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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.
- Section 2 describes 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, with responsibility for monetary policy, the supervision and regulation of much of the financial system as well as the issue of New Zealand’s currency. Having this range of functions helps to keep us well informed about the operation of the economic and financial system. This was particularly beneficial during the global financial crisis (GFC) with the Bank being able to react swiftly and innovatively to emerging issues.

The GFC has produced a range of lessons for central banks and we are continuing to incorporate them into our own policy thinking wherever possible. A key lesson from the GFC has been that financial crises can have a major and prolonged impact on the economy and, consequently, that regulatory policy should lean towards conservative settings. We have also learnt much about the operation of financial markets and their capacity to freeze during periods of stress. In the wake of the crisis, a number of countries were forced to reduce interest rates to zero and to adopt less orthodox forms of monetary policy such as quantitative easing (QE). While this was not necessary in New Zealand, we have attempted to learn from their experiences for reasons of future preparedness. The implementation of such policies can be challenging and their effectiveness remains contentious.

Economy

The New Zealand economy grew 1.5 percent in the year to June 2011 on the back of strong international commodity prices and a recovery in consumer and business sector confidence. We expect economic growth to reach around 3 percent over the coming year due to high export revenues and the reconstruction activity generated by the Canterbury earthquakes. However, a key issue is the extent to which recent global financial market turbulence, and signs of slowing trading partner growth undermine this outlook over the months ahead.

Headline inflation has remained elevated over the past year peaking at 5 percent, partly reflecting last year’s GST increase. However, our latest assessment is that core inflation remains relatively well contained.

Provided global developments have only a mild impact on New Zealand, it is expected that the Official Cash Rate (OCR) will need to gradually increase over the next 18 months in order to ensure that inflation settles back within the 1-3 percent target band by early 2012. We will continue to update the outlook for inflation and monetary policy in our regular Monetary Policy Statements.

Global financial markets

Global financial markets have been intensely focused on high levels of public debt in many countries, especially in Europe, along with the capacity and willingness of policymakers to cut fiscal deficits and avoid default on their outstanding debt. While various measures have been proposed or adopted, the outlook remains volatile.

For New Zealand the consequences of these concerns have been manifest in two ways. First, worries about European banks’ exposure to peripheral sovereign debt have contributed to a tightening in global debt markets in recent months, on which New Zealand’s banks are heavily reliant. And secondly, a slowdown in global growth has the capacity to undermine the recovery in New Zealand’s economy, which has been assisted by a strong terms of trade. In the event that access to global debt markets remains difficult for an extended period, the Reserve Bank has the capacity to provide additional liquidity to the banking system if required. More generally, the global experience underscores the desirability of ensuring that New Zealand’s own fiscal position is managed on a sustainable path.
**Canterbury earthquakes**

The Canterbury earthquakes have resulted in exceptionally high levels of claims for insurers both in terms of quantity and cost. The continuity of new residential insurance in the wake of continued seismic instability is proving to be a significant issue for Canterbury and one which has the capacity to hinder rebuilding in the region.

The earthquakes are expected to prompt some structural changes within the insurance industry and we are seeing the beginnings of an adjustment in insurance premiums for both households and businesses throughout the country.

**Domestic market operations**

Domestic market operations support the effective implementation of monetary policy by helping to keep wholesale interest rates aligned with the OCR, promoting liquidity and managing the Crown’s financial liquidity. Extraordinary liquidity facilities were required during the GFC when global debt markets became impaired. While these facilities have since been withdrawn the Bank maintains its capacity to use its balance sheet to provide additional support should this become necessary given the ongoing turbulence in financial markets.

**Foreign reserves management**

The Bank holds a portion of its foreign reserves on an unhedged basis. The low interest rate environment and a cautious approach to credit in the management of foreign reserves has reduced the returns on our unhedged reserves.

Furthermore, the returns on the reserves will remain volatile as the New Zealand dollar ebbs and flows with bouts of risk seeking / risk aversion on international markets.

The Bank is in the process of implementing a new foreign reserves asset allocation and management approach, which includes the establishment of independent benchmarks for the foreign reserves portfolio.

**Regulation and supervision of banks**

Despite the ongoing global financial market turbulence currently evident, New Zealand’s banking system remains sound and our financial regulatory and supervisory framework continues to serve us well.

The Bank is taking the opportunity, nevertheless, to review all the policy instruments it has available to promote a more stable and resilient financial system. These ‘macro-prudential’ instruments generally take the form of additional capital and liquidity buffers designed to provide the financial system with extra shock-absorbing capacity at times when this is desirable. We also intend to proceed with the implementation of Basel III capital and other requirements for banks.

The Bank has consulted banks on the changes that would be required to their IT systems to implement Open Bank Resolution (OBR) in a failure situation. The purpose of OBR is to avoid the ‘too big to fail’ taxpayer bailouts and to place responsibility of failure effectively on shareholders and creditors while allowing the bank to continue to operate as a going concern. Banks are required to submit implementation plans to the Bank by the end of February 2012.
**Regulation and supervision of other institutions**

In September 2008 the Bank became the prudential regulator of non-bank deposit takers (NBDT). Currently these institutions are required to comply with prudential requirements relating to risk management, credit ratings, capital, liquidity, governance and related-party exposures. Trustees are the front line supervisors of NBDTs. A new NBDT Bill, introduced in August this year, will also impose a licensing requirement, an associated suitability assessment of directors and senior officers, and give powers to the Bank to gather information, issue directions, and remove and replace directors.

In September 2010 the Bank became the regulator and supervisor of licensed insurers. The Bank will be in a position to more closely monitor the financial position and solvency of insurers once the powers under the Act come into force in March 2012. In the meantime it is in the process of moving all insurers through to full licensing by September 2013.

In 2009 the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act was passed. This made the Bank the AML/CFT supervisor for banks, NBDTs and life insurers. At present the Bank is assisting reporting entities to prepare for the advent of their new obligations.

**Macro-financial policy**

Over the past two years, the Bank has been undertaking research into macro-prudential tools and their possible role in New Zealand. We have identified several instruments that we believe could be helpful if and when we face periods of excessive credit growth here. While current weak credit growth means that there is little immediate need for such tools, our work has been clearly focused on future preparedness.

**Currency**

The Reserve Bank meets the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

There are indications that the protection offered by the security features on New Zealand’s current banknotes has diminished in recent years. The Bank is now in the early stages of a project to update the security features of New Zealand banknotes and to refresh their look. The earliest the new notes will be issued is 2014. It will have been 14 years since the current series of notes were issued.
KEY ISSUES

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SECTION 1

The current environment

The financial environment

It has been more than three years since the onset of the global financial crisis, which caused major financial upheaval and economic fallout around the world. Progress has been made in re-shaping regulatory frameworks, but financial institutions and sovereigns in many countries remain under considerable stress, particularly in Europe. Financial markets have been intensely focused on high levels of public debt among the PIIGS\(^1\) countries and the capacity and willingness of policymakers to undertake the required measures to avoid sovereign default in countries including Greece, Italy and Spain. Fiscal concerns have also been to the fore in the US and have been compounded by ongoing political deadlock. Partly reflecting these pressures, the global economic recovery has softened, adding to financial market concerns. Global equity and commodity prices have fallen sharply in recent months and yields on government bonds in major economies have fallen as investors seek safer assets.

The consequences of this upheaval for New Zealand’s financial system are twofold. First, concern about European banks’ exposure to peripheral sovereign debt has contributed to a tightening in global markets for bank debt in recent months, on which New Zealand’s banks are heavily reliant. Second, a slowdown in global growth has the capacity to undermine the recovery in New Zealand’s economy, which has been assisted by a strong terms of trade.

New Zealand’s banks have been well-funded over this period, given the considerable debt issuance undertaken in the past two years (as banks have lengthened the term of their funding) and very limited balance sheet growth. However, the banks will need to raise debt over the coming year to replace maturing issues and to fund an expected modest increase in the demand for credit. Assuming recent debt market pressures persist, funding costs for the banks will increase, putting additional pressure on lending and deposit rates relative to the Official Cash Rate (OCR). Although monetary policy will take this into account, this could be reflected in the cost of credit for some domestic borrowers. Moreover, the possibility of ongoing periods of global market disruption cannot be ruled out during which the banks may find it difficult to undertake debt placements.

