Funding Agreements for the Reserve Bank

Mike Wolyncewicz, Financial Services Group[1]

This article discusses the policy rationale underpinning Funding Agreements which provide a basis for financing the Reserve Bank's operating expenditure for a five-year period. The article explains the various checks and balances in the funding framework. It then goes on to describe the process by which a Funding Agreement is developed, and provides a brief overview of the profile of the Bank's operating expenditure since 1990.

1 Statutory requirements

Section 159 of the Reserve Bank Act 1989 ("the Act") requires the Minister of Finance and Governor of the Reserve Bank to enter into agreements that provide funding for the Bank's activities. All Funding Agreements entered into to date have been for periods of five years, the maximum length of time permitted by the Act.

Funding Agreements become effective in law only when they are ratified by Parliament. The Act provides that if Parliament does not ratify a Funding Agreement, then the Bank's level of funding provided for in the last year of an existing Funding Agreement is to be carried forward until a new agreement is ratified.

The Bank's primary source of income is interest income from its investment in New Zealand government securities. The portfolio of government securities is financed by the Bank's equity and by currency that has been issued by the Bank and is in circulation. While government securities are interest-earning assets, the Bank does not incur interest costs in respect of currency in circulation and the resulting interest income is used to finance the Bank's operating expenses to the extent permitted by the Funding Agreement.[2]

Funding Agreements themselves are very straightforward documents. They specify, for each year, the amount of income of the Bank which may be retained by the Bank to meet its operating expenses.

Each Funding Agreement defines the operations of the Bank which are subject to the Funding Agreement. In the event that there is a change to the scope of the Bank's operations such that it is necessary to either amend the Funding Agreement or negotiate a new agreement, then the amendment or new agreement is required to be ratified by Parliament.

In the event that the Bank's operating expenditure exceeds the amount specified in the Funding Agreement for that year, then the Bank is required to fund the excess from equity. Conversely, any underspending against the amount provided in the Funding Agreement for a particular year is added to the Bank's equity.[3]

2 Policy intent behind the Bank's funding arrangements

The Bank's funding arrangements differ from most government departments and other government-owned entities for a number of reasons. Most government departments and other government-owned entities are subject to the Public Finance Act and their financial resources are provided by Parliament in the government budget and annual appropriation process.

In contrast, the Bank's use of resources is subject to formal Parliamentary approval at five-yearly intervals, although as explained below, there are many checks and balances in place, which provide both scrutiny of the Bank's performance and incentives for it to ensure its use of resources is appropriate.

1 Mike Wolyncewicz is the Chief Financial Officer for the Reserve Bank of New Zealand.

2 Most central banks around the world typically derive funding from seigniorage – issuing currency that does not incur interest and investing the proceeds in government securities – and this is also the case for the Bank. Where the Bank differs from most central banks is that there is an explicit arrangement that governs the amount of seigniorage that the Bank can retain to fund its operations.

3 The amount available for distribution by the Bank each year is known as notional surplus income. Broadly, this is equal to the Bank's income for the relevant year, to the extent it is realised, less the amount of operating expenditure provided in the Funding Agreement. The Minister of Finance determines the amount of notional surplus income that is to be distributed or added to the Bank's reserves having regard to the capital requirements of the Bank, the views of the Bank's Board and any other relevant matters.

The Funding Agreements are designed to reinforce the operational independence of parts of the Bank. Central Bank operational independence is grounded in the notion that if day-to-day monetary policy decisions were subject to the political process, policy settings would tend to err towards generating higher inflation. This partly reflects the incentive that governments would face to adopt easier monetary policy settings to boost nominal revenues.

If the Bank's annual operating expenditure was required to be subject to annual appropriation by Parliament, it would be possible for its operational independence to be weakened.

The challenge, then, was to design a regime which ensured that the Bank could operate over the medium term with a significant degree of autonomy, yet still remain answerable to Parliament and be subject to high standards of disclosure, review, and accountability for the use of resources.

3 Framework for managing use of resources

The current arrangements allow an appropriate balance to be maintained, with several points at which the Bank's financial decision making is subject to independent scrutiny. It is worth describing the framework for monitoring the Bank's financial performance by walking through the life-cycle for developing a Funding Agreement and administering the Bank.

Approximately nine months before the expiry of a Funding Agreement the Bank commences a strategic planning process aimed at identifying the major developments that will affect it over the following five years. Cascading down from this strategy, the Bank will establish its three-year *Statement of Intent* and its one-year operational plan.

The Bank, therefore, assesses the key influences and decisions that will shape its use of resources for a period of five years ahead. It calculates the costs of various initiatives and expected industry changes, and assesses the priority to be given to each of the initiatives. The Bank models the cost profile of both existing functions and the new initiatives, and arrives at a central scenario of the cost of operating the Bank for each year of the five years of the period to be covered by the new Funding Agreement.

