# Briefing on the Reserve Bank of New Zealand

*November 2008*

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Introductory note

This paper has been prepared to brief the incoming Minister of Finance on the role and functions of the Reserve Bank of New Zealand. It highlights the key issues the Bank is facing, and the important roles played by the Minister, the Governor, and the Board of Directors.

The *Briefing* has the following structure:

- The Executive Summary sets out the key issues contained in the briefing paper.
- Section 1 provides an overview of the current global and domestic financial and economic environment, and the Reserve Bank’s roles.
- Section 2 described the objectives, issues and strategies relating to each of the Bank’s functions.
- Section 3 outlines the Bank’s functions, governance, and structure.
Executive summary

- The Reserve Bank of New Zealand is a ‘full service’ central bank, well placed to be fully informed and to engage in the economic and financial system.

- New Zealand’s financial system has been weathering extreme disorder in international financial markets, leading to a global ‘credit crunch’ that is dampening the economic outlook.

- The New Zealand economy has contracted over 2008 following a sustained period of growth. We expect the economy to grow only slowly over the next few quarters before gaining more momentum toward the end of 2009.

- We expect to see inflation pressures dissipate further, although price trends for some non-tradeables inflation remain of concern.

- Should the outlook for inflation evolve as projected we would expect to lower the OCR further. We will be monitoring and assessing economic and financial developments and prospects closely when determining the precise timing and extent of OCR reductions over the coming months.

- Markets have become more risk averse and illiquid, New Zealand banks’ access to and cost of offshore funding has been affected.

- We have widened the eligible collateral New Zealand banks can use to access liquidity from the Reserve Bank.

- We are currently consulting with the registered banks on proposed new standards for the management of their funding and liquidity.

- The Government has introduced a temporary opt-in retail deposit guarantee scheme to give assurance to New Zealanders that their deposits are safe; and a temporary opt-in guarantee scheme covering the wholesale debt of investment-grade New Zealand financial institutions to facilitate the banks’ re-entry to offshore wholesale debt markets.

- We are reviewing the longer-term impact of these schemes on prudential supervision policies.

- Implementation of non-bank deposit taker regulation is continuing.

- Insurance prudential supervision legislation is expected to be introduced.
Key Issues

The following issues are covered in more detail in the following pages.

<table>
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<th>Function</th>
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| Monetary policy formulation     | • Maintaining price stability in an environment of global financial turmoil, cost shocks, persistent underlying inflation, and an economic downturn.  
• Dealing with asset price cycles.  
• The relationship between the wider government policy framework and the cyclicality of the economy.  
• Finding supplementary tools to support the OCR. |
| Domestic market operations       | • Market volatility, illiquidity, impaired access to credit markets.  
• Ensuring the financial system has adequate liquidity. |
| Foreign reserves management     |                                                                                                                                                |
| Prudential supervision          | • Higher funding costs and liquidity pressures for banks.  
• Putting in place a liquidity policy for banks.  
• Longer-term impacts of Government guarantee schemes on prudential supervision policies.  
• Continuing implementation and communication of non-bank deposit taker regulation.  
• Introducing insurance prudential supervision legislation.  
• The impact of the introduction of Settlement Systems, Futures and Emissions Unit Bill. |
| Currency                        | • Improving the monitoring of trends in the use of currency.  
• Holding sufficient cash reserves for emergencies.  
• Ensuring counterfeit threat to notes and coins is minimised. |
| Depository and settlement services | • Progressing projects on soundness and efficiency of payments system.  
• Continuing to deliver system enhancements to improve the range of services.  
• Facilitating the inter-operability between ESAS/Austraclear and other providers’ payment and settlement systems.  
• The Minister of Commerce is reviewing New Zealand’s approach to clearing and settlement. |
Section 1
The current environment

The Bank’s most recent perspective on the impact on New Zealand of the extreme global financial disorder experienced over the past few months is covered in our November Financial Stability Report. In this chapter we summarise that view and consider the impact on the Bank itself.

In a number of economies it has become common internationally for monetary authorities to be separated from the financial institution regulator, and sometimes from their payments system overseer. As a ‘full service’ central bank, the Reserve Bank of New Zealand combines all these functions. It is therefore well placed, compared with many other central banks, to be both fully informed and to engage with the various segments of the economic and financial system.

The financial environment

New Zealand’s financial system has been weathering extreme disorder in international financial markets over the past few months. The disorder has led to a global ‘credit crunch’ that is dampening the economic outlook for New Zealand and our trading partners.

Markets became increasingly dysfunctional in September with the failure of Lehman Brothers and ongoing concerns around the viability of other major US institutions. Financial markets became more risk averse and illiquid, equity prices declined sharply and large financial institutions in the US, UK and Europe have been forced to merge or restructure.

While New Zealand’s banks have not experienced the significant financial losses associated with housing lending that have been at the heart of the global financial meltdown, the cost of and access to offshore funding has been affected. The New Zealand banking system relies on offshore funding, in the order of 40 percent of total deposits and much of it short term, a vulnerability we have noted previously. As a result, the availability of credit for New Zealand households and businesses has been tightening.

In response to the market turmoil, central banks and governments around the world have announced a wide range of measures to support their financial systems. In New Zealand these have included the introduction of a temporary opt-in retail deposit guarantee scheme, following the announcement of a comprehensive guarantee in Australia, to give assurance to New Zealanders that their deposits are safe. The Minister of Finance has also announced the introduction of a temporary opt-in guarantee scheme covering the wholesale debt of investment-grade New Zealand financial institutions to facilitate the banks’ re-entry to offshore wholesale debt markets.

To ensure the financial system has sufficient liquidity while overseas markets are dysfunctional, we have also widened the eligible collateral New Zealand banks can use to access liquidity from the Reserve Bank to include bank bills and AAA rated Residential Mortgage Backed Securities (RMBSs). We are also prepared to lend on a temporary and penal basis against unrated RMBSs where these securities are yet to achieve formal ratings.

Recent international events, including the bailout of institutions on a wide scale, are expected to prompt a widespread review of financial regulation and its appropriate balance with market discipline. These events have also demonstrated the risks faced by financial systems that are highly dependent on external financial markets, including those in New Zealand and Australia. We are currently consulting with the registered banks on proposed new standards for the management of their funding and liquidity. It is expected that this policy, when finalised, will reinforce incentives on the banks to diversify away from short-term wholesale funding and thus reduce their vulnerability to market disruptions over the longer haul.
Serious weaknesses in some non-bank financial institutions have been revealed over the past year. These have been exacerbated by slowing property markets, resulting in a large number of failures of non-bank deposit takers and a flow of funds away from investments exposed to this sector. With guarantees now in place, the non-banks have the opportunity, which will be reinforced by the new Reserve Bank prudential regime, to consolidate their balance sheets while improving systems and risk management practices.

Collectively, the banks, which represent the bulk of the deposit-taking sector, appear well placed to weather a weaker economy. New Zealand's banks, and the Australian parents of the large Australian-owned banks, have sufficient capital to withstand an increase in loan losses associated with an economic downturn. Moreover, the banks are not directly exposed to many of the negative factors impacting on their global peers.

Prospects for the New Zealand financial system will remain linked to developments in global markets. In essence, the global financial sector is undergoing a prolonged adjustment to the aftermath of a multi-year period of excessive optimism in asset markets fuelled by lax lending standards in the US and some other regions. Assuming adequate recapitalisation and restructuring of the major distressed global financial institutions, we will eventually reach the point where financial institutions are able to support global economic growth. In the interim, the adjustment process is proving extremely disruptive and it will likely be some time before financial market conditions normalise.

The economic environment

The global financial turmoil and the associated fallout for global growth is also having inevitable impacts on the New Zealand economy. It is making the process of economic adjustment that was already underway much more complex and difficult. The New Zealand economy has contracted over 2008 following a sustained period of growth for most of the decade. Drought conditions slowed growth by lowering production in a number of sectors. Domestic spending has been hit by the sharp increase in oil and food prices until recently, along with the tightening in global credit conditions. In addition, the sharp run-up in house prices and household debt, which had fuelled the expansion and stretched resources, could not be sustained indefinitely.