In the event that the banking system became unable to meet its funding needs from global markets there are number of options we would consider. A number of facilities were developed during 2008/09, when offshore markets were frozen for an extended period, and were shown to work effectively. A possible measure would be to re-activate the Term Auction Facility (TAF) under which the banks would be able to obtain term loans from the Reserve Bank using their holdings of Residential Mortgage Backed Securities (RMBS) as collateral. It would, however, be important to price these facilities in a manner that encouraged the banks to exhaust other market funding avenues in the first instance.

Despite a significant increase in private sector borrowing and rapid increases in house and farm prices in the years prior to the financial crisis, New Zealand’s banks did not experience the marked deterioration in asset quality seen in some overseas banking systems. Aggregate non-performing loans rose during 2009 and 2010 reflecting the flow-on effects of weak economic activity but remained within manageable levels at just over 2 percent of total bank lending. Over 2011, non-performing loans have begun to decline while bank profitability has recovered somewhat from its post-crisis lows. While we expect bank asset quality to continue to improve gradually, this will depend in part on the pace of economic activity and the extent to which commodity prices hold-up.

\(^1\) The PIIGS countries are Portugal, Ireland, Italy, Greece and Spain
New Zealand’s external debt remains elevated by international standards reflecting a prolonged period of low private sector savings relative to investment. The majority of this debt is intermediated via banking sector borrowing from offshore. While the private sector savings position has improved in recent years, this has been partly offset by deterioration in the Crown’s financial position. High levels of external debt were a key factor leading Standard and Poor’s and Fitch to downgrade New Zealand’s long-term sovereign credit rating to AA from AA+ in September (outlook stable) and the long-term local currency rating to AA+ from AAA (outlook stable). Over the longer haul, lower credit ratings are likely to increase the cost of borrowing at the margin and may also reduce the country’s borrowing capacity, particularly during periods of global turbulence. In this context it is important to stabilise government debt levels and to support a structural lift in private sector savings, both of which will help to contain the external debt.

Notwithstanding uncertainty over the outlook for the global economy, our current outlook for New Zealand’s economy over the coming year is for a gradual acceleration of growth, assisted by the Christchurch rebuilding efforts and the flow-on effects of the strong terms of trade. Sustaining that recovery will, in part, depend on the ability of the banking system to meet any increase in the demand for credit. While the terms and conditions on which credit is supplied were tightened following the GFC, we believe the banks are both willing and able to meet a modest increase in credit demand but we will need to keep this assessment under review as global funding market conditions evolve. We continue to expect that private sector demand for credit will remain more modest than in previous recoveries, in part due to the overhang of high debt levels and because much of the expected rise in construction activity will be financed by insurance monies.

The Canterbury earthquakes have resulted in exceptionally high levels of claims for insurers, both in terms of quantity and cost. While this event placed particular pressure on AMI, requiring support from Government, the Reserve Bank generally considers the insurance sector to be sound. However, the continuity of new residential insurance in the wake of continued seismic instability is proving to be a significant issue for the Canterbury region and one which has the capacity to hinder rebuilding in the region. This issue will need to be kept under close review.

The earthquakes are expected to prompt some structural changes within the insurance industry as insurers and reinsurers make decisions about their exposure to and within New Zealand. We are currently seeing the beginnings of an adjustment in insurance premiums for both households and businesses throughout the country and it is also possible that some insurers may choose to withdraw cover for some risks. While we expect this process to take time to play out, we are not expecting a fundamental shift in the availability of insurance, including earthquake insurance.

While the earthquakes were in some ways a very unusual set of events, in undertaking its new role as regulator of the insurance sector, the Reserve Bank will naturally consider any lessons for regulatory policy. We have been consulting with the industry on appropriate catastrophe risk capital requirements with a bias towards setting these more conservatively in future.

The New Zealand dollar has appreciated over the past year hitting a new post-float high against the US dollar. Drivers of this trend include more positive domestic economic data combined with a weakening growth outlook offshore, a strong terms of trade owing largely to continued robust Asian growth. Portfolio diversification away from United States dollar and euro assets by sovereign wealth funds and central banks has also boosted the New Zealand dollar. Whilst a sign of the relative strength of New Zealand’s economy, the high exchange rate in trade weighted terms continues to hinder rebalancing of the economy in favour of stronger tradables sector activity. It appears to be part of the reason why the overall improvement in New Zealand’s trade balance has been modest despite a 37 year high in the terms of trade. In recent months, the New Zealand dollar has eased from its highs as concerns about financial risks have led investors back toward safe-haven currencies.
The Reserve Bank is continuing to improve the regulation of the financial system. The Bank is currently evaluating the new Basel III global regulatory standards for bank capital adequacy and liquidity announced by the Basel Committee on Banking Supervision (BCBS) in November last year. Although New Zealand is not compelled to adopt the new standards, we expect to incorporate most of the standards subject to their suitability for local conditions. The Reserve Bank is also working to enhance its failure management toolkit and is currently consulting with the banks on how to implement Open Bank Resolution (OBR). The primary objective of OBR is to ensure the continuance of the core banking functions of the distressed bank – in a manner that limits the cost to the taxpayer – until its future can be resolved. It is a process designed to ensure that, as far as possible, any losses are ultimately borne by the bank’s shareholders and creditors consistent with the legal obligations they entered into. The OBR policy is intended to reduce the economic disruption associated with a bank failure while also helping to offset the perceived implicit public guarantee of the banks.

The economic environment

Despite the upheaval created by the earthquakes in Canterbury, the New Zealand economy grew by 1.5 percent in the year to June 2011, with the economy expanding by around 1 percent in the first half of 2011. Growth appears to have been supported by strong international commodity prices and a general recovery in both consumer and business sector confidence. The rise in activity, while moderate, has drawn on the economy’s spare capacity, especially within the labour market, leading to an increase in core inflation pressures. Headline inflation has remained elevated over the past year peaking at over 5 percent partly reflecting the overhang of last year’s increase in GST. This, in turn, has contributed to some increase in inflation expectations.

The Reserve Bank’s current ‘central’ economic outlook is for GDP growth to increase over the coming year to around 3 percent supported by elevated export revenues and reconstruction activity associated with the Canterbury earthquakes. While this outlook incorporates a softening in global demand and a moderate decline in New Zealand’s high terms of trade, it assumes the effect of the recent financial turbulence does not dramatically undermine revenue prospects for the external sector or have major financial sector ramifications. Under this central view, core inflation pressures would be expected to increase in the absence of any change in the OCR. The Bank’s current published projections imply a gradual increase in the OCR over the next 18 months with the 90 day interest rate projected to rise by around 150 basis points. Under this outlook, inflation is projected to settle back within the 1-3 percent target band by early 2012.

However, there is a risk that global financial risks continue to intensify and that recent robust growth in China and the broader Asian region begins to soften. In these circumstances, increased funding costs and reduced export demand could have a greater negative impact on the growth outlook. In addition, there remains considerable uncertainty around the timing and magnitude of the earthquake rebuilding activity, which could prove slower than we have assumed. We will continue to assess these risks over the months ahead.
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 regulate and supervise banks and insurance companies and regulate finance companies, building societies and credit unions, with the aim of promoting a sound and efficient financial system. The Bank is also a supervisor for these entities under impending powers associated with anti-money laundering and countering the financing of terrorism legislation.

- **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.

- **Macro-financial stability** – We have a role in promoting the overall stability and efficiency of the financial system that goes beyond a focus on the prudential soundness of individual institutions. In particular, the Bank monitors the build-up of financial system risk that can arise due to extremes in the credit cycle which can create broader macro-economic instability. Part of this function is concerned with the possible deployment of macro-prudential instruments to manage the accumulation of financial system risk.

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

- **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 these obligations to be settled. The Bank also operates the NZClear payments and securities settlement system, and oversees the development of robust and efficient payments systems.

The environment and issues facing each of these interconnected roles are discussed in the following pages.
Monetary policy formulation

Objective

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

Environment

- The New Zealand economy has grown slowly from the recession of 2008. Consumption and investment have been slower to rebound than is typical in a New Zealand recovery.

- From early 2009, rapid monetary loosening abroad and a return of demand for our commodity exports meant that our currency (and the Australian dollar) completed the second, upward, leg of a sharp v-shaped dip against the currencies of major advanced economies. The rise in the Australian dollar was stronger than that of our own currency, causing our bilateral rate with Australia to fall. This, together with returning demand from Asia, supported growth in the export sector.

- In July 2008 the Bank started to lower the OCR from 8.25 per cent, and continued with a rapid easing cycle that brought the OCR to 2.5 per cent in April 2009. Monetary policy has remained accommodative since, though the OCR made a brief foray upward in 2010 before rising global risk and a domestic earthquake led the Bank to unwind the 2010 hikes.