The Governor submits the plan and proposed level of funding to the Board. The Board's role at this stage is to provide advice to the Governor. The Board needs to be satisfied that the Bank will have adequate resources to carry out its statutory duties. Equally, once a Funding Agreement is in place, the Board has a duty to monitor the Bank's use of resources, so that it can be assured that the spending is well managed.

Having received the Board's input, the Governor submits the proposed Funding Agreement to the Minister of Finance who asks Treasury to scrutinise the Bank's bid. Treasury undertakes a detailed review of the Bank's submission, as it does for government departments in respect of their annual expenditure proposals, and reports back to the Minister. Negotiations occur and, once the proposal is finalised, the Minister and Governor execute the Funding Agreement.

The Funding Agreement must be tabled in Parliament within twelve sitting days of it being signed. The Minister proposes a motion that the House ratify the Funding Agreement.

Given the many layers of review by the Board, the Minister, Treasury, and finally Parliament, together with relevant media coverage, the Bank's proposals need to be firmly grounded, easily justified, and not excessive.

Equally, there are strong incentives for the Bank's expenditure not to exceed the levels provided for in the Funding Agreement. While the Bank has not yet exceeded those levels in any year, such an event would be disclosed in the Bank's *Annual Report* and would no doubt be subject to review by Parliament's Finance and Expenditure Committee and media commentary.

There is inevitably a high degree of uncertainty in forecasting expenditure over a five year period, so it is appropriate that modest provision be made within the Funding Agreement for risks and initiatives that cannot reasonably be foreseen over an extended time.

4 Ongoing financial review

The Funding Agreement provides a broad framework for setting expectations for the cost of delivering services. It does not constrain the Bank's expenditure on individual functions; instead it provides flexibility to redeploy resources as priorities change. Other checks and balances exist to ensure that changes in resource use are reasonable and justified.

Each year the updated *Statement of Intent* records the Bank's objectives and strategies for the current and following two years. The *Statement* also requires that the Bank disclose its budget for the first year of the three-year period. The draft *Statement of Intent*, like the Funding Agreement, is subject to review by the Bank's Board. The Minister of Finance must receive a copy on or before 31 May each year and the Governor is required to consider any comments that the Minister has before publishing the *Statement of Intent* on or before 30 June. The published document must be tabled in Parliament.

The Bank's projected statement of financial performance is developed as the result of a detailed annual budgeting and planning process. Having established objectives for three years and agreed detailed priorities for twelve months, Bank departments develop detailed financial plans. These are subject to review by a Planning and Budgeting Working Group and a committee of the senior management – known as the Governor's Committee – before the Governor requests advice from the Board and the budget is finalised.

Treasury provides input to the annual budgeting process by reviewing the draft *Statement of Intent* on behalf of the Minister.

Actual financial outcomes against plans are reviewed by the Bank's Board at each Board meeting. The Bank's *Annual Report* includes a review and commentary on financial outcomes against budget and against the previous year's outcomes. The *Annual Report* is also tabled in Parliament and is subject to review by the Finance and Expenditure Select Committee.

It can be seen from the above that while the Funding Agreement affords the Bank a substantial degree of autonomy, there are strong mechanisms and incentives in place to ensure that it remains fully accountable for financial outcomes.

5 Recent changes

The Funding Agreement and related legislation have been refined over the last five years or so. The Funding Agreement for 2000-2005 was developed so that the binding constraint agreed to was net expenditure; that is, expenditure incurred after deducting revenue received from designated sources such as from disposal of obsolete coins, sale of collectors' currency, rental income, and fees for provision of registry and banking services. The rationale for the change was that if the Funding Agreement focused only on gross expenditure then it would create perverse incentives for the Bank to avoid investing in services that created a positive economic return. For example, the Bank would have no incentive to invest in changes to its building, which could generate long-term rental income, if the focus were on expenditure rather than net expenditure.

At the same time the Bank brought within the scope of the Funding Agreement its registry and banking operations. Prior to June 2000, these activities were outside the Agreement, with any profits being directly added to equity, and conversely any losses financed by Bank equity. Once the Bank resolved the issue of perverse incentives referred to above, there was no reason to treat registry and banking activities differently from other Bank functions and so, from 2000, these functions were included within the ambit of the Funding Agreement.

