate as the policy rate consistent with the economy growing at its potential in the medium term and having inflation expectations matching the price stability objective.
ii) International risks

Other than unanticipated major geo-political developments, the main risk on the international side lies with the build-up of global debt.

If one examines why the large advanced economies move into recession it has generally been because of inflationary shocks (and the policy response to them) or problems in their financial sectors. For example, since the early 1970s the US economy has experienced five recessions. Three had their origins in sharp spikes in oil prices, and the last two resulted from asset price corrections that affected financial market stability.\(^{19}\)

The likelihood of central banks having to lean hard against a rapid burst in global inflation looks to be low. Structural factors are playing a dominant role in the low inflation environment. These factors include: ongoing declines in the cost of information technology and capital goods; increasing global competition in the services sector (e.g., in education, health care, construction, retailing and distribution); the emergence of the gig economy,\(^{20}\) the technological revolution in the oil and gas industry that has dramatically lowered production costs and enabled new sources of supply; and the wage moderation that is taking place across the advanced economies. Wage moderation seems to be linked to several factors, such as the diminished bargaining power of labour, technological change, global

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\(^{19}\) In the US the 1973-5, 1981-2, and 1990-91 recessions were triggered to a significant extent by sharp rises in oil prices in 1973 (OPECI), 1979 (OPEC2) and 1990 (Iraqi invasion of Kuwait). The 2001 recession was related to the collapse of the high-tech bubble, and the 2008-9 recession was due to the range of financial market and regulator factors that led to the GFC.

\(^{20}\) i.e. an increase in the use of temporary labour and contractors for short-term engagements.
outsourcing, demographics, and changes in labour market composition.

The greater risk lies in a large correction in asset prices that leaves investors with little or no equity in their investments at a time when the broader economy is under pressure. Two aspects are of concern in this regard:

- The global stock of non-financial sector debt is at a historical high of 220 percent of GDP – up from 180 percent in 2007.

<table>
<thead>
<tr>
<th>Table 2: Non-financial sector debt as a share of GDP (%)</th>
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<tr>
<td>Total (share of global GDP) 2007 2016</td>
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<tr>
<td>Advanced Economy (share of AE GDP) 2007 2016</td>
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<tr>
<td>Emerging Market Economies (share of EE GDP) 2007 2016</td>
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<th></th>
<th>2007</th>
<th>2016</th>
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<tbody>
<tr>
<td>Total (share of global GDP)</td>
<td>180</td>
<td>220</td>
</tr>
<tr>
<td>Advanced Economy (share of AE GDP)</td>
<td>235</td>
<td>270</td>
</tr>
<tr>
<td>Emerging Market Economies (share of EE GDP)</td>
<td>110</td>
<td>175</td>
</tr>
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Source: BIS

Most of the growth in debt has occurred in the emerging markets especially on the corporate side (which has increased from 55 percent to 95 percent of EE GDP) and household sector (from 20 percent to 35 percent). Most of the growth in advanced economy debt occurred in the general government sector – which rose from 70 percent to 115 percent of AE GDP).

- Asset valuations (e.g. fixed income, equities) are high relative to a variety of benchmarks. Whether current prices represent fair value depends a great deal on the outlook for future inflation and interest rates, particularly in the advanced economies.

On this front, financial markets remain confident that central banks will continue to maintain highly stimulatory monetary policy settings for the foreseeable future. Measures of financial market volatility remain close to historic lows. However, investors are acutely conscious that the major central banks are large holders of long-dated Government securities, (and some have corporate debt and equities in their portfolios), and are highly attuned to any hint of a possible tightening in policy rates or winding back in the scale of quantitative easing.

If growth in the global economy slows because of debt-related or other issues, our economy will be affected. However, there is scope to help buffer against such shocks. We have greater room for monetary policy manoeuvre than central banks in many advanced economies. Our Official Cash Rate is 1.75 percent – above the zero and negative policy rates of several advanced country central banks - and the Bank has not grossed up its balance sheet by buying domestic assets. Similarly, with budget surpluses and low net Government debt relative to GDP, the Government has flexibility on the fiscal policy side.

5. New Zealand’s Monetary Policy Framework

i) Flexible inflation targeting remains highly relevant

Flexible inflation targeting was introduced by the RBNZ in 1990 and has been adopted by
most central banks in the advanced economies and several emerging market economies. With inflation below target in nearly all advanced economies, there have been questions from time to time whether flexible inflation targeting is still an appropriate framework for monetary policy.