Looking forward, we expect the economy to grow only slowly over the next few quarters before gaining more momentum toward the end of 2009. Household and business spending is likely to remain subdued for some time, notwithstanding the boost coming from easier fiscal policy and declining oil and food prices. Export growth will be restricted by the weakening in global activity. Together these will see inflation pressures dissipate further, although price trends in some non-tradeable areas remain of concern.

Should the outlook for inflation evolve as projected we would expect to lower the OCR further. We will be monitoring and assessing economic and financial developments and prospects closely when determining the precise timing and extent of OCR reductions over the coming months.

The consolidation of domestic spending and an expected recovery in national savings should also contribute to an improvement in the country’s external balance assisted by the recent depreciation in the New Zealand dollar.

The Reserve Bank's role

A major challenge for financial and monetary authorities has been the enormous reach of the current financial crisis into financial institutions, systems and markets around the world. This crisis has been like no other in recent memory, and has been likened to “the biggest episode
of instability since the start of World War I\textsuperscript{1} – eclipsing comparisons with even the 1929 stock market crash.

As described earlier, the disorder has infected bank assets, short-term liquidity and funding, solvency (in some notable overseas cases), the ability of markets to operate, credit access and cost, and the safety of deposits in financial institutions. Equity, exchange and interest markets have recorded extreme volatility. Asset and commodity prices are falling rapidly, though inflation levels remain high. Economic growth is slowing.

The Reserve Bank’s broad range of functions means it has direct information flows from all of these critical areas and powers to respond where necessary. As Figure 1 below illustrates:

- Our prudential supervision powers mean we can directly monitor the financial health of our banks and non-bank deposit takers, and ensure appropriate regulations are in place.
- Our foreign reserves and domestic market operations provide real-time information on financial flows and market dynamics, and allow us to ensure there is sufficient liquidity for institutions and the financial system to function.
- Our payments system operations alert us to any problems arising between banks and other institutions as they settle their daily obligations with each other.
- As the sole supplier of notes and coins, we can gain early signals of changes in the public’s cash preference.
- Our economists analyse numerous information flows on the state of the economy – garnered for our primary purpose of ensuring price stability.
- We maintain close links with other domestic Crown agencies to inform us on Crown financial flows and company data, while liaising with private sector companies and agencies to monitor economic trends. We cooperate with overseas regulatory authorities and other central banks.
- We monitor information from the financial media and other web sources.

In the following pages, we describe in more detail the objectives, environment, issues and initiatives and strategies of each our functions in this continually evolving environment.

Figure 1

Early Warning Indicators Available at Reserve Bank for Mapping Financial Turbulence
Section 2
Functions

Overview

The Reserve Bank is constituted under the Reserve Bank of New Zealand Act 1989.

As New Zealand’s central bank, the Reserve Bank performs a number of functions that promote monetary and financial stability:

- **Monetary policy** – Our primary function is to conduct monetary policy to achieve and maintain a stable general level of prices.

- **Domestic market operations** – Through market operations we implement monetary policy and assist in the efficient functioning of the New Zealand financial system.

- **Foreign reserves management** – We manage foreign exchange reserves so we can intervene in the foreign exchange market if necessary, to help maintain a functioning foreign exchange market and ensure critical cross-border transactions can be made.

- **Prudential supervision** – We register and supervise banks, and regulate finance companies, building societies and credit unions, with the aim of promoting a sound and efficient financial system.

- **Crisis management** – We have powers to respond to financial system distress, including the handling of bank failures and acting as Lender of Last Resort to the financial system.

- **Currency** – The Bank is the sole issuer of bank notes and coins, and has a responsibility to maintain the integrity of that currency.

- **Depository and settlement services** – The Bank operates the interbank settlement system through which banks settle obligations between each other. It manages the terms on which liquidity is made available to enable those obligations to be settled (this is, in fact, the way in which monetary policy is implemented). We also operate the Austraclear payments and securities settlement system, and oversee the development of robust and efficient payments systems.

The environment and issues facing us in each of these interconnected roles are discussed in later in this document.
Monetary policy formulation

**Objectives**

- Under the Reserve Bank Act, monetary policy is the Reserve Bank’s “primary function”. Section 8 of the Act specifies that the Bank is required to “formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices”.

- The Bank’s approach to monetary policy is based on the principle that maintaining price stability is the best contribution that monetary policy can make to help an economy realise its maximum sustainable growth rate. Good monetary policy is supported by a sound overall government policy framework that does not itself contribute to economic fluctuations. It also depends strongly on what is happening in foreign demand and foreign interest rates.

- Inflation typically hits hardest those who least can afford it.

- Inflation also obscures the relative price signals that must come through clearly if the economy is to adapt to change and make the most of opportunities for growth. At present, high oil prices should be encouraging energy efficiency and alternative fuels development. High dairy prices should shift land use towards dairy production. An environment of stability in the general level of prices helps these signals come through so that the right consumption, investment and other business decisions are made.

- The Act does not define “stability in the general level of prices”. It provides for the specific policy target to be negotiated between the Governor and the Minister of Finance through a Policy Targets Agreement (PTA).

- The inflation target in practice is not as simple as just a target number for CPI inflation. We make choices and judgments about the path of inflation we will aim for over the medium term, and what risks need to be taken into account. The judgments are complicated by the lags with which monetary policy acts on the economy, and the uncertainty involved in forecasting.

**Environment**

- Through to the end of 2007 the New Zealand economy experienced a long and strong economic expansion, accompanied by an extended house price cycle, a high exchange rate, a large current account deficit and a rise in non-tradeables inflation.

- Over 2006 and 2007 monetary policy was geared to bringing about a moderation in activity and an easing in inflation. However, repeated positive shocks meant it has been difficult to rein in inflation pressures. These circumstances formed part of the background to the Finance and Expenditure Committee (FEC) Inquiry into the Future Monetary Policy Framework.

- As 2008 has progressed the economy has changed markedly, albeit with CPI inflation to date remaining uncomfortably high.

- We estimate the economy contracted over the first three quarters of 2008. Drought, rising borrowing costs, a decline in house prices, a high exchange rate and low consumer and business confidence offset high (until recently) world prices for a number of our commodity exports (dairy in particular) and easier fiscal policy. External developments, particularly the ongoing dysfunction of global financial markets, have been a key part of the mix, lowering trading partner growth, increasing
the cost of banks raising funds overseas and sapping consumer and business confidence. As a result we have seen a broad-based slowdown in retail spending and the housing market and weak export growth.

- Although growth has slowed, inflation has increased and inflation expectations have risen. The inflation picture has been exacerbated by a sharp rise in commodity prices, most notably for oil and food. This has pushed annual CPI inflation up to 5.1 percent in the September 2008 quarter.

- In the current global financial turmoil, expectations of global growth are being revised down, in the US and Europe toward recession levels. To date non-Japan Asia has been a relative stand-out performer but there are signs of slower growth ahead. Growth in Australia is also easing.

- We estimate inflation has peaked and will return inside the 1 to 3 percent target range toward the end of 2009. Economic activity is expected to begin rebounding slowly from the end of 2008. The slow pace of household spending is expected to be the major drag on overall growth, reflecting both the extent to which households need to improve their financial position, and that effective borrowing costs are expected to remain high for some time to come.

**Live issues**

- New Zealand, like other countries, is facing a difficult combination of influences not seen since the oil shocks of the 1970s and possibly the 1930s (in the case of global financial markets). Financial market developments are having a significant impact on the prospects for maintaining macroeconomic stability and the lines between financial and macro stability are being increasingly blurred.

- Through all this, the Reserve Bank’s task of maintaining price stability is a difficult one.

- We start from a position of persistent underlying inflation, with a series of cost shocks having pushed up headline inflation in the near term. We believe weak activity over 2008 and 2009 will ease inflationary pressures and we have begun to move monetary conditions to a less restrictive position.

