
Reserve Bank of New Zealand

Statement of Intent

For the period 1 July 2006 to 30 June 2009

Contents

Introduction	2
Foreword	3
Planning and reporting framework	5
Reserve Bank Strategic Priorities for 2006/07	6
Governance and structure	7
Functions and operations	9
Organisational health and capabilities	14
Financial management	20
Monitoring the Bank's performance	25
Appendix A: Key document references	27

ISSN 1175-6786

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Introduction

Under section 162A of the Reserve Bank of New Zealand Act 1989 (the Act), the Reserve Bank is required, prior to each financial year, to provide the Minister of Finance with a *Statement of Intent (SOI)* traversing the following three years.

Section 162B of the Act states that the Reserve Bank's *SOI* must contain:

- key background information about the Bank and its operating environment;
- the nature and scope of the Bank's functions and its principal areas of operation;
- the nature of the Bank's specific objectives;
- the proposed strategies for achieving objectives and carrying out operations;
- the proposed strategies for managing the organisational health and capability of the Bank; and
- a statement of the projected income and expenditure for the first financial year in the period to which the *SOI* relates.

Foreword

The *SOI* is our three-year forward-looking picture of Reserve Bank activities. It covers our work by function, and highlights the Strategic Priorities, the big and important things we will be doing this year, as well as all the business as usual.

A new five-year Funding Agreement was ratified by Parliament last year. In this we recognised that there would be more demands on our policy outputs in a changing economic environment, and that we would need to replace obsolete systems and effectively mitigate a number of risks. This *SOI* represents our first formal opportunity to review our priorities.

In monetary policy, we still face considerable challenges. While growth in economic activity has begun to slow down, the economy is still showing pressures from a sustained period of growth and demand for limited resources. The upward shift in oil prices in recent years has added to the mix. These factors together have moved actual and projected inflation temporarily above our target band, widened the current account deficit, reduced household savings, and caused wage pressures as skill shortages persist. This has necessitated high interest rates, by world standards, and the exchange rate, while softening, remains at high levels.

It is vital that the Bank's economic toolkit is adequate to the task of keeping up with the changing nature of our economy. In this *SOI*, we have set strategic priorities for replacing or redeveloping the current forecasting model and investigating how we can best maintain price stability without causing unnecessary damage to the exporting sector.

Within a three-year context, we can expect to see a strong line of continuity between one year's strategic priorities and the next. Where last year, for instance, we developed policies on fundamental banking regulatory issues – such as outsourcing, the Basel II¹ capital adequacy regime for banks, local incorporation, and bank-failure management – implementing these policies will be carried forward in 2006/07. We will also be contributing to a review of the supervision of the non-bank financial sector.

Similarly, where we readied our currency systems in 2005/06 for the design and production of new 'silver' coins, implementing this modernisation of our coinage will be a key task for the coming year. A public awareness campaign has been launched for the introduction of smaller and lighter 10 cent, 20 cent, and 50 cent coins, and the withdrawal of the 5 cent coin from circulation. Logistically, this will be the biggest currency change since decimalisation in 1967 – a change that will deliver considerable savings to the New Zealand taxpayer.

We must always ensure we have good management skills, to enable us to manage our functions and resources. In 2005/06, we initiated programmes to develop the leadership potential among our managers and enhance communication between teams that are spread across quite varied and specialist functions. We will build on the progress achieved in 2005/06 in enhancing our managers' leadership skills.

¹ Basel II is a new international framework for determining how much capital banks should be required to hold, taking account of the risks that they take. As with the original Basel capital framework, Basel II was developed by the Basel Committee on Banking and Supervision.

Finally, in our priorities for 2006/07 we will also review the structure of the Bank's balance sheet to ensure that it best meets the statutory requirements of the Bank – that is, monetary policy, currency, bank liquidity, and foreign reserves.

The five-year Funding Agreement recognised that, in meeting the challenges outlined in this *SOI* and its predecessor, we can no longer sustain past decisions to defer investment. The Bank's ability to operate in the current demanding environment will be supported by changes to several back-office systems. We are upgrading our financial reporting, web capability, document management, and forecasting and data systems, while further investment is needed to ensure continuity of operation in the event of major disasters. A new public heritage museum to be opened in Wellington later in 2006 will offer a new window on the Bank, its history and valuable currency artefacts, as well as the role it plays in the New Zealand economy today.