- Domestic inflation fell sharply through 2009 and by early 2010 was just above 2 per cent, and the strong currency was keeping down tradables inflation. Transitory spikes in prices – GST increase, tobacco and alcohol excise increase and the Emissions Trading Scheme – have had a significant effect on headline Consumers Price Index (CPI) inflation and inflation expectations, but these are expected to be short-lived. The Reserve Bank’s estimates of core inflation sit within the target range of 1–3 percent over the medium term.

- In February 2011, a further earthquake in Canterbury caused large scale damage. The disruption and shock to confidence led the Bank to drop the OCR by 50 basis points at its March Monetary Policy Statement.

- A subsequent weakening of the world environment, with some European sovereigns facing high debt burdens and needing external support, and the US running large deficits and needing fiscal consolidation weighed further on the outlook. Financial problems in the major advanced economies through the GFC led to tight credit conditions in New Zealand prompting the Bank to undertake measures to ensure banking system liquidity.

- The Bank continues to weigh this risky outlook in advanced western economies against support from the Asia Pacific region and modest but improving domestic momentum. The Bank projects policy tightening, but this is conditional on the world progressing as envisaged.
**Live issues**

- Headline inflation is well above the target band, largely as a consequence of the increase in the rate of GST, which the Bank expects to be transitory. However, the high rate of headline inflation has been boosted by a succession of ‘one-off’ charges and has led to increasing inflation expectations. As well as the GST increase, the last two years has seen regular tobacco and alcohol excise increases and the phased introduction of the Emissions Trading Scheme. By the end of January the GST-effect will have dropped out of headline CPI measures, but the Bank would need to see inflation expectations fall subsequently to be comfortable with maintaining the Bank’s price stability objective.

- Global financial market sentiment has deteriorated markedly since the start of the year. Sovereign debt concerns in Europe have raised bond yields to very high levels, and further concerns about private bank exposure to these sovereigns have caused international bank funding markets to tighten. Despite being well funded currently, the indicative cost of international funding for New Zealand banks has increased materially. Should banks need to go to the market for funding (if for example demand for credit increased), funding costs and retail interest rates would be higher than at present.

- The major risk to New Zealand’s economic activity is through trade channels. Should financial disruption in the US and/or Europe reduce demand for Asian goods, this could have significant flow on effects to demand for goods from Australia and New Zealand, reflected in both prices and volumes. A drop in export income would widen the current account deficit and hinder recovery in domestic activity.

- Repairs and rebuilding in Canterbury will have a substantial influence on the New Zealand economy. Construction activity will be boosted for several years creating resource shortages, particularly in the building industry. However, the timing and eventual scale of the rebuilding is very uncertain. So far only limited rebuilding has taken place, as the flow of funds from the insurance sector has been hindered by constant aftershocks. The Bank projects rebuilding to get underway in earnest from the middle of 2012, on the basis that seismic stability is reached shortly and that private insurance funds are freed up.

**Initiatives and strategies**

- There are limitations and quality issues related to New Zealand’s current suite of macro-economic statistics, primarily in the area of national accounts. The lack of coverage of the current suite of national accounts statistics can affect their quality, and therefore our interpretation of the New Zealand economy. Quality and coverage issues also often disadvantage New Zealand in cross-country comparisons. Additional resources are needed to improve the overall range, quality, and timeliness of New Zealand’s macro-economic statistics.
Financial market operations

Objectives

Domestic market operations

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;
- Assisting with the Crown’s financial liquidity through the provision of the Crown Settlement Account; and
- Maintaining confidence in the efficient functioning of New Zealand’s financial markets.

Foreign reserves management

The Foreign reserves management team within the Financial Markets Department 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 and suitable for foreign exchange market intervention.

Environment

Global financial markets remain turbulent. Pressure on European sovereign debt (Portugal, Ireland, Greece, and Spain) has had negative impacts on financial institutions holding that debt and has required financial support from other Euro-denominated countries and the European Central Bank (ECB). US debt continues to grow and there was a risk during 2011 that US politicians would not allow the US debt ceiling to increase and maturing US government bonds to be repaid.

As a result of these events and the uncertainty around the future path of the international economy in general, credit ratings for some sovereigns and many financial institutions have been lowered, and interest rates, exchange rates, credit spreads and other financial prices have remained extremely volatile.

Domestic banks have been able to fund their balance sheets within this environment and they are currently well positioned for the near term. However, the Bank will continue monitoring the liquidity and funding capabilities of domestic banks closely. At this time, the possibility remains that the Bank might need to step in and use its balance sheet to help correct pressure in local funding markets if global funding markets become cut off as they did in 2008.

During the 2008 global financial crisis, the Bank introduced temporary liquidity facilities and expanded the range of collateral that it provides loans against to meet market liquidity needs. The last of those temporary facilities were removed at the end of 2010, although the expanded collateral list remains in place at this time.
During 2011, the Bank has managed domestic liquidity increasingly through open market operations and reverse repurchase agreements. This is a slight change from recent years where liquidity management was predominantly through foreign exchange swaps.

Since 2007 we have held a portion of our foreign reserves on an unhedged basis. This is achieved by funding part of our foreign reserves using NZ dollar liabilities rather than foreign currency denominated loans. The low interest rate environment (driven by soft international economic conditions and accommodative international monetary policy), and a cautious approach to credit in the management of foreign reserves has reduced the returns on our unhedged reserves.

**Live issues**

It is difficult to see how the international situation will play out. What is most likely is that the uncertainty and volatility affecting international markets will remain for a protracted period. The Bank feels that it is well placed to increase liquidity facilities for NZ banks rapidly if conditions deteriorate severely and these facilities became necessary once again. On a more positive outcome the Bank will look to rationalise its liquidity facilities taking into account global and Basel III trends.

Returns on the Bank’s foreign reserves are likely to remain volatile as the New Zealand dollar ebbs and flows with bouts of risk seeking / risk aversion on international markets. At present the Bank’s open exchange rate position is close to the Bank’s benchmark so returns are likely to be in line with its benchmark.

The downgrading of counterparties internationally is affecting the Bank’s investment strategies. As a conservative investor, the Bank holds high-rating sovereign and commercial paper. As institutions are downgraded the Bank’s preferred exposure to these entities is reduced putting pressure on the range of assets available to meet our investment strategy and reducing returns on our foreign reserves.

**Initiatives and strategies**

**Liquidity facilities:** We will be reviewing our liquidity facilities and eligible collateral categories so that the facilities can meet the financial system’s needs in the new Basel III environment.

**Reserves management:** We are implementing a new foreign reserves asset allocation and management approach, which includes the implementation of independent benchmarks for the foreign reserves portfolio.

**Business continuity:** We have established a market operations office in Auckland for business as usual and business continuity purposes. The Auckland office performs normal day-to-day operations alongside the Wellington office and is positioned to provide, in the event of a disruptive incident in Wellington, seamless business continuity of critical market functions albeit at a lower than normal capacity.

**Asset and liability management**

The structure of the Bank’s balance sheet reflects its statutory functions and provides the capacity to carry out those functions. The scale of the balance sheet reflects the demands of the Bank’s key ‘customer’ groups – the Crown, the commercial banks and the public. The Bank is required, by virtue of its statutory obligations, to supply its liabilities (currency and settlement account balances) to its customers in an amount demanded by them.
Growth in the Bank’s balance sheet tends to reflect trends in the underlying economy, Crown cash and debt management decisions along with swings in the precautionary demand for liquidity by commercial banks. The Bank has significant exposure to interest and exchange rate risk across its balance sheet with the exposure to credit risk being more modest, reflecting the conservative nature of the Bank’s investment/lending policies. These risk exposures are managed within a comprehensive risk framework. In the case of exchange rate risk there is a significant active/discretionary component as the Bank has a policy of varying the amount of its unhedged foreign reserves with the exchange rate cycle. Fluctuations in the value of the NZ dollar have a significant effect on the Bank’s annual profit, as the value of the NZ dollar increases the value of the net foreign reserves (open exchange rate) decreases and vice versa. These fluctuations result in significant mark to market profits and losses but any gains or losses are not realised until the absolute level of net foreign reserves (open exchange rate) is closed.

Since the GFC the Bank has taken a more conservative approach to investment in the foreign reserves portfolio to reduce the likelihood of any credit loss. This conservative approach has lead to a slightly lower return than was achieved in earlier years.

The outlook for the Bank’s balance sheet is for steady organic growth in line with the nominal economy, although there are significant risks of quite different outcomes (e.g. if there are renewed funding difficulties among the banks, or if the Crown chooses to pre-fund future deficits and leave the excess cash raised in their account at the Bank).