- If monetary conditions remain too tight for too long, there is a risk that the New Zealand economy enters a prolonged downturn unnecessarily. This could result in significant underinvestment and potential financial instability, hampering the long-term growth prospects for the economy.

- However, easing monetary conditions too quickly in response to these risks could leave inflation above the target and increase the likelihood that inflation expectations become un-anchored, resulting in the need for a more costly disinflation in the future. It is likely to be early next year before we know whether slower activity is translating into lower underlying inflation. Furthermore, over-stimulating the economy at this time would risk slowing the unwinding of the macroeconomic imbalances that have built up over recent years, increasing the likelihood of a potentially larger and more disruptive adjustment in the future.

- Monetary policy can only do so much. The challenge for us is to be flexible in taking account of the negative forces currently buffeting the economy, without undermining public confidence in our commitment to price stability.
Initiatives and strategies

- Good monetary policy means being flexible about responding to price and demand pressures. Our numerical target, “future CPI inflation outcomes between 1 percent and 3 percent on average over the medium term”, incorporates flexibility. The “medium term” is not formally defined, but we normally aim to ensure inflation is within the range in the second half of a three-year forecast horizon.

- We are actively assessing how far and how fast monetary conditions should be eased and therefore the path for bringing inflation back “comfortably” within the target range. We are closely monitoring developments here and overseas and policy will continue to remain attuned to new information.

- Other PTA clauses reinforce the flexible approach. Clause 2(a) requires the Reserve Bank to monitor a range of prices. This explicitly ensures that the reference to the CPI does not blinker our view of inflation pressure in the economy – we should “look at everything”. The use of the CPI reflects that it is readily accessible and understood, and calculated by an independent agency (Statistics New Zealand).

- Clause 3(a) recognises that specific prices, such as oil and food currently, will sometimes move a lot, causing CPI inflation to move temporarily away from the target. However, Clause 3(b) then says that these circumstances are not reasons to lose sight of the medium term inflation target.

- Finally, Clause 4(b) requires that in pursuing the target the Reserve Bank should avoid unnecessary volatility in output, interest rates and the exchange rate.

- These clauses mean we should not be “trigger happy” in responding to new events, but should use the full width of the target range, in light of the particular shocks that arise.

- There is always scope to consider modifications to the detail of these arrangements (e.g. to the Policy Targets Agreement), but our judgment is that there are not any clear cut improvements to be made at the current time. Moreover, there are likely to be costs to change.

- Although inflation-targeting countries differ somewhat in their implementation details, the key elements of an inflation target plus independence plus accountability are widely accepted. Even non-inflation-targeting countries, such as the US and Japan, have independence and accountability arrangements that result in their central banks interacting with the public and financial markets in much the same way as in New Zealand.

- These elements were confirmed by FEC’s Inquiry into the Future Monetary Policy Framework.

Longer-term issues

- Inflation targeting is not an elixir for stabilisation. The current very large international forces remind us that small economies like New Zealand are especially dependent on developments offshore. Until recently, the New Zealand dollar has been very strong, materially complicating monetary policy – due partly to the sizeable gaps that opened up at various times between our interest rates and those in some other countries, including Japan, the US and Switzerland. Rising commodity export prices have also played a role. There is little we can do about other countries’ interest rates or international commodity markets.
• Dealing with asset price cycles and their consequences for price stability is another issue that central bankers across the world are grappling with. Housing market booms occurred this decade not only in New Zealand, but also the UK, Australia and the US. The aftermath of these booms is at the heart of current financial market dysfunction and it will be some time before we know how events will playing out both in New Zealand and elsewhere.

• On the positive side, there are things that can be done to enhance the environment within which monetary policy operates. These include a wider government policy framework that at least does not contribute to the cyclicality of the economy, and to the tendency for inflation shocks to become entrenched. Even better are government policies that reduce cyclicality – such as the well-known “automatic stabiliser” features of well-designed fiscal policy frameworks. Although economic stabilisation is not the primary motivation for these other policy areas, we do work with other government agencies to try to enhance the stabilisation properties of government policy where possible, including reducing structural distortions that tend to generate economic cycles.

• These issues motivate us to continue to look for other instruments that might support the OCR as tools to promote macroeconomic stability. As the Finance and Expenditure Select Committee’s Inquiry into the Future Monetary Policy Framework found, we do not think there are any magic bullets available. Having said that, we do think that certain adjustments to tax and other regulatory and competition structures might reduce their contribution to the cyclicality of the economy or the persistence of inflation. We also think there is merit in considering frameworks that lean more explicitly against pro-cyclical fiscal policy. Analysis of the other instruments and approaches suggested they would be either ineffective in the long run, or would introduce large economic distortions.

• As noted earlier, the differences in central bank mandates, inflation targeting frameworks and monetary policy conduct across countries are not large enough to explain the differences in long-run growth performance we observe. Savings, investment and average interest rate patterns reflect the long-running fact that New Zealanders remain willing to borrow and spend at much higher interest rates than those prevailing in other countries. What is also needed is savings and investment behaviour geared towards growth.

• We have found no clearly superior alternatives to the flexible inflation targeting approach to maintaining price stability. Such things as monetary targeting and fixed exchange rates have been tried before in New Zealand, as in other countries that are now inflation targeters. Both monetary and exchange rate targeting regimes tend to be very inflexible. They require the burden of many types of shocks to be forced through output, rather than absorbed by the policy instrument itself, and tend to be most suitable for situations where inflation expectations are poorly anchored and the commitment of the central bank to price stability is doubted by the public.
Inquiry into the Future Monetary Policy Framework


The Committee did not recommend any changes to the monetary policy framework or its operation – although New Zealand First expressed a minority view supporting a broader focus for policy.

The report contained four recommendations relating to the Reserve Bank. These were (with our response/position) that:

• the Reserve Bank consider making the results of its monitoring and evaluation of the housing market more accessible. (page 24 of the FEC report)

We are continuing to deepen our understanding of housing market developments, and will continue to draw on information in Monetary Policy Statements and Financial Stability Reports as relevant. We will also continue to use the Bulletin and Discussion Papers to make available our analysis.

• further analysis be undertaken of the interactions between fiscal, monetary, and general economic policy, given the impacts of fiscal policy on output, inflation, and the exchange rate. (page 50 of report)

We have recently undertaken a workshop on monetary-fiscal policy interactions and have ongoing engagement with Treasury on monetary-fiscal policy linkages.

• the Reserve Bank continue to highlight the distinction between cyclical and structural inflation drivers such as resource scarcity. (page 84)

The relative contributions of cyclical and structural factors to inflation will continue to drawn out in our Monetary Policy Statements.

• further to the advice tendered by our independent specialist adviser, the Government consider whether existing prudential legislation unduly restricts the Reserve Bank’s capacity to respond to inflation through the use of its prudential tools, given the implications of the rapid expansion of credit for the risks in household sector balance sheets and for the inflation outlook. The National Party rejects any suggestion that the Reserve Bank could or should use its prudential supervision powers to achieve monetary policy objectives. In the context of a global credit crunch, the Reserve Bank has a critical role maintaining confidence in the financial system. Any change to the current objectives and method of prudential supervision would put New Zealand out of step with internationally accepted norms and could create costly confusion in an already stressed financial system. (page 46)

The interactions between monetary and prudential policies are an area of active debate internationally in light of the current global financial crisis. As policy-makers move from crisis management to look at the implications for the future global financial architecture, it is possible we could see current policy approaches evolve. In the New Zealand-only context we examined some of these issues in the 2006 Supplementary Stabilisation Instruments report with Treasury. Going forward we will look to draw on international developments to inform our own thinking of the appropriate medium-term policy framework.

Domestic market operations
Foreign reserves management

Objectives

Domestic market operations conducted by the Bank’s Financial Markets Department support the effective implementation of monetary policy and promote the efficient functioning of New Zealand’s financial system. This is done by:

- Keeping short-term wholesale interest rates consistent with the Bank’s monetary policy stance.
- Promoting adequate liquidity in the New Zealand banking system to facilitate payments.
- Managing the Crown’s financial liquidity through the provision of the Crown Settlement Account.
- Maintaining confidence in the efficient functioning of New Zealand’s financial markets.