We believe that it is still the best monetary policy framework for New Zealand. It has helped to deliver low inflation while enabling the Bank to take account of domestic and external developments in framing its monetary policy responses. No country has abandoned flexible inflation targeting, nor has any country adopted nominal income targeting or price level targeting that are sometimes suggested as alternatives.

ii) Maintaining flexibility in specifying the inflation goal

Central banks make monetary policy decisions by drawing on the data available, research, models, forecasts and judgement. At a technical level it involves estimating potential output, output gaps, and the neutral interest rate, and assessing the transmission mechanisms through which interest rate changes affect output growth and inflation, and the time lags involved.

Structural changes in the economy can have important effects on factors that are central to monetary policy decision making. We've seen the relationship between the output gap and inflation change with Philips curves flattening across the advanced economies, even in countries with rapid employment growth and low unemployment rates. The fact that the Reserve Bank has much less control over tradables inflation did not matter as much when the annual percentage change in import prices in world terms was 2.6 percent in the five years prior to the GFC, but it does when they have averaged minus 1.4 percent since March 2013.

The specification of a target range for CPI inflation should be the main focus of the Policy Targets Agreement (PTA). It's important that the PTA also recognise that several factors can cause inflation to move outside the target range and require the Bank to provide analysis and explanations in the Monetary Policy Statement when this occurs. Specifying a single inflation rate that the central bank should seek to achieve at all times should be avoided - it suggests a spurious accuracy that central banks are unable to deliver. A reference to the mid-point of the target range however, is appropriate – our research indicates this was a useful factor in reducing inflation expectations.

Some offshore commentators have suggested that central banks should raise their inflation targets, perhaps to around 4 percent, in order to move policy rates away from the effective lower bound and give central banks more policy flexibility to respond to any marked slowdown in activity. It is not clear that central banks could readily increase inflation to these levels and attempting to do so would further stimulate asset markets, at least in the short

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21 Flexible inflation targeting involves assigning the central bank the explicit goal of maintaining inflation in a range of consistent with overall price stability, giving the central bank the independence to pursue that goal and holding it accountable for reaching the price stability objective.

22 Around 30 countries have adopted flexible inflation targeting.

run. Raising an inflation target when productivity growth is weak makes little economic sense.

Some have suggested that the inflation goal should be specified in terms of core inflation rather than headline CPI inflation. A CPI benchmark has many benefits – it’s easier to communicate because it more closely resonates with people’s experience of living costs, and headline CPI inflation affects real rates of return and real wage outcomes that in turn influence household labour supply and spending decisions.

iii) The importance of continually reassessing policy settings

Monetary policy decisions involve balancing various risks facing the economy, while recognising that inflation outcomes and policy choices are often shaped by decisions that lie beyond the influence of the central bank.

Inevitably, central bank forecasts and assumptions require modification as new information becomes available. For example, the Bank raised the OCR four times in the first half of 2014. At that time the IMF were forecasting higher global growth and the New Zealand economy was growing rapidly, with the latter due to the terms of trade being at a 40-year high, strong construction activity, rising net immigration and highly accommodative monetary policy. We forecast a positive output gap and rising inflationary pressures. This view was shared by private sector forecasters and the IMF, and market pricing built in increases in the OCR.

By late 2014, the global economy was not strengthening as anticipated, oil prices had almost halved since June 2014 and whole milk powder prices were down by 40 percent. Faced with the prospect of a weaker economy and lower inflation pressures, the Bank moved to a neutral bias and then began the first of seven OCR cuts in June 2015.

Central banks do not expect to be able to accurately forecast commodity prices. What matters is that central banks make sensible decisions on the basis of the information available, reflect carefully on the views held by financial markets and key institutions, remain open-minded, carefully assess new information as it becomes available, and change their forecasts and policy settings when it considers it appropriate. We are satisfied that the Bank met these tests.

iv) Macro-prudential policy is valuable in addressing financial stability risks

Experience in several countries indicates that monetary policy is generally not a good vehicle for leaning against inflated asset prices. In these situations interest rates would have to increase very substantially in order to dampen asset prices and the rise in interest rates could do substantial damage to the economy by depressing spending, reducing risk taking, and undermining the competitiveness of the tradables sector.

Prudential and macro-prudential policies can play a valuable role in reducing the systemic risks to the banking system associated with inflated asset markets. We are likely to see macro-prudential instruments become even more important and widely deployed by countries in years to come.
6. Prudential regulation

On the prudential side, over the last five years we tightened prudential standards, adjusted inefficient or poorly targeted regulation and took steps to lower compliance costs. We completed the licensing of nearly 100 insurers. A year-long review of bank regulation, with a particular focus on policy development and regulatory processes, was undertaken with extensive consultation with the banking sector. We clarified and tightened the policy on outsourcing of banks' key functions and systems, and obtained Government approval for the regulation of key financial market infrastructures. We are currently reviewing the quality of bank capital instruments and assessing whether banks are adequately capitalised, and reviewing the effectiveness of the Insurance (Prudential Supervision) Act, 2010.