The Bank’s balance sheet is significant compared to the core Crown balance sheet although the Bank’s balance sheet tends to act as a diversifier within the broader Crown balance sheet. In tough times the Bank tends to be more profitable when the asset portfolios across the broader Crown balance sheet are performing relatively poorly and when Crown tax revenue is relatively weak.
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 regulation and supervision;
- insurance regulation and supervision;
- non-bank deposit taker regulation;
- payment system oversight; and
- anti-money laundering supervision.

The Reserve Bank is also a member of the newly-established Council of Financial Regulators. The purpose of the Council is to share information, identify important trends and issues and coordinate responses to those issues, and ensure appropriate coordination arrangements are in place to respond to events and developments. The permanent members of the Council are the Financial Markets Authority and the Reserve Bank. The Treasury and Ministry of Economic Development are associate members.

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 21 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 has weathered the financial crisis well and remains sound, despite the ongoing financial market turbulence, largely due to the sovereign debt and banking crises in the Eurozone. Although our banks have no direct exposure to the PIIGS, they source a lot of their wholesale funding from the European debt markets, which have been significantly disrupted by the recent turbulence.

- Our banks remain well-funded and are now a lot more resilient against liquidity shocks than they were before the global financial crisis. However, they remain dependent on global funding markets and they will have to raise funding over the coming year in order to replace maturing debt, service modest credit growth and meet regulatory requirements, e.g. liquidity requirements. Banks are likely to have to pay more for that funding, which could drive up the cost of loans and mortgages, and may impact on their profitability. There are a number of actions the Reserve Bank could take to help banks if international funding markets were to shut down for a longer period of time, as mentioned in the domestic market operations and foreign reserves management section.
Bank supervision in New Zealand emphasises 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. Moreover, our prudential supervision regime is risk based, which means that systemically important institutions generally receive more supervisory and regulatory focus than their smaller counterparts. 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.

However, while maintaining this regulatory approach, the Reserve Bank has made changes to the regulatory framework to further strengthen our banking system. In 2010 we introduced a new liquidity policy, ahead of similar proposals made by the Basel Committee. Two mismatch ratios ensure that banks have enough liquid assets to meet their short-term obligations and a core funding ratio (CFR) provides greater resilience against global funding market stress by requiring banks to have more ‘sticky’ funding, i.e. retail deposits and long-term funding with maturity of more than one year. The minimum CFR was raised (to 70 percent) in July 2011 and will rise to 75 percent in the future. Banks have responded well to the new liquidity policy but funding markets are currently disrupted and to the extent that banks could raise any funding at all, they would have to pay a substantially elevated price for it, which has the potential to impact on the availability of credit and economic recovery more generally. The Reserve Bank has therefore decided to defer the next increase in the CFR to 75 percent, which had originally been scheduled for July 2012, by six months to January 2013.

Since 2010 banks have been issuing covered bonds (debt securities backed by assets), subject to certain regulatory limits. Covered bonds provide a stable source of funding and aid the diversification of funding sources. Work on a legislative framework to give enhanced legal certainty to covered bonds is currently under way. In the current difficult international environment, this is seen as an important initiative as it will broaden the banks’ access to the global covered bond market.

More recently, we have begun to implement our Open Bank Resolution policy (OBR), aimed at minimising the costs and disruption of a bank failure. Although the Reserve Bank’s regulatory framework reduces the likelihood of a bank failure, it has never been intended to guarantee the safety of each institution and bank failures remain a possibility. OBR ensures that should a failure occur, losses are swiftly attributed and the bank can continue to perform its vital function so as to minimise the impact on other institutions, consumers and the economy more widely.

The Reserve Bank intends to align its capital adequacy standards with most of the Basel III capital requirements. Although our current capital standards are already conservative, our analysis supports the tighter capital standards proposed by Basel III. This means higher capital requirements, more emphasis on common equity and restrictions on the eligibility of capital instruments. However, we will not adopt eligibility criteria unsuited to New Zealand circumstances.

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. There is also still the potential for liquidity pressures to re-emerge
but the higher proportion of core funding within our banks’ funding mix, as compared with three years ago, offers some protection this time around.

- We plan to increase the core funding ratio to 75 percent in early 2013, but we will continue to monitor conditions on funding markets. An increase to 75 percent has been well-signalled and we aim to confirm it in the first half of next year in order to give banks regulatory clarity.

- Banks have been asked to make changes to their systems and to prepare implementation plans to facilitate OBR in a failure situation. It is intended that OBR functionality will be implemented in some banks by the end of 2012. Banks that have to make more substantial changes to their systems may need a bit longer but should by then also be well-advanced in their implementation of OBR functionality. It is likely that Australian parent banks will be asked to draw up ‘living wills’ outlining how to resolve their bank in a failure. While we do not expect it to affect our OBR policy, we have commenced work on the interactions between the two policies in a crisis.

- The Reserve Bank is currently developing the policy to put in place a legislative framework for covered bond issuance by New Zealand banks. The objective of the legislative framework is to create greater certainty as to the treatment of covered bonds in the event of an issuing bank being placed into statutory management. The main elements proposed are a registration system for covered bond programmes and amendments to the statutory management regime to ensure that the resolution process relating to a failing bank is separate from the resolution process for a covered bond programme. Providing this legal certainty to covered bonds will broaden the investor base that bank issuers can tap into, thus helping to alleviate the very tight funding conditions faced by the banks.

- The Reserve Bank intends to proceed with the implementation of Basel III capital and other requirements. In the immediate future this means consulting with banks on our proposed capital standards, the definition of capital and our intention not to implement a leverage ratio. In 2012 we will be consulting on a number of other Basel III measures such as a conservation buffer and counterparty credit risk requirements.

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

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 our banks and the New Zealand financial system if necessary.

- Having implemented our policies on, for example, liquidity and bank resolution before comparable proposals were made by the Basel Committee means we are more advanced than most countries in this area. However, as Australia is likely to implement the Basel III requirements and our big banks are Australian owned, it is desirable to align our policies with Basel III where we can and to ensure they remain fit for purpose. This may include going beyond international regulatory minima if it is in New Zealand’s interest to do so.

Non-bank deposit taker regulation

Objectives

The Bank’s Prudential Supervision Department is 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. This is done in a manner that is relevant to New Zealand and that delivers a cost-effective balance between regulatory requirements and self- and market-discipline.

Environment

- NBDTs comprise retail-funded finance companies and savings institutions such as building societies, and credit unions. There are around 50 NBDTs in New Zealand.

- The non-bank deposit taking sector has faced considerable upheaval in recent times, and the landscape of the sector continues to change, with the merger of some entities, and the failure of others, including one of the larger finance companies. Remaining NBDTs are facing difficult funding conditions due to weak credit demand, heightened competition from banks, and low depositor confidence in the sector.

- Given the slow and uneven recovery in the global economy, and shocks to the domestic economy from the Canterbury earthquakes, there remain relatively high risks to the balance sheets of NBDTs.

- 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.

- The Reserve Bank became the prudential regulator of NBDTs in September 2008. NBDTs are required to comply with prudential requirements relating to risk management, credit ratings, capital, liquidity, governance, and related-party exposures. Trustees are the front-line supervisors of NBDTs.

- The Extended Retail Deposit Guarantee Scheme started on 12 October 2010 and expires on 31 December 2011. A small number of NBDTs joined the extended scheme, with only three remaining: Heartland Building Society (formerly Combined Building Society); Fisher and Paykel Finance Limited; and Wairarapa Building Society.

- A strong non-bank sector continues to have a role to play in financing activities that banks have not been involved with traditionally. The scale of that role has diminished following the high profile failure of many finance companies. The NBDTs that have survived the turbulent market conditions prevalent over the last few years have reasonably strong capital and liquidity practices. The Reserve Bank’s prudential regime has helped reinforce those practices. Notably, many of the surviving NBDTs do not have significant exposure to the property development sector.

- Lending in the sector has shown some signs of recovery, but not in the property development sector. The level of risk involved in such projects renders funding from a retail depositor base an inappropriate model. New projects in this sector will likely require alternative funding vehicles to succeed (and probably a greater share coming from the developers’ own funds as was traditional) and we have seen some evidence of private equity stepping into this space to fund new and existing projects. In any event, it is important that investors understand the risks of investing in such projects and disclosure requirements (which are the domain of the Financial Markets Authority in this context) are crucial to this end.