A team within the Financial Markets Department also manages a pool of foreign reserves to support and execute the Bank’s foreign exchange intervention policy, and to maintain an effective crisis intervention capability. Foreign reserves are held at a level agreed with the Minister of Finance in a liquid and secure form, suitable for foreign exchange market intervention.

Environment

- Recent global financial market turmoil has resulted in greater volatility in interest and exchange rates, credit spreads and other financial prices.
- Liquidity in New Zealand’s financial markets has also been adversely affected. This includes the foreign exchange swaps market, which is the main channel through which the Bank injects liquidity.
- The liquidity management regime introduced by the Bank in 2006 (where the Reserve Bank moved to a ‘cashed-up’ system\(^3\)) was ideally suited to deal with the recent global credit issues. Other central banks responded in a similar fashion by increasing the level of settlement cash in their systems. We needed only to add a small amount of cash to improve liquidity conditions.
- The Bank has introduced a further range of measures over the past year to help alleviate liquidity pressures and to ensure adequate liquidity in the event of global market disruptions. The range of acceptable securities for domestic market operations has been progressively expanded and now includes AAA rated Residential Mortgage Backed Securities and other high quality securities.
- The Reserve Bank maintains the capacity to intervene in the foreign exchange market in a crisis, or as a tool to influence the level of the exchange rate. In June 2007, the Bank announced that it had intervened in the New Zealand dollar market for the first time since the New Zealand dollar had been floated in March 1985.
- The intervention capacity consists of a diversified portfolio of foreign currency assets that can be realised quickly. These assets are financed by a mix of foreign currency loans from the Treasury and from the Bank’s own liabilities. The Minister of Finance, in consultation with the Bank, determines the amount of reserves required, specified as a range denominated in Special Drawing Rights (SDRs). Total reserves held for intervention at 30 September 2008 were 4.9 billion SDRs ($NZ11.4 billion).
- Since 2007, the Bank has held a portion of its foreign reserves on an un-hedged basis as opposed to the historical approach of holding them fully hedged. This has

been achieved by funding part of the Bank's foreign reserves using New Zealand dollar liabilities rather than foreign currency denominated loans.

- Increased turbulence in credit markets has made the investment of foreign reserves and the management of risk more challenging.

**Live issues**

- Despite a series of measures undertaken by the major central banks and governments, international financial market conditions are likely to remain volatile over the coming months. Periods of illiquidity and impaired access to overseas credit markets are likely. A key challenge is to ensure that the liquidity management regime is operated in a manner that ensures that the domestic banking system has adequate liquidity and that the associated risks (both to the Bank and financial institutions) are balanced appropriately.
- The Bank has taken a relatively cautious approach to credit in the management of the foreign reserves. It has increased the amount of government and AAA rated securities, decreasing exposures in lower rated entities. Whilst this has reduced credit risk, it will reduce return.

**Initiatives and strategies**

- The Reserve Bank is continuing to work closely with the banks to ensure that recent changes to its liquidity management arrangements become operational as soon as possible.
- The Bank is accepting bank paper in its daily operations and intends to offer longer terms than usual, up to six months, in order to help ease liquidity pressures in wholesale money markets.
- The Bank has announced the potential introduction of a new facility which will make Asset Backed Securities (ABS) eligible as collateral in its domestic liquidity facilities in addition to RMBS. This is intended to further broaden the range of assets and institutions that have access to Reserve Bank liquidity. The proposed terms for this facility have been subject to industry consultation and are currently being finalised.
- The Bank, along with the Treasury, Ministry of Economic Development and Inland Revenue, is supporting the industry-led taskforce that has been set up to produce a blueprint and action plan to further develop New Zealand's capital markets.
Prudential supervision

The Reserve Bank has a number of functions and powers and undertakes several activities relating to the following areas of prudential supervision:

- banking system oversight;
- non-bank deposit taker regulation;
- insurance regulation and supervision;
- payment system oversight; and
- proposed anti-money laundering regulatory regime.

Banking system oversight

Objectives

We register and supervise 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.

Environment

- There are currently 18 banks registered in New Zealand. The banking system is concentrated, with the four largest banks having almost 90 percent of total banking system assets, and most of the other banks being of relatively little systemic importance. The four largest New Zealand banks are owned by Australian parent banks.

- The New Zealand banking system remains sound, despite significant turbulence in the US and global financial markets, initially triggered by losses in the US sub-prime mortgage market. The New Zealand banks are not involved in the sort of complex financial transactions that have caused significant losses in many of the large global institutions, and the New Zealand banks are not directly exposed to these institutions. However, with heightened uncertainty investors have become more risk averse and this has resulted in a tightening in the availability of funding on global debt markets. This has increased liquidity risks and increased the cost of funding for New Zealand banks which source a significant amount of their funding from global financial markets.

- The situation is similar for the Australian parent banks, although these banks are expected to face some losses from exposures to troubled US financial institutions.

- Although the New Zealand banks remain profitable, the increased cost of funding, together with the slowing New Zealand housing market and slowing New Zealand economy, are likely to lead to a higher level of impaired assets and lower profits compared with the strong results of recent years.

- The Reserve Bank's approach to bank supervision has three main strands:
  - Promoting self-discipline by banks in the management of their risks through an emphasis on director responsibility;
  - Fostering effective market discipline on the banking system through disclosure requirements; and
  - Implementing regulatory discipline though the imposition of rules such as capital adequacy requirements.

- Bank supervision in New Zealand has placed considerable emphasis on market- and self-discipline. Compared to most overseas jurisdictions, our rules are not detailed or prescriptive, and unlike most other bank supervisors, the Reserve Bank does not
undertake onsite visits for the purposes of validating banks’ risk management procedures.

• Within the approach described above, recent changes to the regulatory framework for the New Zealand banking system include new policies relating to bank capital and liquidity. Early in 2008, the new international capital standard for banks (known as ‘Basel II’) was implemented in New Zealand. The new standard increases the risk sensitivity of capital requirements to key bank risks, particularly credit risk. In November 2008, the Reserve Bank released a draft of its revised bank liquidity policy for consultation. The development of this policy was underway prior to the period of international financial market volatility. However, the new policy takes into account lessons from these events and should ensure that banks are less vulnerable to future liquidity shocks and disruptions in global markets.

• Also in October 2008, the Crown Retail Deposit Guarantee Scheme (administered by The Treasury) was introduced. This covers deposits for New Zealand-registered banks and eligible non-bank deposit-takers (including building societies, credit unions and finance companies). The objective of the two-year opt-in scheme is to ensure ongoing retail depositor confidence in New Zealand’s financial system given the international financial market turbulence.

Live issues

• It is very difficult to anticipate how events in the international financial markets will unfold during the coming months. However, it is possible that the volatility will continue for some time. If this is the case, the New Zealand banks are likely to remain exposed to higher funding costs and potential liquidity pressures.

• The revised liquidity policy is expected to be finalised and in place early in 2009. The policy will be given effect through changes to banks’ conditions of registration.

• No major changes to bank regulations are proposed or expected to be submitted to Ministers in the near term.

• The introduction of the Crown Retail Deposit Guarantee Scheme has potential implications for the Reserve Bank’s approach to bank supervision. The scheme potentially changes the nature of financial sector risk and the incentives faced by banks and other market participants.

Initiatives and strategies

• We will continue to monitor the volatility in international financial markets on a daily basis. The Reserve Bank stands ready to support the liquidity of the New Zealand financial system if necessary, and has recently implemented a number of measures designed to alleviate liquidity pressures. These measures are similar to those put in place by other central banks.

• A period of time may be needed for New Zealand banks to comply with the revised liquidity policy given current funding pressures. Implementation will be supported by a compliance plan that each bank will agree with the Reserve Bank.

• The Reserve Bank has begun considering the implications of the Crown Retail Deposit Guarantee Scheme on its approach to bank supervision. This work is still ongoing.