The Bank will endeavour to achieve its strategic and day-to-day goals with the continued best interests of the New Zealand economy and taxpayers in mind.



Alan Bollard
Governor



Adrian Orr
Deputy Governor

15 June 2006

Planning and reporting framework

Where the 2006-2009 Statement of Intent Fits					
	2005/06	2006/07	2007/08	2008/09	2009/10
(i) Planning					
		Funding Agreement (fixed term)			
		Statement of Intent (rolled forward)			
		Detailed Budget			
(ii) Reporting					
		Annual Report			

A number of our Strategic Priorities for 2006/07 are multi-year priorities, set in the context of our longer-term planning and funded through a five-year Funding Agreement.

The funding agreement, signed in April 2005, and subsequently ratified by Parliament, covers the five years to 30 June 2010. Funding rises from \$39 million in the first year (2005/06) to \$43 million in 2009/10. This is a material increase in spending over the previous five-year period, reflecting various factors, including the need to:

- invest in the replacement and upgrading of our treasury and document management systems; our economic forecasting and data systems; and our core financial reporting system;
- strengthen our supervisory capability; and
- ensure that robust business continuity arrangements remain in place.

Reserve Bank Strategic Priorities for 2006/07

	Department	Priority
1	Bank-wide	Management Improve leadership and management competencies through training and development.
2	Economics	Core model redevelopment Replace or redevelop the current forecasting model. ²
3	Economics	Macroeconomic policy framework Assess how to maintain price stability without unnecessary damage to the external sector.
4	Financial Stability	Non-bank regulatory arrangements Help to develop institutional arrangements for prudential regulation, including for deposit-taking institutions and insurance providers, and contribute to the review of anti-money laundering arrangements.
5	Financial Stability	Basel II implementation Develop and implement policy on bank capital requirements under Basel II international standards.
6	Financial Stability and Financial Services	Review of the Bank's balance sheet Review the balance sheet structure to best meet monetary policy, currency, bank liquidity and foreign reserve requirements.
7	Currency	'Silver' coin modernisation Implement the modernisation of New Zealand's 'silver' coins.

² A multi-year priority

Governance and structure

Board of Directors

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

The Board, through an Audit Committee, reviews the Bank's financial statements. Each year the Board writes an assessment of the Bank's and the Governor's performance, which is provided as advice to the Minister of Finance and made public later, in the Bank's *Annual Report*.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. The Minister of Finance can only appoint a Governor recommended by the Board. The Board can recommend to the Minister of Finance that the Governor be dismissed if the Board believes that the Governor's performance has been 'inadequate' in various respects. The Board appoints the Deputy Governor on the Governor's recommendation.

The Board typically meets formally nine times a year. The current Board members are Dr Arthur Grimes (Chair); Mr Paul Baines; Mr Hugh Fletcher; Mr John Goulter, DCNZM, JP; Mrs Alison Paterson, QSO (Deputy Chair); the Rt Hon Edmund Thomas, DCNZM, PC, QC; Dr Marilyn Waring; and Dr Alan Bollard (Governor). Board members are appointed for five-year terms and are eligible for reappointment.

Management structure

Under the Act, the Governor – who is also the Bank's Chief Executive – is accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor alone. The Governor is appointed for a five-year term. The Act sets specific procedures for the appointment, reappointment, and dismissal of the Governor. The Governor can be reappointed for further terms of up to five years.

The Reserve Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Operations, and the heads of the Bank's various departments, as outlined on page 8. The posts of Governor and Deputy Governor are required by statute. Two other members of the senior management team are designated Assistant Governors – the Head of Operations and the Head of Economics. Currently the Deputy Governor is also the Head of Financial Stability.

The Governor receives advice from a number of internal committees within the Bank.