- We have seen several instances recently of overseas entities buying the existing mortgage books of NZ lenders. For example, Pepper Home Loans (an Australian lender which specialises in the sub-prime market) bought the mortgage book of GE Capital in New Zealand for $A5.1bn. Although Pepper Home Loans will concentrate on managing existing loans, should it decide to offer new mortgages, it may, depending on its funding model, fall under our regime. This would represent the first significant new presence in
the sector for some time. In any event, we will continue to monitor the market for new funding models to ensure that our capital regime is applied appropriately.

**Live issues**

- The Non-Bank Deposit Takers Bill was introduced in August 2011, and has been referred to the Finance and Expenditure Select Committee. The NBDT Bill imposes a licensing requirement on NBDTs, with an associated suitability assessment of directors and senior officers, and it also provides powers for the Reserve Bank to gather information, issue directions, and remove and replace directors. The current prudential requirements will be carried forward under the NBDT Bill.

- Regulations will be required to implement the new regime. The Reserve Bank expects to have key regulations prepared in time for the commencement of the NBDT Bill.

**Initiatives and strategies**

- The Reserve Bank will be responsible for the implementation of the Non-Bank Deposit Takers Bill (when enacted), and enforcing the regulatory regime for the NBDT sector.

- The Reserve Bank is required to review and report on the NBDT regulatory regime, and preparation for this exercise is getting underway. The review is expected to be completed in 2012, for presentation to Parliament in September 2013.

**Insurance regulation and supervision**

**Environment**

- In September 2010 the Insurance (Prudential Supervision) Act 2010 (the Act) was passed. The Act provides for the Reserve Bank to be the regulator and supervisor of licensed insurers and establishes a licensing regime for persons carrying on insurance business in New Zealand, as well as imposing prudential requirements on insurers.

- All persons who wish to carry on insurance business in New Zealand are required to be licensed by the Reserve Bank. All persons who were carrying on insurance business in New Zealand before the enactment of the Act are required to hold a licence by 7 March 2012 (this licence can be a provisional licence) and are required to hold a full licence by 7 September 2013. All new entrants must have a full licence before carrying on insurance business in New Zealand.

- Over the course of 2011 the Reserve Bank has issued solvency standards for non-life insurance business, life insurance business, captive insurers transacting non-life insurance business and a specific standard for AMI Insurance Limited which is based largely on the non-life insurance business standard. A Fit and Proper Standard for licensed insurers was also issued which sets out the matters that must be taken into account by a licensed insurer when determining if its directors and relevant officers should be appointed to, or continue to hold, positions.

**Live issues**

- Between now and early 2012 the Reserve Bank will be working on the statutory fund regulations required under the Act.

- There are over 150 insurers in the New Zealand market. The Reserve Bank is also working to get all insurers through the licensing phase which is a significant task to complete. It is expected that a number of these insurers will not progress to full licensing and that there will be some market consolidation.
The Canterbury earthquakes continue to have a high profile in the New Zealand insurance sector. The scale of the earthquake claims settlement process facing insurers, combined with ongoing aftershocks, means that there is considerable uncertainty about the timing of claims settlements, including the commencement of reconstruction.

The stresses faced by non-life insurers as a result of the earthquakes are being reflected in financial statements and include underwriting losses on New Zealand non-life business, with the cumulative costs of reinsurance reinstatements adding to losses.

Life insurers have not been impacted in the same way as property insurers from the Canterbury earthquakes and we are fortunately seeing a far less significant impact in terms of the cost of claims.

The Reserve Bank will be in a position to more closely monitor the financial position and solvency of insurers when our powers under the Insurance (Prudential Supervision) Act 2010 start to come into force from 7 March 2012.

**Initiatives and strategies**

- Progressing all insurers through to full licensing by 7 September 2013. This is expected to be a significant amount of work.

- Monitoring the solvency of licensed insurers throughout the claims payment phase resulting from the Canterbury earthquakes.

**Payment system oversight**

**Objectives**

The Bank’s Prudential Supervision Department oversees payment systems and designated settlement systems 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.

- The establishment of Payments NZ Limited (PNZ) in October 2010 means that there is now an industry body primarily focused on promoting innovation, safety and efficiency in payments. The Reserve Bank conducts a high level of engagement with PNZ.

- Under Part 5C of the Reserve Bank of New Zealand Act 1989, the Reserve Bank and Financial Markets Authority are joint regulators of designated settlement systems other than those classed as ‘pure payment systems’. Designation ensures settlement finality in the event of insolvency of a participant in a designated system. It also makes it clear that the rules of a designated settlement system relating to payment and settlement are valid and enforceable in all circumstances.

**Live issues**

- An important part of the international efforts to improve the resiliency of the financial system following the global financial crisis in 2008 has been to move to having all over-the-counter derivatives contracts traded on exchanges, reported to trade repositories and
cleared through central counterparties by the end of 2012. While the Reserve Bank sees no particular need to impose on New Zealand banks requirements to report and centrally clear these products, banks here may move towards reporting and clearing due to pressure from global/offshore regulators and offshore counterparties. It will therefore be important to ensure that New Zealand banks have access to appropriate reporting and clearing infrastructure.

- New principles for financial market infrastructures are being developed by the Committee on Payment and Settlement Systems and the International Organisation of Securities Commissions. These principles seek to strengthen the minimum standards expected of payment and settlement systems, central securities depositories and trade repositories. Once the new principles have been finalised, the Reserve Bank will incorporate them into its payment and settlement system oversight activities as appropriate.

**Initiatives and strategies**

- In recent years the Reserve Bank has taken a more active interest in payment and settlement system matters and increased its engagement with the industry. While this approach has helped expedite industry-led projects, it has also raised some questions about the adequacy of the Bank’s statutory powers with respect to payment and settlement systems. At the same time, there has been an increasing international focus on ensuring that financial market infrastructures are sound and do not amplify or transmit problems originating elsewhere in the financial system. The Bank is intending to review the available regulatory powers in the light of these developments.

**The anti-money laundering regulatory regime**

**Environment**

- The Ministry of Justice has led an interagency policy programme to develop the regulatory framework to detect and deter money laundering and terrorist financing. Much of this work is now completed.

- 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 Organisation for Economic Cooperation and Development (OECD). New Zealand is currently non-compliant with a number of FATF standards.

- In September 2008, Cabinet agreed to a new regulatory framework for AML/CFT, which was given legislative effect by the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the Act). 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 life insurers. Within the framework, the Financial Markets Authority (FMA) and the Department of Internal Affairs (DIA) are also supervisors. Regulations gazetted in June 2011 provide that the various obligations on reporting entities (the collective title for entities caught by the regime) will take effect on 30 June 2013.

- The New Zealand Police Financial Intelligence Unit (which is responsible for handling suspicious transaction reports) produced its first national risk assessment (NRA) in March 2011. The NRA is a high level assessment of risk in the New Zealand money laundering and terrorist financing environment. This was followed by sector risk assessments (SRAs) produced by the Reserve Bank, DIA and FMA. The SRAs assess the risk of money laundering and terrorist financing in each of the respective sectors they will supervise.
**Live issues**

- New Zealand was assessed against FATF standards in October 2009 following a visit in April 2009. New Zealand was found to be non-compliant in several areas (partly because there was insufficient time for new measures to take effect). The Ministry of Justice has recently drafted a follow up report to FATF in which it outlines developments made in developing the legislative and regulatory framework since the previous FATF assessment.

- Although historically few AML/CFT issues have arisen in the financial sector, a poor FATF assessment can 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. Although there are some areas that will require further attention, we are hopeful that the current programme of regulatory reform will be sufficient to demonstrate that steps are being taken.

- At the supervisory level, the challenge for reporting entities will be to prepare for the advent of their new obligations, which in some cases, is a significant undertaking. To assist them, the supervisors have issued various pieces of joint guidance to the industry and a joint Code of Practice to provide clarity to reporting entities regarding their obligations. Weekly meetings are held between the Reserve Bank, DIA and FMA to ensure the appropriate level of consistency in our respective approaches to tackling our various obligations under the Act. We continue to engage with the reporting entities for which we are responsible for supervising, with a view to ensuring that they will be compliant from the first day their obligations take effect.
Macro-financial stability

Objectives

The Reserve Bank’s macro-financial stability function focuses on maintaining a sound and efficient financial system that supports the functioning of the economy. Where possible, an objective is to reduce or manage the risks to the financial system arising from extremes in the credit cycle or developments in liquidity conditions and global debt markets. This function is closely inter-related with the Reserve Bank’s Prudential Supervision function.