The IMF’s Financial Sector Assessment Programme (FSAP) conducted last year identified the types of banking sector risks (high exposure to housing and inflated house prices, heavy reliance on external funding, exposure to commodity price fluctuations) that are regularly discussed in our Financial Stability Reports. It concluded that the banking system is well placed to withstand large but plausible shocks, as judged by a range of stress tests.

However, the IMF recommended, among other things, strengthening the macro-prudential regime to include a debt-to-income instrument, and addressing weaknesses in the approach to financial market infrastructures regulation and bank crisis resolution. There were no particular surprises in the IMF’s recommendations, although they did comment that the Bank is not adequately resourced to support its existing low-intensity approach to banking regulation and supervision. We are reviewing the IMF’s recommendations.

7. Operational business

In addition to meeting its responsibilities in respect of price stability and financial stability, the Bank manages a $27 billion balance sheet and runs several businesses that include treasury operations, payments systems, and currency and custody management. These businesses are undergoing major technology renewals and/or changes to their business models. A highlight of the last five years was the delivery of a new series of bank notes with enhanced security features that were well-received by the public and international bank note producers. A disappointing element was the failure of negotiations to sell New Zealand Clear.

Considerable emphasis has been placed on increasing the management strength across the Bank, benchmarking performance, testing back-up systems with the Auckland office and managing enterprise risk. This emphasis is essential as the Bank has broad responsibilities, conducted with only 260 staff, and needs to manage multiple business and policy-related risks.

Concluding Comments

Every five year window brings its own set of challenges. On the international front we’ve seen increasing use of unconventional monetary policies, sluggish international trade, sharp swings in commodity prices, a continued rapid build-up in global debt, and unexpected political developments in Europe, the UK and the US.

Back home we’ve experienced the strongest migration surge since the 1800s, probably the
longest period of negative tradables inflation since the Great Depression, a 75 percent decline in dairy prices before recovering, a major shift in resources to the non-tradables sector to support the Canterbury rebuild, and annual national house price inflation reached 21 percent.

Despite these challenges, the New Zealand economy has generally performed well during this time. Since 2012, GDP growth has averaged 2.8 percent and employment growth 2.5 percent. Both exceed the trend rate of growth. Headline CPI inflation averaged 1 percent due to 4½ years of negative tradables inflation, while core inflation averaged 1.4 percent.

Over the past five years, the Bank’s monetary policy has been an important driver behind the rate of output and employment growth, and the path of non-tradable inflation and inflation expectations. Long term inflation expectations remain well anchored at the target mid-point of 2 percent.

We have also had a stable financial system. Nationwide annual house price inflation has declined to 1 percent due to LVR restrictions, the tightening in bank lending, the rise in mortgage rates and increasing concerns about housing affordability. LVR restrictions have been effective in reducing financial stability risks as house prices became increasingly stretched.

LVRs are not expected to be a permanent measure, but their removal would require a degree of confidence that financial stability risks won’t deteriorate again. However, debt to income ratios have risen in recent years, and with the underlying drivers of housing demand (population growth, low interest rates) remaining strong and demand outstripping supply, there’s a risk of a housing market resurgence (and a sharp lift in high LVR lending) if LVRs were removed at this time.

In the absence of major unanticipated shocks, prospects look promising for continued robust economic growth in New Zealand over the next two years. The greatest risk we face at this stage relates to the inflated global asset prices and the continuing build up in global debt.

If growth in the global economy slows, we have some scope to buffer our economy. We’ve greater room for monetary policy manoeuvre than central banks in many advanced economies. Our official cash rate is 1.75 percent – above the zero and negative interest rates of several advanced country central banks – and the Bank has not grossed up its balance sheet by buying domestic assets. With a budget surplus and low net debt relative to GDP, there’s also flexibility on the fiscal policy side.

I wish to thank the Board of the Bank for their intensive scrutiny, support and advice over the past five years. The Board plays a critical role in monitoring the performance of the Bank and the Governor. I have been fortunate to work closely with three excellent and insightful chairs in Dr Grimes, Dr Carr and Dr Quigley.

Above all, I wish to thank my colleagues in the Bank. It has been a great pleasure to work with my fellow governors on the Governing Committee and with the Senior Management Group. The fact that the Bank continues to maintain a strong international reputation is due to the high calibre, dedication and commitment of colleagues throughout the institution.