Non-bank deposit taker regulation
Objectives

The Bank’s Prudential Supervision Department recently become responsible for the regulation of non-bank deposit takers (NBDTs) for the purposes of promoting the maintenance of a sound and efficient financial system, and to avoid significant damage to the financial system that could result from the failure of a non-bank deposit taker.

Environment

- NBDTs comprise finance companies and savings institutions such as building societies, credit unions and PSIS Ltd. There are around 100 NBDTs in New Zealand.

- The sector has faced considerable upheaval in recent times with many finance companies placed into receivership or reporting serious difficulties. Savings institutions have experienced fewer difficulties as their lending portfolios are generally less risky (i.e. heavily weighted towards residential mortgages). Also the better quality finance companies have sought to differentiate themselves from those with lower quality lending portfolios.

- As the sector accounts for a relatively small portion of total financial sector assets (less than 10 percent), the difficulties experienced have not had and are unlikely to have widespread negative effects on the financial system or broader economy.

- A combination of factors has contributed to the recent finance company failures, including high-risk lending and low reinvestment rates. Also a review of the NBDT sector (which was in train before the recent failures) identified a number of deficiencies in the regulatory regime.

- As a result of the review, new legislation was passed in September 2008 that made the Reserve Bank the regulator of NBDTs and requires NBDTs to comply with a new set of prudential requirements. Trustees Companies will continue to be front-line supervisors of NBDTs.

- The new prudential requirements set rules to govern the behaviour of deposit takers, improve the disclosure of financial risk to investors by providing for a mandatory credit ratings regime.

- More recently, as noted above, the Crown Retail Deposit Guarantee Scheme was introduced in October 2008 and non-bank deposit taking institutions can apply to join.

Live issues

- Further legislation scheduled for 2009 is needed to put in place some important remaining elements, such as licensing requirements and checks on the suitability and integrity of prospective directors and senior managers. These elements are fairly standard in any prudential regime but may not be well received by some industry participants.

- Regulations are needed to implement the new regime. It was initially planned that regulations would be in place by the middle of 2009. However, the introduction of the Crown Retail Deposit Guarantee Scheme has made the imposition of greater prudential discipline on non-bank deposit takers a more immediate concern. Consequently, the Reserve Bank is bringing forward its workplan, and expects to be able to have key regulations before the end of the year.
• More generally, the new regime presents some communication issues. For instance, it needs to be understood that some of the new requirements will take time to put in place. Also, new requirements themselves need to be understood. Finally, as the Reserve Bank has the power to exempt some NBDTs from the new regime (or parts of the regime) under certain conditions, there may be some lobbying by institutions seeking to be exempt.

**Initiatives and strategies**

• Given the introduction of the Crown Retail Deposit Guarantee Scheme, it is anticipated that regulations to give effect to capital and related-party lending requirements will be brought forward so they can take effect before the end of 2008.

• The Reserve Bank is planning some public education initiatives to assist understanding of the new regime. Over time, ensuring an understanding of the use of credit ratings will be an important aspect of these initiatives.

• To ensure a consistent approach is taken to exemptions, the Reserve Bank is developing an exemptions policy which will be applied to all exemption applications.

**Insurance regulation and supervision**

**Environment**

• The insurance sector comprises three broad product areas: life insurance, general insurance and health insurance. Each of the life, general and health sectors is characterised by a small number of large insurers with large market share and some quite small providers. Australian ownership dominates the New Zealand life and general insurance sectors.

• Current insurance regulation is administered by the Insurance and Superannuation Unit within the Ministry of Economic Development.

• Cabinet has agreed to a new prudential framework for insurers that includes the Reserve Bank as prudential regulator and supervisor of the insurance sector. The objective for the prudential supervision of the insurance sector will be to encourage the maintenance of a sound and efficient insurance sector that promotes policyholder confidence.

• The Reserve Bank’s role will be licensing and monitoring insurers, including financial disclosure requirements. The Bank will also be able to intervene in situations of distress or exit, but only where this is appropriate to minimise adverse impacts on policyholders and the sector. Product disclosure and other market conduct aspects of insurance regulation will rest with other agencies.

**Live issues**

• Well designed insurance regulation is important for maintaining policyholder confidence, which in turn contributes to the stability of the insurance sector and wider economic activity. Ongoing confidence in the sector can be quickly undermined by even a small amount of unexpected distress where the supervisor is ill equipped to take effective mitigating action.

• An example of this is the US authorities’ rescue of the American insurer AIG. Insurance companies have been much less affected by the financial turmoil than banks. But if AIG had not been rescued, the effect on confidence could have been severe – including in New Zealand where the company has two branch insurance operations. The events
underline the need to provide appropriate protection for the New Zealand policyholders' position in the event of future such scenarios – which is a fundamental feature of the proposed Insurance Prudential legislation.

• The new prudential framework agreed by Cabinet will address inadequacies that exist in the current arrangements. A Bill is being drafted to give effect to Cabinet’s decisions. It is planned that following consultation on the Bill, it will be introduced to Parliament in 2009, with the legislation taking effect in 2010. The Bill is not expected to be controversial. However, given its significance as outlined above, it is important that it is assigned a sufficiently high priority on the 2009 legislative programme.

Initiatives and strategies

• Although the need for modern prudential requirements is accepted, the new regime is a significant initiative for industry and the Reserve Bank. We plan to consult on the draft Bill as a strategy to ensure industry buy-in and an efficient Select Committee process.

• As ratings will be a mandatory prudential requirement for all insurers (subject to an exemption for small insurers), the planned public education initiatives referred to above are also relevant to this sector.

Payment system oversight

Objectives

The Bank’s Prudential Supervision Department oversees the payment system for the purpose of promoting the maintenance of a sound and efficient financial system.

Environment

• The Reserve Bank’s payment system oversight powers are relatively limited compared to its banking supervision powers and the payment system oversight powers of many other central banks. As a result, the Reserve Bank relies significantly on dialogue with industry and on moral suasion to progress its oversight objectives.

• A recent development is the introduction to Parliament of the Settlement Systems, Futures and Emissions Unit Bill in September 2008. This Bill supports the introduction of emissions trading markets by making technical changes to the regulatory framework for securities and futures exchanges and clearing and settlement systems.

• Among the changes made by the Bill are amendments to expand Part 5C of the Reserve Bank of New Zealand Act 1989. Part 5C currently provides for payments finality in the event of insolvency of a designated payment system participant. It also makes it clear that the rules of a designated payment system relating to payment and settlement are valid and enforceable in all circumstances. The Bill provides for a similar regime for designated settlement systems. The Bill also provides for the Reserve Bank and the Securities Commission to become joint regulators of designated systems other than those classed as ‘pure payment systems’.

Live issues

• For some years the Reserve Bank has been engaged with the payment sector on industry-led projects that seek to address important soundness and efficiency issues within the retail payment system. The Reserve Bank has recently expressed its concern to the industry that these projects are progressing too slowly.
• The Settlement Systems, Futures and Emissions Unit Bill may be controversial and is expected to be enacted in the first half of 2009. There is likely to be pressure to process security settlement system designation applications soon after the legislation comes into effect. The Reserve Bank will be working with the Securities Commission to formulate and manage the application process.

Initiatives and strategies

• The Reserve Bank has recently reviewed the nature of its engagement with the New Zealand payment system industry. It intends to take a more active interest in payment system matters and increase its engagement with the industry. It is anticipated that this approach will help to expedite the industry-led projects currently underway.

Proposed anti-money laundering regulatory regime

Environment

• The Ministry of Justice is leading an interagency policy programme to establish a new regulatory framework to detect and deter money laundering and terrorist financing.

• The international standards for anti-money laundering and countering the financing of terrorism (AML/CFT) are prescribed by the Financial Action Task Force (FATF). FATF is an inter-governmental body established by the OECD. New Zealand is currently non-compliant with many FATF standards.