Environment

Since the global financial crisis, there has been considerable international interest in macro-prudential policy, which focuses on the use of various prudential instruments to promote a more stable and resilient financial system, particularly in response to strong domestic credit growth. In New Zealand, our prudential regulation framework has always had a strong focus on system stability. This is consistent with the requirements of the Reserve Bank Act which requires prudential regulation to be undertaken to maintain and promote stability and efficiency in the financial system. However, there may be a role for new tools (or new forms of existing prudential tools) to assist in promoting financial system stability.

Macro-prudential instruments take the form of additional buffers (such as capital or liquidity requirements) designed to provide the financial system with extra shock-absorbing capacity at times when this is desirable. This, in turn, is likely to reduce the risks of a sharp economic slowdown during periods of financial system stress. In addition, some macro-prudential tools may have a role to play in helping to dampen periods of excessive credit growth. Over the past two years, the Reserve Bank has been undertaking research into macro-prudential tools and their possible role in New Zealand. We have identified several instruments that we believe could be helpful if and when we face periods of excessive credit growth in New Zealand in the future. However, our work also suggests that expectations need to be realistic about what can be achieved and most tools entail costs as well as possible benefits.

Types of instruments

Core Funding Ratio (CFR)

The minimum CFR for banks is now an important part of bank regulation and should work to ensure that bank credit is funded using a greater proportion of retail deposits and longer-maturity term debt than in the past. In general, we would not envisage a need for frequent adjustments to the CFR.

However, were we to face excessive bank credit growth in the future, adjustments to the CFR could be warranted to further mitigate bank funding risks. Our work suggests that increasing the CFR might help to lean against excessive credit growth as it would reinforce demand for funding that is typically more expensive than that raised in short-term wholesale markets. This funding cost wedge might be helpful from a monetary policy viewpoint by enabling the OCR to be set lower than otherwise.

Counter-cyclical capital buffers (CCB)

Counter-cyclical capital buffers (CCB) involve the application of an additional capital requirement for banks, over and above the minimum Basel requirements, to help mitigate financial system risk arising from excessive bank credit growth. The CCB is part of the recent Basel III proposals. The Basel guidelines are that the buffer be an additional 2.5 percent of risk weighted assets, although this is subject to national discretion. The CCB would be built up during the upswing of the credit cycle and released during the subsequent downturn when banks might need it to absorb credit losses.
Basel guidelines are that the buffer be used only during episodes of exceptionally strong credit growth, not during a more benign cycle (when minimum capital requirements should suffice).

Whilst primarily intended to promote bank resilience to a credit boom, a CCB might help to rein-in credit and asset and price cycles by increasing the banks’ cost of funds. However, this remains contentious. The impact of the CCB on credit growth might be enhanced by a ‘moral-suasion’ effect as its deployment would send a highly-visible signal to banks, investors, rating agencies and depositors about the Reserve Bank’s unease about credit growth.

**Basel II risk weight adjustments**

Capital overlays (i.e. additional capital requirements) could also be applied on a more targeted basis if lending to particular sectors (e.g. housing or farming) became excessive. An overlay would help build lenders’ resilience to systemic credit risks associated with high credit growth or indebted sectors by requiring them to hold additional capital against such lending.

One of the downsides of an overlay is that it potentially muddies the purpose of the existing Basel II risk weights. Under Basel II, banks are required to adopt ‘through-the-cycle’ estimates of risk which should be calibrated to economic downturn conditions. Thus in principle, an overlay should be unnecessary for soundness purposes as banks are expected to internalise the risks associated with lending to a particular sector. However, an overlay might still be desirable to deal with a period of ‘irrational exuberance’.

**Loan-to-Value Ratio restrictions on housing lending**

While Loan-to-Value Ratio (LVR) restrictions have been widely used in Asia, other countries (e.g. Sweden, Canada) are increasingly adopting them. LVR restrictions can either be applied as a long-standing limit or ‘switched-on’ during periods of rapid credit growth characterised by high LVR lending. LVR caps could help to promote greater resilience of the financial system by reducing the accumulation of riskier, high LVR lending. They are also a highly visible and public way of signalling unease about the housing cycle and household debt.

LVR restrictions may assist in stabilising the housing credit cycle and house price cycles to the extent some high LVR lending may not be undertaken. However, international evidence on their effectiveness as a stabilization tool is mixed. LVR caps have not prevented housing cycles in the countries that have used them, but some countries believe they helped rein-in the cycle to some degree. One limitation of LVR restrictions is their tendency to force lending to occur from institutions outside the financial system (or for whom the LVR cap does not apply). This argues in favour of using such restrictions only when faced with a period of exceptional credit growth.

**Live issues**

While macro-prudential tools may help to build financial system resilience by leaning against the credit cycle, our work has also focused on the challenges of using such instruments and the circumstances in which they might not work as intended. Some of these issues include:

- Some macro-prudential instruments like LVR restrictions may be subject to avoidance issues unless enforced vigorously.
- The risks of financial disintermediation – macro-prudential instruments could displace the credit growth to sectors other than the banks. We might need to consider applying some instruments more widely than just the banks.
Cyclical variability – our work has noted that the effectiveness of the CFR as a brake on credit growth could be reduced during a boom if global funding spreads become compressed.

Equity and distributional issues – some instruments, such as LVRs or sectoral capital overlays, are quite intrusive in nature, raising important equity issues.

We would need to weigh these issues carefully against the benefits of using any macro-prudential tools.

Under the Reserve Bank Act, the Reserve Bank has powers to implement prudential regulations for banks (typically as a condition of registration) consistent with promoting the soundness and efficiency of the financial system. Variations in the Core Funding Ratio or changes to capital requirements would fall within the Reserve Bank’s powers for banking regulation provided we were undertaking them for the purposes of promoting financial stability. However, if we felt it desirable to deploy some instruments, such as LVR restrictions, we would do so in consultation with the Minister. This is because these instruments are more intrusive in nature and could have broader economic consequences (e.g. LVRs would have a bearing on matters like home affordability).

In terms of macro-prudential instruments applied via non-bank deposit takers, an Order in Council would be required to change capital or liquidity requirements. Other macro-prudential instruments, like LVR restrictions would require a change in the Reserve Bank Act, because the Act sets out explicitly the areas for which regulations for deposit takers can be made.

We would expect the case for macro-prudential decisions to be considered by the Reserve Bank’s Macro-Financial Committee, consulting you and Treasury at the point where we felt the case had been established for the use of such instruments. The Bank’s Macro-Financial Committee would need to establish the existence of imbalances in credit and asset markets that might warrant deploying macro-prudential instruments (in other words periods of ‘excessive’ credit growth). To support this process, the Macro-Financial Committee now formally considers a range of indicators of credit and asset markets with the aim of reaching a view as to whether credit and asset price trends might warrant some form of macro-prudential intervention.

Initiatives and strategies

Monitoring of financial system risks: We are developing a range of indicators to assist internal decision-making on the use of macro-prudential instruments. These indicators are now regularly considered by the Bank’s Macro-Financial Committee.

Instrument development: While we have identified several instruments that may have a role to play in New Zealand, further work is planned to refine the design of these instruments and the implementation frameworks that would be used.

Developments in macro-prudential policy and the implementation of macro-prudential tools will be covered on an ongoing basis in the Bank’s six-monthly Financial Stability Report.
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. The value of currency in circulation at the end of June 2011 was $4.2 billion. This has grown by 4.6 per annum over the last 5 years.

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. About 40% of the repatriated notes are machine 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 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 global financial crisis, the earthquakes in Christchurch and other natural disasters around the world have caused spikes in the demand for cash in New Zealand and overseas. The increased use of electronic methods of payment around the world may be a vulnerability rather than a strength in times of crisis if cash is not readily available. This confirms the need for central banks to hold significant contingency reserves of cash and to ensure they will be readily available in an emergency.

As noted above, the incidence of counterfeiting in New Zealand is low by international standards. However, it has risen over the last two years and most central banks overseas perceive a growing threat from the increasing sophistication and wider general use of digital
copying and printing processes. There are indications that the protection offered by the security features on New Zealand’s current banknotes has diminished in recent years.

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.

Initiatives and strategies

The Bank has started planning for the development of a new series of banknotes with upgraded security features. The new series will retain the current themes and will include images of the same highly respected individuals. However, the designs will be refreshed to incorporate new security features and to take advantage of more modern banknote printing techniques. The new banknotes will be issued not earlier than 2014.