Reserve Bank organisational structure

Governors	Department/Heads	Functions	Internal services	
Governor <i>Alan Bollard</i>	Assistant Governor/ Head of Economics <i>Grant Spencer</i>	Economics	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability <i>Adrian Orr</i>	Financial stability	Market operations Foreign reserves management Financial system surveillance and policy	
		Currency and Building services <i>Brian Lang</i>	Currency operations	Property management Security
		Financial services <i>Mike Wolyncewicz</i>	Settlement services Registry and depository services	Accounting services Treasury services
		Knowledge services <i>Yogesh Anand</i>		Library services Data services Computer services
	Assistant Governor/ Head of Operations <i>Don Abel</i>	Human resources <i>Tanya Harris</i>		Human resources strategy and services
		Communications/ Board secretary <i>Mike Hannah</i>		Communications strategy and services Reputation management Board secretary services
	Risk assessment and assurance <i>Steve Anderson</i>		Audit services Risk assessment and assurance	

Functions and operations

Monetary policy formulation

Objective statement

To achieve and maintain stability in the general level of prices. A published Policy Targets Agreement requires the Bank to keep future inflation outcomes, as measured by the Consumers Price Index, between 1 and 3 per cent per annum 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."

Scope of operations

- Setting an Official Cash Rate (OCR) every six weeks, around which the Bank lends to, and borrows from, registered banks, directly influencing other short-term interest rates.
- Announcing four OCR decisions at the same time as the Bank's quarterly *Monetary Policy Statements* (MPSs), which set out the Bank's views on the economy and inflationary pressures, and the basis for the OCR decision.
- Announcing four other OCR decisions approximately halfway between each MPS.

Issues

- Ensuring that best-practice modelling methods and a wide range of data are used in generating forecasts and monetary policy advice.
- Considering policy options that will reduce cyclical pressures on the external sector while maintaining price stability.
- Ensuring that the monetary policy framework appropriately deals with uncertainty.
- Understanding household consumption/savings behaviour and its interaction with household balance sheets.
- Ensuring monetary policy is communicated to the widest group in the most appropriate manner.
- Ensuring that statistics prepared by the Bank are of high quality and meet user needs.

Initiatives and strategies

- Replace or redevelop the current forecasting and policy model (two-year project).
- Review macroeconomic policy options for reducing cyclical pressures on the external economy while maintaining price stability.
- Develop and maintain a range of best-practice structural and statistical models for use in forecasting and policy analysis.
- Analyse trends in the composition of household balance sheets; identify key drivers; and model the impact on household spending and savings.
- Improve the quality, accessibility, relevance, and reliability of Reserve Bank statistics.

Market operations and foreign reserves management

Objective statement

To assist in the efficient functioning of the New Zealand financial system; to manage official foreign reserves; to manage the Crown's financial liquidity; and to implement monetary policy.

Scope of operations

- Managing official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purpose; managing liquidity in the banking system; providing and managing the Crown Settlement Account; and monitoring and reporting developments in the financial market to enhance monetary policy decision making and financial stability monitoring.
- Acting as lender of last resort to the financial system if necessary, as well as assisting the Bank in the resolution of any financial market or banking crisis.
- Ensuring the effective implementation of monetary policy through the Governor's decision on the level of the OCR.

Issues

- Increasing the Bank's foreign exchange intervention capacity and capability.
- Assessing the optimal balance sheet structure for the Bank.
- Finalising policies for implementation of lender-of-last-resort facilities for a banking system in stress.
- Providing advice to the Governor on financial market developments and issues for the formulation of monetary policy.

Initiatives and strategies

- Review the structure of the Bank's balance sheet to ensure that it best meets the statutory requirements of the Bank (including monetary policy, currency, bank liquidity, and foreign reserves).³
- Complete and potentially implement the liquidity management review, which aims to ensure that the banking system has adequate liquidity, with collateral requirements and risks being balanced appropriately.
- Continue to work closely with the Debt Management Office to ensure that the comparative advantages offered by the two agencies in managing the Crown's foreign exchange and debt management business are being utilised fully.

³ A joint project with Financial services

Financial system surveillance and policy

Objective statement

To register and supervise banks so as to maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.

Scope of operations

- Setting specific criteria for bank registration.
- Subjecting banks to a specific monitoring regime.
- Publishing regular *Financial Stability Reports* assessing the state of the New Zealand financial system in terms of soundness and efficiency.
- Having a capacity to respond if a bank fails or gets into financial distress, including giving directions to a registered bank; recommending to the Minister that a bank be placed in statutory management; and acting as lender of last resort to the financial system, providing liquidity in a crisis.
- Overseeing payment systems.