• In September 2008, Cabinet agreed to a new regulatory framework for AML/CFT. This framework incorporates a multiple supervisor model in which the Reserve Bank is the AML/CFT supervisor for registered banks, non-bank deposit takers and insurers. Within the framework, the Securities Commission and the Department of Internal Affairs are also supervisors. Legislation is planned for 2009 that will give effect to Cabinet’s decisions.

Live issues

• New Zealand will be assessed against FATF standards in October 2009 following a visit in April 2009. Notwithstanding recent Cabinet decisions, New Zealand is likely to be found materially non-compliant in several areas (partly because there will not have been sufficient time for new measures to take effect).

• Although historically few AML/CFT issues have arisen in the financial sector, a poor FATF assessment could affect the reputation of New Zealand’s financial sector in the medium term. However, we assess the risk of adverse effects to be low, providing it can be demonstrated that New Zealand is taking steps to adequately comply with FATF standards. In our view, the current programme of regulatory reform is likely to be sufficient to demonstrate that steps are being taken, providing it progresses as planned.
Currency

The Reserve Bank has the sole right to issue legal tender bank notes and coins in New Zealand.

Objectives

The goal of Currency Operations is to meet the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

There are three specific objectives. These are:

- To hold sufficient reserves of currency so that all orders from banks that meet the Reserve Bank’s guidelines are supplied within agreed times.
- To ensure that notes and coins in general circulation are of a good quality.
- To keep the number of counterfeits at a very low level.

The Reserve Bank also issues legal tender collectors’ coins through an outsourcing arrangement with New Zealand Post.

Environment

The Reserve Bank purchases bank notes from Note Printing Australia. It buys the 10, 20 and 50 cent coins from the Royal Canadian Mint and the one and two dollar coins from the British Royal Mint. There were 118 million bank notes and 424 million coins in circulation in New Zealand at the end of September 2008. The value of currency in circulation was $3.5 billion.

The Bank holds reserves of bank notes as contingency stocks for a crisis and to meet seasonal peaks in demand, e.g. at Christmas. The contingency stocks could be needed in the event of an earthquake or tsunami, a pandemic, a major breakdown in the infrastructure for electronic transactions, or a financial crisis. Some of the contingency stocks are held in Australia. Reserves of coins are held principally to meet the steady growth in the number of coins in circulation.

Each year we issue about 60 to 70 million notes to banks and receive a similar number as repatriations. These notes are processed to confirm the reported value, to identify and destroy unfit notes and to check for counterfeits.

The number of counterfeit bank notes and coins found in New Zealand is very low by international standards and their quality is normally not high. However, it is important for the Bank not to be complacent regarding the potential threat posed by a ‘professional’ counterfeit attack. This might involve high quality forgeries that members of the general public would find difficult to distinguish from genuine notes.

Live issues

The Bank needs to continually monitor trends in the use of currency so that it anticipates, where possible, changes in the demand for cash generally, or for particular denominations of notes and coins.

The Bank also has an ongoing requirement to hold sufficient reserves of cash to meet reasonably plausible emergencies and to be ready to issue cash promptly.

As noted above, the incidence of counterfeiting in New Zealand is very low. However, most central banks overseas perceive a growing threat from the increasing sophistication and
wider general use of digital copying and printing processes. Consequently, many central banks have shortened the lifetime of note series to seven to nine years.

Initiatives and strategies

The Currency Operations team is undertaking a project to upgrade its information systems and to improve the efficiency of its operations.

The Bank plans to undertake a review of the security features on New Zealand’s bank notes with a view to possibly issuing a new series of bank notes during the 2010–2015 Five-Year Funding Agreement. The current series of bank notes was first issued in 1999.
Depository and settlement services

Objective

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

The Bank operates two settlement systems:

- ESAS – for recording settlements of interbank transactions.
- Austraclear – for recording settlement of securities transactions by financial institutions on a ‘delivery versus payments’ basis (that is, where there is simultaneous transfer of cash and securities).

Environment

- Stable, secure and efficient payment and settlement systems are critical elements of the country’s infrastructure. Competition for depository services in New Zealand is emerging. Standards for system performance and resilience are being lifted.

- We introduced new governance arrangements for the Austraclear system in 2007/08, establishing the Austraclear Users’ Advisory Committee. This governance formalises members’ input to systems changes and pricing, and gives users the opportunity to review the performance of the Bank as operator of the system. We retain decision-making power in respect of the system, but are required to consider and formally respond to members’ views.

Live issues

The main issues for the Bank are:

- Continuing to deliver systems enhancements which improve the range of services provided by these recently upgraded systems.

- Establishing interfaces that will facilitate inter-operability between ESAS/Austraclear and other providers’ payment and settlement systems, to increase efficiency and meet user needs.

- Additionally, the Minister of Commerce is reviewing New Zealand’s approach to clearing and settlement. The objective of the review is to consider broader issues around competition, efficiency, innovation, and market structure – matters that are outside the scope of the Settlement Systems, Futures, and Emissions Units Bill. The Bank will be providing input to this review.
Corporate services

Knowledge services

Objective

The Bank’s Knowledge Services Group provides core technology infrastructure (both payments systems and the internal Bank network), applications development and support, helpdesk and web support, library, information and records management, and programme management services. The department’s annual budget is in the order of $6m.

Environment

Capital Expenditure

The following table details the capital expenditure programme since 2004.

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Projects and Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004/05</td>
<td>$5.2m</td>
<td>Findur treasury system, Documentum information management system, Austraclear.</td>
</tr>
<tr>
<td>2005/06</td>
<td>$3m</td>
<td>Findur, Austraclear/ESAS, computer room upgrade, web publishing.</td>
</tr>
<tr>
<td>2006/07</td>
<td>$3.4m</td>
<td>Austraclear/ESAS/Swift.</td>
</tr>
<tr>
<td>2007/08</td>
<td>$1.8m</td>
<td>Storage Area Network, Austraclear/ESAS, Intranet upgrade, telephone upgrade phase I, payments systems (lodges/uplifts) and new servers</td>
</tr>
<tr>
<td>Budget 2008/09</td>
<td>$2.6m</td>
<td>Financial Sector Information System, payments systems, telephone upgrade phase II, server infrastructure</td>
</tr>
</tbody>
</table>

Overview of Systems

There are a range of services, logically split between the Bank’s payments systems and internal network infrastructure. The main components are grouped in the diagram below.
Issues

Overall, the Bank’s systems performance is robust and meets the Bank’s expectations. However, we are working in an increasingly complex environment as the Bank’s systems and infrastructure evolves. Internal network systems availability is exceptionally good. The capital expenditure programme for infrastructure projects over the last four financial years has mitigated concerns in regard to risks of some single points of failure and ageing technology.

The payments systems network has a robust Wellington/Auckland alternating site regime that provides significant protection and ensures a high level of availability. However, there is also scope to further enhance automation and improve resilience.

Significant Projects this Financial Year

- **Financial Sector Information System (FSIS)**

The FSIS project will replace and upgrade the Bank’s capability to manage survey data which contributes to the Bank’s supervisory role. The project is split into a number of phases, the first delivering a core system this financial year. Subsequent phases will involve the integration and migration of existing survey returns, leading to the retirement of legacy systems. FSIS will become the Bank’s major data repository.
• **Business Continuity Planning (BCP)**

This is a continuation of work already underway. Planning will focus on improving our disaster recovery capability with the establishment of a small business support office in Auckland. We continue to assess our infrastructure capability to ensure our BCP requirements are met on an ongoing basis.

• **Austraclear / ESAS Enhancements**

The Austraclear / ESAS system upgrade went live in September 2007. This provided the Bank with a robust applications platform on which to make additional functional enhancements in the future.
Financial services

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

Environment

• The Bank manages a very large and complex balance sheet with associated accounting responsibilities.

• In the last year, a significant upgrade was made to ensure the Bank’s core treasury system remains fully updated and supported into the future.

• The decision in July 2007 that a portion of the Bank’s foreign reserves would be held on an unhedged basis entailed changes to the risk measurement and monitoring regime administered by the Bank’s Financial Services Group.