This is a large and important project. It is crucial that the new banknotes are well regarded by the New Zealand public and they meet the needs of special groups such as the blind and partially sighted community. They must also be acceptable to banks, retailers, and operators of cash handling machinery such as vending machines and parking meters.

The Bank must select new security features which are easily authenticated by retailers and the general public. These security features must also be very difficult to replicate, durable and proven to be ‘production ready’. The Bank must conduct transparent, competitive tenders for the supply of the new banknotes in order to obtain a high quality product at a competitive international price.

The Currency Operations team will review the levels and location of currency reserves held for contingency purposes, drawing on lessons from the Christchurch earthquakes. It is very important that the Reserve Bank should hold sufficient, readily available contingency reserves of currency.
Settlement services

Objectives

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

The Bank operates two settlement systems:

- **Exchange Settlement Account System (ESAS)** – for recording settlements of interbank transactions.
- **NZClear** – 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

- Regular upgrades of the ESAS and NZClear systems allows the Bank to provide competitive, functional enhancements to users.
- International standards for system performance and resilience are being lifted.
- The Reserve Bank and NZX Limited are working together to improve operation of New Zealand’s clearing and settlement infrastructure.
- It is intended that NZClear will become a designated settlement system under the Reserve Bank Act and it is now at the final stage of consulting with members on the proposed changes to its rules as required by the joint regulators.

Scope of operations

Operating the ESAS and NZClear systems, including the infrastructure required for settlement of foreign exchange transactions through Continuous Linked Settlement (CLS) Bank².

Live issues

The main issues for the Bank are:

- Continuing to enhance ESAS and NZClear system functionality;
- Improving business continuity planning and disaster recovery capabilities; Responding to higher international operating standards; and
- Facilitating the industry decision to move to ‘Settlement Before Interchange’ (SBI) for intra-day bilateral settlement and interchange of retail banking transactions.

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² Continuous Linked Settlement (CLS) Bank is a US registered bank owned by a grouping of international commercial banks.
Initiatives and strategies

- Continue to enhance ESAS and NZClear as agreed with the industry.
- Consolidate the Bank’s new Auckland office and its disaster recovery capability.
- Implement SBI functionality within ESAS to replace the retail settlement function performed by Interchange Settlement Limited, thereby reducing payment settlement risk.
- Through a recently established joint industry council, work with NZX Limited to improve the operation of New Zealand’s clearing and settlement infrastructure.
Corporate services

Knowledge services

Objectives

The Bank’s Knowledge Services Group provides core technology infrastructure (both payments systems and the internal Bank network); business analysis and applications development; help desk and web support; library, information and records management; and programme management and business continuity services.

Environment

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

Live issues

Overall, the Bank’s systems performance is robust and meets the Bank’s needs. However, we are working in an increasingly complex environment as the Bank’s systems and infrastructure evolves. Internal network systems availability is exceptionally good. There is an ongoing capital expenditure programme to mitigate the risks of some single points of failure and aging 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.

Initiatives and strategies

- **Prudential Supervision Framework** – implement a common mechanism to support the ongoing supervisory function across insurance, NBDT and banking sectors and support Prudential Supervision’s role in monitoring AML/CFT measures across the banking sector.

- **Financial Markets Benchmarking** – introduce trader benchmarks. Change to the Findur (Treasury Management System) portfolio and reporting structures.

- **Technical Refresh 3** – work closely with the Financial Services Group and Datacom to refresh the payments systems infrastructure to improve system resilience and maintain support continuity for the SWIFT (international messaging) platform and network upgrades.
Financial services

Objectives

The Financial Services Group provides the financial control for the Bank's activities.

Services provided include financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

Environment

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

Scope of operations

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

Live issues

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

Initiatives and strategies

- Continue to enhance workflows, reports and processes for financial control and financial operations and securities transactions.
- In conjunction with the Bank's Knowledge Services Group, revise reporting for financial market operations to give effect to portfolio management changes, including implementing a new asset allocation and performance benchmarking framework.
- Consolidate the implementation of the new Financial Management Information System (FMIS) commissioned in June this year.
Human resources

Objectives

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

Environment

Interest in the economy and the role of the Reserve Bank continues to keep our profile high for prospective staff. Within tight cost parameters we are able to recruit and retain staff without compromising our purpose and we continue to provide a strong and vibrant working culture.

Live issues

With an expanding set of responsibilities and an ever-tightening global market in skilled people, the Bank continues to focus on attracting and retaining high quality staff through good working conditions, training and development and strong leadership.

As the demographics of the workforce change, our Human Resources policies will evolve to ensure that operational capability is both maintained and refreshed.

Our approach to remuneration and reward fits within the context of public sector remuneration. While reflecting the overall constraints on pay we are able to recognise individual performance as appropriate.
Communications

Objectives

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 global economic and financial environment.

- The Bank’s communications now encompass its new role as the prudential regulator for NBDTs and insurers.

- To enhance economic efficiency, the Bank will support programmes to improve the financial capability of the wider public.

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.

- The Bank is currently assessing more recent media tools such as social media for any potential opportunities or risks they may pose for the Bank.

- 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 between other agencies to address the need to improve New Zealanders’ financial capability.
SECTION 3

Governance and management

The Reserve Bank Act provides:
(1) Considerable day-to-day operational autonomy to the Bank;
(2) An important role for the Minister of Finance in some key decisions; and
(3) 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

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\(^3\). The present Governor’s term will terminate on 25 September 2012. Unlike other Crown entities, authority and accountability for exercising the Bank’s powers rests with the Chief Executive, rather than the Board.

Responsibilities of 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.

Responsibilities of 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 Board should bring governance assurance to the Bank, with the skills looked for in Board members encompassing an understanding of governance and central banking, and/or of financial markets.

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

\(^3\) 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.
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.
# Significant Powers under the Reserve Bank of New Zealand Act 1989

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<tr>
<td>9</td>
<td>Determine Policy Targets</td>
<td>Agree</td>
<td>Agree</td>
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<td>12</td>
<td>Change Monetary Policy Objective</td>
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<td>Right</td>
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<td>18/20</td>
<td>Fix Foreign Exchange Rates</td>
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<td>Suspend Foreign Exchange Trading</td>
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<td>26</td>
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<td>26</td>
<td>Call in Currency</td>
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<td>34</td>
<td>Government Banking</td>
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<td>Registry Services</td>
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<td>Appointment of Governor</td>
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<td>Appoint</td>
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<tr>
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<td>Appointment/Removal of Deputy Governor</td>
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<td>Removal of Governor</td>
<td>May recommend</td>
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<td>63</td>
<td>Fees &amp; Expenses of Directors</td>
<td>May recommend</td>
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<td>73</td>
<td>Register Banks</td>
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<td>✔</td>
<td>Gazette</td>
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<td>77</td>
<td>Deregister Banks</td>
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<td>81</td>
<td>Public Disclosure Statements</td>
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<td>Give Directions to Banks</td>
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<td>117</td>
<td>Statutory Management</td>
<td>Recommend</td>
<td>Right</td>
<td>Required</td>
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<tr>
<td>119</td>
<td>Advisory Committee</td>
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<td>144</td>
<td>Terminate Statutory Management</td>
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<td>Advances to Statutory Management</td>
<td>Recommend</td>
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<tr>
<td>Section</td>
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<tr>
<td>156ZA</td>
<td>Bank may decide application for designation by payments system</td>
<td>Recommend</td>
<td>Right</td>
<td>Required</td>
<td>Co-regulator with FMA</td>
<td></td>
</tr>
<tr>
<td>156ZC</td>
<td>Bank may disallow proposed amendment to rules of settlement system</td>
<td>✓</td>
<td></td>
<td></td>
<td>Co-regulator with FMA</td>
<td></td>
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<tr>
<td>156ZH</td>
<td>Bank may independently begin review of settlement system</td>
<td>✓</td>
<td></td>
<td></td>
<td>Co-regulator with FMA</td>
<td></td>
</tr>
<tr>
<td>Part 5D</td>
<td>Bank may recommend making of regulations relating to capital, related party exposures, and liquidity, to be complied with by NBDTs</td>
<td>✓</td>
<td></td>
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<tr>
<td>157G</td>
<td>Bank may exempt NBDTs from compliance with Part 5D</td>
<td>✓</td>
<td></td>
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<tr>
<td>157J</td>
<td>Bank may approve credit rating agencies to rate NBDTs</td>
<td>✓</td>
<td></td>
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<tr>
<td>157ZE</td>
<td>Bank may require trustees to attest as to compliance by NBDTs</td>
<td>✓</td>
<td></td>
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<tr>
<td>157ZI/</td>
<td>Bank may obtain information from NBDTs</td>
<td>✓</td>
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<tr>
<td>157ZJ</td>
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<tr>
<td>159/160</td>
<td>Determine funding for the Bank</td>
<td>Agree</td>
<td>Agree</td>
<td></td>
<td>Parliament ratify</td>
<td></td>
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<tr>
<td>162</td>
<td>Surplus Income (Dividend)</td>
<td>Recommend</td>
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<td>Right</td>
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<td>167</td>
<td>Performance Auditor Appointment</td>
<td></td>
<td>Right</td>
<td></td>
<td>Tabled in House</td>
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</tbody>
</table>
### Significant Powers under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009