In December 2004, section 159 of the Act was amended in order to resolve some technical difficulties that existed with respect to the Agreement. In particular, the section referred to "expenditure" rather than "operating expenditure". Technically, the Bank could have been required to agree all "expenditure" including interest expenses and foreign exchange losses at the time the Funding Agreement was negotiated. Clearly the ability to forecast such expenditure is impossible given the nature of the Bank's business. Failure to agree on a level of expenditure for such items could have impacted the calculation of income available for distribution and in turn affected the Bank's capital. Acknowledging this, the Funding Agreement was amended in March 2004 when the Bank acquired an increased capacity to intervene in foreign currency markets. The Act was subsequently changed so that Funding Agreements focus on "operating expenses" rather than "expenditure", which was always the intention.

6 Outcomes under successive Funding Agreements

Figure 1
Actual net expenditure and agreed levels of operating expenditure[4]

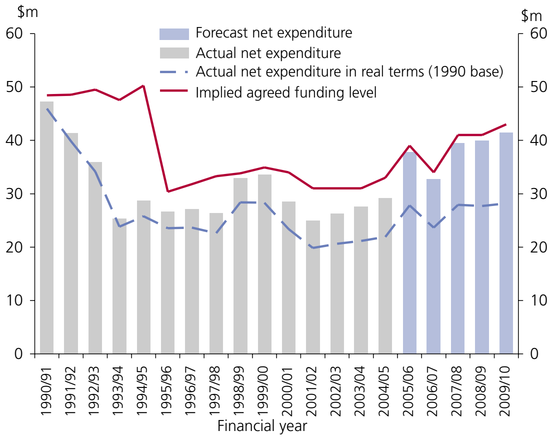

Figure 1 shows the level of net operating expenditure incurred by the Bank under successive Funding Agreements over the past fifteen years, together with the forecast expenditure and Funding Agreement levels for 2005–2010.

The graph shows that the Bank has undergone significant change in its expenditure profile. During the 1990s it achieved large reductions in both nominal and real levels of expenditure as the Bank was restructured and various policy reforms were put in place. In particular, the currency function underwent material change, including the closure of the Bank's Auckland and Christchurch operations; the introduction of polymer notes, and the adoption of a wholesale distribution model. In addition, major changes occurred with respect to banking supervision with the adoption of a disclosure-based regime in the mid-1990s. In 2000 the Bank outsourced its registry operations and in 2004 it exited the retail registry operations business entirely. In 1999, the Bank restructured those of its operational departments that were charged with internal service delivery so as to consolidate operations into fewer operating divisions. In 2003 the Bank merged its Banking System and Financial Markets Departments into a new Financial Stability Department, and reinvigorated its supervision of the financial system.

Having achieved significant cost savings during the early 1990s, the Bank was able to largely contain costs during the period 1994 to 2005. During the final years of that period the Bank commenced a programme of major capital investment to replace systems which were fully depreciated and coming to the end of their economic lives.

In particular, the Bank's document management system, its treasury system, note counting equipment, security systems, and real-time gross settlement systems required major capital expenditure, all of which will significantly increase depreciation expenditure during 2005–2010.

Other major drivers of cost increases during this upcoming period include risk reduction measures, in particular further investment in the Bank's business continuity planning capability to meet higher standards. This involves the purchase of additional systems capabilities and the establishment of back-up sites/capabilities in Wellington and out of Wellington. This will provide greater assurance that the Bank can continue to operate across a range of services in the most extreme disasters.

Finally, the Funding Agreement for 2005–2010 makes provision for additional resources in the Bank's regulatory arm to meet increased demands, especially with respect to international developments such as Basel II, trans-Tasman cooperation, and payments systems developments.

The Bank still continues to innovate, looking for efficiencies and ways to increase effectiveness. From 2006/07 the

4 From 1 July 2000, the Funding Agreement was expressed as a level of net expenditure which took into account revenue from specified activities. For the year ended 30 June 2000 and earlier years, the Funding Agreement was based on gross expenditure. For the year ended 30 June 2000 and earlier years, figure 1 presents the implied Funding Agreement level on a comparable basis, that is by deducting from the agreed levels of gross expenditure revenue earned from those specified activities.

5 cent coin will be withdrawn from circulation and the 10, 20 and 50 cent coins replaced by lighter and less expensive coins made of plated steel. This will save $2 million per annum in the cost of issuing new currency.

7 Conclusion

The Bank's Funding Agreement gives it significant financial autonomy which helps to guarantee the ongoing effectiveness of monetary policy. This autonomy is carefully balanced by an extensive set of checks and accountability measures which ensure that the Bank makes responsible use of resources at its disposal.

A review of the Bank's operating expenditure shows that the Bank has achieved significant changes and has been innovative in delivering its statutory outputs and achieving material reductions in its cost profile. Equally, the process works well in making sure the Bank has access to appropriate resources when challenges facing it call for additional resources to be deployed.