• In June 2008, we became the first central bank to become a member of CLS Bank, which allows the Bank to simultaneously settle both elements of foreign exchange transactions, thereby reducing settlement risk. Currently, the Bank uses the CLS Bank system for settlement of transactions involving the exchange of US dollars and New Zealand dollars. Preparatory work to add other currencies is underway.

Live issues

• The Bank is seeking to maximise efficiency through improvements to processes and systems, including replacement of the Bank’s own accounting systems before 2011.

• A new five-year Funding Agreement will need to be negotiated for the period 2010/11 – 2014/15, as the Bank’s current Funding Agreement concludes on 30 June 2010.

Initiatives and strategies

• We will continue to enhance workflows, reports, and processes for financial operations and securities transaction activities, including a review of options for replacement of the Bank’s own accounting systems.

• We will initiate preparation of the Bank’s Five-Year Strategic Plan and Funding Agreement for the period 2010/11 – 2014/15.
Human resources

Objective

The Human Resources team provides strategic human resource advice and support services to the Bank.

Environment

Historically the Bank has experienced relatively low staff turnover. The current labour market conditions are putting increasing pressure on recruitment and retention of staff.

Live issues

The Bank’s priorities reflect the need to manage key-person risk and to continue to provide management and leadership development to create a strong and vibrant working culture.

The Bank is currently recruiting additional staff to carry out its expanded prudential regulation functions.

Communications

Objective

The Communications team provides strategic advice and management for the Bank’s external and internal communications and for the maintenance of its reputation and credibility.

Environment

- The Bank is closely managing its communications in the current uncertain and volatile global economic and financial environment.
- The Bank’s communications now encompass its new role as the prudential regulator for non-bank deposit-takers and insurers.
- To enhance economic efficiency, the Bank will support programmes to improve financial literacy.

Live issues

- To ensure its messages are informed, accessible, timely, and delivered to target audiences, the Bank communicates through a range of public statements, speeches, online and hardcopy publications.
- There is an increasing need to coordinate relationships with New Zealand and Australian agencies to ensure clear communication and preparedness in a volatile environment.
- The Bank sponsors appropriate programmes and works with other agencies to address the need to improve New Zealanders’ financial literacy.
Section 3
Governance and management

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

Responsibilities of the Governor...

The Governor is the Bank’s chief executive officer, appointed by the Minister of Finance on the Board of directors’ recommendation. This structure provides a form of ‘double veto’, as both the Minister and the Board must have confidence in any person appointed as Governor. The Governor is appointed for a term of five years, and can be reappointed for further terms, each of up to five years. Unlike other Crown entities, authority and accountability for exercising the Bank’s powers rests with the chief executive, rather than the Board.

... the Minister...

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

...and the Board

The Board has prime responsibility for monitoring the performance of the Bank and the Governor on a continuous basis. It is, in effect, the agent of the Minister of Finance. It can also advise the Governor on the conduct of the Bank’s functions and administration of the Bank.

The Bank’s Board consists of between five and seven non-executive directors appointed by the Minister of Finance for five-year terms, plus the Governor. The Board is chaired by one of the non-executive directors, elected by the Board from among their number each year. The current chair is Dr Arthur Grimes. The Board is also required to issue an annual report setting out its assessment of the Bank’s and the Governor’s performance. This is published in the Bank’s Annual Report. An Audit Committee, comprising four non-executive members of the Board, monitors the accounting practices, accounting policies, and internal control systems of the Bank; reviews the internal audit function; and has direct access to the external and internal auditors.

The Board is required to advise the Minister of Finance if it is satisfied that the Bank has not adequately carried out its functions, the Governor has not adequately discharged the responsibilities of office, or the Governor’s performance in ensuring that the Bank carries out the Policy Targets Agreement has been inadequate. In these circumstances, the Board may recommend to the Minister of Finance that the Governor be removed from office. Where the Minister of Finance is satisfied that the criteria set out in the Act for the removal of the Governor have been met, he or she may advise the Governor-General to remove the Governor.

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4 The Act also requires the appointment of a Deputy Governor as a Deputy Chief Executive. That appointment is made by the Board on the recommendation of the Governor.
## Powers under the Reserve Bank of New Zealand Act

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<th>Section</th>
<th>Powers</th>
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<tr>
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<tr>
<td>77</td>
<td>Deregister Banks</td>
<td>Recommend</td>
<td>Right Required</td>
<td></td>
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<td>81</td>
<td>Public Disclosure Statements</td>
<td>Recommend</td>
<td>Right Required</td>
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<td>113</td>
<td>Give Directions to Banks</td>
<td>Require</td>
<td>Consent</td>
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<td>117</td>
<td>Statutory Management</td>
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<td>Right Required</td>
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<td>119</td>
<td>Advisory Committee</td>
<td>Recommend</td>
<td>Right</td>
<td>Gazette</td>
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<td>144</td>
<td>Terminate Statutory Management</td>
<td>Recommend</td>
<td>Right Required</td>
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<td>149</td>
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<td>Co-agree</td>
<td>Co-agree</td>
<td>Parliament ratify</td>
<td></td>
<td></td>
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<td>165</td>
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</tbody>
</table>
Reviewing the Bank’s performance

The Bank and the Governor are also subject to ongoing assessment by Parliament’s Finance and Expenditure Committee, including a hearing after each quarterly Monetary Policy Statement. The Committee is advised by a part-time economist.

Both the Reserve Bank Act and the State Sector Act enable the Executive to require a review or performance audit of the Bank.

The Bank’s operational autonomy is balanced by a responsibility to exercise its powers under public scrutiny through a number of public documents:

- The Policy Targets Agreement – This publicly discloses the monetary policy objective.
- **Monetary Policy Statement** – The Bank is required to issue at least every six months a Monetary Policy Statement specifying the policies by which the Bank intends to achieve the policy target, stating the reasons for adopting those policies, and reviewing and assessing monetary policy implementation. In practice, the Bank has for some years issued Monetary Policy Statements quarterly.
- **Statement of Principles: Bank Registration and Supervision** – The Bank is required to publish a statement setting out the principles on which it acts in carrying out its registration function and in setting prudential requirements. The Bank consults extensively on material changes in its supervisory policy and practice.
- **Financial Stability Report** – A six-monthly report also discloses our thinking on the risks facing the financial system.
- **Annual Report** – This includes externally audited financial statements.\(^5\)
- **Statement of Intent** – The Bank is also required to provide a Statement of Intent before the start of each financial year. This sets out the Bank’s objectives for the next three years and the budget for the first year of that period. The Bank must have regard to any comments made by the Minister on the Statement of Intent.

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\(^5\) The Auditor-General is responsible for the audit of the Reserve Bank’s accounts.
Organisational structure

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 management structure is set out on the following page. The main committees are:

- Senior Management Group, which meets weekly to consider the management and day-to-day operation of the Bank.

- Monetary Policy Committee, which meets weekly to advise the Governor on economic and financial developments.

- Official Cash Rate Advisory Group, which comprises a subset of MPC plus two part-time external advisers, and which has responsibility for advising the Governor on OCR decisions.

- Financial System Oversight Committee, which meets fortnightly to consider policy issues relating to the soundness and efficiency of the financial system.

- Asset and Liability Committee, which meets monthly to review risks and risk management frameworks around the Bank’s balance sheet and its operations in financial markets.