<table>
<thead>
<tr>
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</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 under the Insurance (Prudential Supervision) Act 2010

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<tr>
<td>19</td>
<td>Bank may grant a licence</td>
<td>✓</td>
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<tr>
<td>21(2)</td>
<td>Conditions of licence</td>
<td>✓</td>
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<tr>
<td>30</td>
<td>Cancel a licence</td>
<td>✓</td>
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<tr>
<td>36</td>
<td>Issue fit and proper standards</td>
<td>✓</td>
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<tr>
<td>38</td>
<td>Bank may remove directors or relevant officers from appointment</td>
<td>✓</td>
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<tr>
<td>49</td>
<td>Approve or refuse any amalgamation or portfolio transfer application</td>
<td>✓</td>
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<tr>
<td>55</td>
<td>Issue solvency standards</td>
<td>✓</td>
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<tr>
<td>108</td>
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<tr>
<td>121</td>
<td>Require insurer to supply information</td>
<td>✓</td>
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<td>143</td>
<td>Bank may give directions to insurer or associated person</td>
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<td>151</td>
<td>Apply to High Court for liquidation</td>
<td>Apply</td>
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<tr>
<td>153</td>
<td>Apply to High Court for voluntary administration</td>
<td>Apply</td>
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<td>170</td>
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<td>Right</td>
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<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>Right</td>
<td>Required</td>
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<tr>
<td>244</td>
<td>Bank may issue provisional licence</td>
<td>✓</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 (FEC), including a hearing after each quarterly Monetary Policy Statement and half-yearly Financial Stability Review

- FEC is advised by a contracted 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 that discloses the Bank’s thinking on the risks facing the financial system.
  
  - *Annual Report* – This includes externally audited financial statements\(^4\).
  
  - *Statement of Intent* – The Bank is 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.

For a full list of key Reserve Bank documents please see the latest *Statement of Intent* (page 36).

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\(^4\) 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** – meets weekly to consider the management and day-to-day operation of the Bank.

- **Communications Committee** – meets weekly to consider communications issues.

- **Monetary Policy Committee** – meets fortnightly to advise the Governor on economic and financial developments.

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

- **Macro-financial Committee** – meets fortnightly to monitor the overall stability and efficiency of the New Zealand financial system, including emerging risks, and consider the possible implementation of macro-prudential policies.

- **Financial System Oversight Committee** – meets fortnightly to consider prudential issues relating to the financial system, including both regulatory and operational matters applicable to regulated entities.

- **Assets and Liabilities Committee** – meets monthly to review risks and risk management frameworks around the Bank’s balance sheet and its operations in financial markets.
## Management Structure

*As at November 2011*

### Reserve Bank organisational structure

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

<table>
<thead>
<tr>
<th>Non-executive</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Arthur Grimes</td>
<td>Chair Reserve Bank of New Zealand Board of Directors</td>
</tr>
<tr>
<td></td>
<td>Economic Consultant</td>
</tr>
<tr>
<td></td>
<td>First appointed 13 March 2002 – current term expires 12 March 2012</td>
</tr>
<tr>
<td>Hugh Fletcher</td>
<td>Deputy Chair Reserve Bank of New Zealand Board of Directors and Chair Reserve Bank of New Zealand Board of Directors’ Audit Committee</td>
</tr>
<tr>
<td></td>
<td>Company Director</td>
</tr>
<tr>
<td></td>
<td>First appointed 10 June 2002 – current term expires 9 June 2012</td>
</tr>
<tr>
<td>Dr Chris Eichbaum</td>
<td>University Reader</td>
</tr>
<tr>
<td></td>
<td>First appointed 1 August 2008 – current term expires 31 July 2013</td>
</tr>
<tr>
<td>Professor Neil Quigley</td>
<td>University Professor</td>
</tr>
<tr>
<td></td>
<td>First appointed 1 February 2010 – current term expires 31 January 2015</td>
</tr>
<tr>
<td>Sue Sheldon</td>
<td>Company Director</td>
</tr>
<tr>
<td></td>
<td>First appointed 1 May 2009 – current term expires 30 April 2014</td>
</tr>
<tr>
<td>Keith Taylor</td>
<td>Company Director</td>
</tr>
<tr>
<td></td>
<td>First appointed 1 July 2009 – current term expires 30 June 2014</td>
</tr>
<tr>
<td>Kerrin Vautier</td>
<td>Consulting Research Economist</td>
</tr>
<tr>
<td></td>
<td>First appointed 9 February 2010 – current term expires 8 February 2015</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Executive</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dr Alan Bollard</td>
<td>Governor</td>
</tr>
</tbody>
</table>
Financial Management

Financial Structure

Balance sheet overview and funding of the Bank’s operations

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


Under the Reserve Bank Act, the Minister and the Governor are required to enter into a funding agreement to specify the amount of the Bank’s income that may be used to meet operating expenses in each financial year. The funding agreement comes into force only after it is ratified by Parliament. The Act provides for each funding agreement to apply for a period of five consecutive financial years. This contrasts with the arrangements for government departments, which are funded on an annual basis. The Bank’s funding arrangements are designed to strike an appropriate balance between providing a high degree of operational independence, and providing strong incentives for effective management of operating expenditure, while ensuring accountability for use of resources. Capital expenditure is funded by the Bank, with depreciation of fixed assets included in annual operating expenses. The funding agreement requires that the Bank include in its annual report a comparison of expenditure against the specified amount of net operating expenses for each year, together with a comparison of cumulative expenditure against the cumulative specified amount of net operating expenses for the term of the agreement.

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

The agreement focuses on extending capacity in new regulatory and supervision areas, and completing unfinished work upgrading information technology, business continuity and building infrastructure, in particular, establishing the Auckland office.

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

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

Under the Reserve Bank of New Zealand Amendment Act, the Bank’s annual dividend is determined using the principles listed below in the Statement of dividend principles. The Bank applies the dividend principles and makes a recommendation to the Minister of Finance of the amount to be paid. The Minister then decides how much should be paid having regard for the recommendation of the Bank, the views of the Board of the Bank and any other relevant matters.

Statement of dividend principles

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

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

Drivers of the Bank’s financial performance and financial position

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

- **The value of currency in circulation.**
  
  Currency in circulation is a non-interest-bearing liability. Trading banks are charged for the currency issued to them and the funds received are invested and earn interest income (seigniorage).

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

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

- **Interest rates earned on the Bank’s investment in government securities and other securities.**
  
  Under the New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), the Bank’s holdings of New Zealand government securities are valued at market value, with unrealised gains and losses on those holdings booked to equity. Interest income is recognised in the Bank’s Income Statement.
The size and performance of the Bank’s foreign reserve management and market operations functions.

The Bank holds foreign reserves that can be liquidated at short notice to support its functions, including monetary policy objectives and the maintenance of orderly markets.

Operating expenditure incurred by the Bank.

As noted in the previous section about the Funding Agreement, the level of operating expenditure is expected to increase, reflecting further expansion of the Bank’s financial system regulatory and supervision capacity, improvement of business continuity capabilities, commencement of changes to currency in circulation, and the renewal and replacement of systems.

The level of equity available for investment and the dividend paid by the Bank.

The Bank requires equity to absorb any losses arising from carrying out its functions and equity is reviewed annually to assist in determining the Bank’s annual dividend.

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 (APRA).

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 NZClear; and operational risks in all of the transactions and processing areas of the Bank. Financial risks are managed within parameters set out in the Bank’s Risk Management Document, monitored by the Financial Markets Risk Unit and overseen by the Assets and Liabilities Committee (ALCO).

Staff – As a small specialised organisation (around 250 fulltime equivalent staff) we are exposed to a risk of losing key highly-experienced staff and the associated institutional knowledge. This risk is mitigated by a well-developed programme of staff training and an annual review of potential succession for critical positions.

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 Markets 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.