- Communications Committee, which meets weekly to consider communications issues.
**Management Structure**  
*As at November 2008*

<table>
<thead>
<tr>
<th>Governors</th>
<th>Department/Heads</th>
<th>Functions</th>
<th>Internal services</th>
</tr>
</thead>
</table>
| Assistant Governor/Head of Economics  
*John McDermott* | Economics | Monetary policy formulation |  |
| Deputy Governor/Head of Financial Stability  
*Grant Spencer* | Financial Markets  
*Simon Tyler* | Domestic market operations  
Foreign reserves management  
Macro-financial stability |  |
| Prudential Supervision  
*Toby Hennes* | Financial system surveillance and policy |  |  |
| Governor  
*Alan Bollard* | Currency and Building services  
*Alan Boaden* | Currency operations  
Property management  
Security |  |
|  | Financial services  
*Mike Wolyncewicz* | Settlement services  
Registry and depository services |  
Accounting services  
Treasury services |  
Library services  
Technology services  
Project management  
Web publishing |
| Assistant Governor/Head of Operations  
*Don Abel* | Human Resources  
*Lindsay Jenkin* | Human resources strategy and services |  |
| Communications/Board secretary  
*Mike Hannah* | Communications strategy and services  
Reputation management  
Board secretary services |  |  |
| Risk assessment and assurance  
*Steve Anderson* | Risk assessment and assurance  
Audit services  
Legal services |  |  |
## Board of Directors

<table>
<thead>
<tr>
<th>Non-executive</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dr Arthur Grimes</strong></td>
<td><em>Chair Reserve Bank of New Zealand Board of Directors</em></td>
</tr>
<tr>
<td></td>
<td><em>Economic Consultant</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 13 March 2002 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>12 March 2012</em></td>
</tr>
<tr>
<td><strong>Alison Paterson QSO</strong></td>
<td><em>Deputy Chair Reserve Bank of New Zealand Board of Directors</em></td>
</tr>
<tr>
<td></td>
<td><em>Chair Reserve Bank of New Zealand Board of Directors’ Audit</em></td>
</tr>
<tr>
<td></td>
<td><em>Committee Company Director</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 1 February 1995 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>31 January 2010</em></td>
</tr>
<tr>
<td><strong>Paul Baines</strong></td>
<td><em>Company Director</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 1 July 1999 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>30 June 2009</em></td>
</tr>
<tr>
<td><strong>Dr Chris Eichbaum</strong></td>
<td><em>University Senior Lecturer</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 1 August 2008 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>31 July 2013</em></td>
</tr>
<tr>
<td><strong>Hugh Fletcher</strong></td>
<td><em>Company Director</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 10 June 2002 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>9 June 2012</em></td>
</tr>
<tr>
<td><strong>John Goulter DCNZM JP</strong></td>
<td><em>Company Director</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 9 February 2000 – current term expires</em></td>
</tr>
<tr>
<td></td>
<td><em>8 February 2010</em></td>
</tr>
<tr>
<td><strong>Dr Marilyn Waring</strong></td>
<td><em>University Professor</em></td>
</tr>
<tr>
<td></td>
<td><em>First appointed 4 February 2004 – current term expires</em></td>
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<tr>
<td></td>
<td><em>3 February 2009</em></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Executive</th>
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</thead>
<tbody>
<tr>
<td><strong>Dr Alan Bollard</strong></td>
<td><em>Governor</em></td>
</tr>
</tbody>
</table>
Financial and risk management

Funding structure
The Reserve Bank is both a statutory agency and a financial institution. It receives no direct funding through the central government budgetary process. Instead, the Bank’s main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the Government’s equity contribution to the Reserve Bank. Currency in circulation is, in effect, an interest-free loan from the public, and the proceeds are invested by the Reserve Bank in government bonds. The Bank’s equity has been increased in recent years to enable the Bank to absorb the risks from any foreign exchange intervention undertaken at its discretion, as well as the greater volatility in reported equity arising from accounting changes.

The Minister of Finance and the Governor are required to enter into Funding Agreements to specify the amount of the Bank's income that may be used to meet the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and requires ratification by Parliament.

Each funding agreement applies for five consecutive financial years. This is designed to provide the Bank with operational independence, while also ensuring accountability for its use of resources. The Bank engages in an internal annual budgeting process.

The current Funding Agreement covers the five years to 30 June 2010. Funding rises from $39 million in the first year (2005/06) to $46.9 million in 2009/10. A variation to the Funding Agreement was ratified by Parliament in June 2008 for the 2008/09 and 2009/10 financial years to cover the costs of additional advice and establishment of new non-bank prudential responsibilities. The variation increases funding for 2008/09 from $41.0 million in the original Funding Agreement to $43.3 million, and for 2009/10 from $43.0 million to $46.9 million.

The current Funding Agreement reflects various factors, including the need to:

• invest in the replacement and upgrading of our treasury and document management systems, our economic forecasting and data systems, and our core financial reporting system, and the introduction of new ‘silver’ coins;

• strengthen our supervisory capability, including the extension of our prudential responsibilities to cover non-bank deposit takers and insurance companies; and ensure that robust business continuity process arrangements remain in place.

The Reserve Bank of New Zealand Bill (No3) changed the regime governing payment by the Bank of an annual dividend to the Crown.

The rules relating to whether the Bank is required to pay a dividend to the Crown or retain profits as reserves are key to the overall governance and accountability of the Bank and to the Bank’s relationship with the Minister of Finance.

The Reserve Bank of New Zealand, like other central banks, requires sufficient capital to be able to prudentially manage the risks associated with delivering its statutory functions.

The Reserve Bank of New Zealand Bill (No3) changed the regime governing the Bank’s dividend policy from a formula-based approach (i.e., the Act previously contained the formula, known as Notional Surplus Income, for calculating the annual
dividend the Bank recommended to the Minister each year) to a principles-based approach.

The Reserve Bank of New Zealand Bill (No3) removed the concept of Notional Surplus Income from the Act and instead requires the Bank to publish in its Statement of Intent a statement of dividend principles it must apply in determining its dividend recommendation each year.

Under the principles-based approach, the prime consideration for the Bank in making its dividend recommendation to the Minister will be to ensure that the Bank retains sufficient capital to absorb the risks of performing its policy functions and with surplus capital being distributed to the Crown.

Last financial year, the Reserve Bank spent a net $38.1 million on activities covered by its Funding Agreement, which was 7.1 percent below the $41 million specified in the Agreement. The Bank generated a surplus of $535 million, of which $344 million was unrealized gains from the holding of foreign reserves. A dividend of $168 million was paid to the Crown.

Primarily because of the requirement to account for unrealised gains and losses on the Bank's foreign exchange open position, the Bank's financial performance will likely appear more volatile in future years. From 1 July 2007, following the adoption of IFRS, the Bank's portfolio of New Zealand Government securities is accounted for at market value with unrealised gains and losses recorded directly in equity. As a result, reported equity will also be more volatile than in the past.

Risk management

The Reserve Bank faces a wide range of risks, in particular associated with our policy responsibilities (policy mistakes or misjudgments):

- Monetary policy – We supplement economic forecasts with a programme of talking to businesses and monitoring the forecasts of other analysts. We incorporate a broad diversity of views in the policy formulation process, by involving a range of staff advising the Governor and by engaging two part-time external advisers. The Bank also periodically engages foreign central bankers and academics to provide peer reviews of our monetary policy process.

- Financial stability – We consult with other government agencies and affected private sector institutions before implementing changes to the policy framework. We liaise with overseas banking supervisors, particularly the Australian Prudential Regulatory Authority.

- Financial – The Bank faces financial risks because of our operations in the domestic financial system and because of our holdings of foreign exchange reserves. The risks are associated with credit, market dealings, interest and exchange rate movements, currency processing and storage, facilitating large-value securities transactions via Austraclear; and operational risks in all of the transactions and processing areas of the Bank.

- Staff – As a small specialised organisation (around 220 fulltime equivalent staff) we are exposed to a risk of losing key highly-experienced staff and the associated institutional knowledge.
The Bank has developed a strong risk management culture and a number of management systems and internal controls based on best international practice. We ensure we can function in the event of physical crises, including localised loss of access to our building and a wider regional disaster.

We have two units with specific responsibilities for monitoring and managing risk:

- The Risk Assessment and Assurance Department, responsible for general risk monitoring. The internal audit role and the Legal Counsel also reside in this department.

- The Risk Unit within the Bank’s Financial Stability Department, which provides specialised advice on interest and exchange rate risk, credit risk, and liquidity risk, and the appropriate limits the Bank needs to have in place to ensure the prudent and effective conduct of its operations.

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