Issues

- Implementing the Bank's outsourcing policy.
- Implementing the Basel II capital adequacy regime for banks.
- Ensuring the Bank's capability to manage a bank failure or wider crisis.
- Ensuring appropriate mutual recognition, harmonisation, coordination, and cooperation with home regulators, the Trans-Tasman Council on Banking Supervision being a particularly important forum.
- Accommodating updates in global regulatory standards.
- Improving monitoring of non-bank financial institutions.
- Contributing to the review of institutional arrangements for prudential regulation of non-bank deposit-taking institutions and insurance providers, and to the review of anti-money laundering arrangements.
- Reviewing the efficiency of the banking sector and the Reserve Bank's supervision methods.

Initiatives and strategies

- Continue to work with other agencies to assess the scope for wider prudential regulation of the non-bank financial sector and the role of the Bank in this area.
- Complete the implementation of the Bank's policies on outsourcing, Basel II, and local incorporation.
- Complete the formulation and implementation of the Bank's crisis management capabilities, assessing their robustness through failure management scenarios.
- Potentially become the prudential regulator of some sectors of the non-bank financial sector (eg, some deposit-taking institutions).
- Review the efficiency of the banking system.

Currency operations

Objective statement

To meet the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

Scope of operations

- Distributing bank notes and coins to the banking system, as the sole issuer of currency.
- Issuing legal tender collectors' currency through an outsourcing arrangement with New Zealand Post.

Issues

- Introducing new smaller, lighter 'silver' coins, and removing the 5 cent coin from circulation.
- Reducing the cost of supplying currency.

Initiatives and strategies

- Implement the modernisation of the 'silver' coins.
- Improve the forecasting of currency demand.
- Report on currency trends and electronic-money developments.

Depository and settlement services

Objective statement

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

Scope of operations

Operating the Exchange Settlement Account System (ESAS) and Austraclear systems, including the infrastructure required for settlement of continuous linked settlement (CLS) transactions through CLS Bank.

Issues

- Undertaking a significant systems upgrade to ensure that the payments infrastructure continues to operate efficiently.
- Being prepared for the possibility that a new entrant could emerge and offer depository services.
- Improving business continuity planning and disaster recovery capabilities, and responding to higher international operating standards.
- Responding to changing industry requirements regarding the times at which payment settlements take place.

Initiatives and strategies

- Improve business continuity planning and disaster recovery capability by arranging for out-of-Wellington business support for payment systems, and ensure greater flexibility in backup computing and service provision arrangements.⁴
- Engage with the settlements industry to define long-term needs and to evaluate options for delivering the services required.
- Complete the upgrade for ESAS and Austraclear systems before 31 December 2007.⁴

⁴ See also 'Knowledge services', p15

Organisational health and capabilities

Human resources

Objective statement

To provide strategic human resource advice and support services.

Scope of operations

- Assisting departments with recruitment, contract negotiation, employment relations, and legislative advice.
- Organising specific bank-wide training and development programmes, key-person-risk planning, secondment, and study arrangements.
- Facilitating the annual remuneration review and performance management programmes.

Issues

- Ensuring high quality of staff for the Bank through training and recruitment.
- Identifying areas where skills can be enhanced and developed to meet future requirements.

Initiatives and strategies

- Provide leadership training to support managers to be high-performing individuals and leaders within the Bank.
- Continue a formal review of key-person risk within the Bank and how it can be mitigated.
- Continue the Bank's staff appraisal system that incorporates a career development plan for each staff member.

Knowledge services

Objective statement

To provide information management and information technology services.

Scope of operations

Developing and maintaining core technology infrastructure; business analysis and applications; helpdesk and web support; library and records management; and project and portfolio management services.

Issues

Managing capital expenditure to upgrade IT capability, largely for business continuity purposes, to provide efficient payments services, and to proactively replace legacy business solutions.

Initiatives and strategies

- Enhance the Bank's web functional capability to provide a more secure information-sharing medium.
- Extend the Bank's knowledge management strategy by implementing the collaboration and workflow tools provided with the Bank's new document management system; and evaluating digital capture of archive records and physical documents.
- Upgrade all internally developed computer applications over the next three years in order to ensure the versions of software used are fully supported and, where possible, use standardised language.
- Continue enhancing the Bank's business continuity infrastructure, through reviewing arrangements for an out-of-Wellington business support for critical functions and ensuring greater flexibility in backup computing arrangements.
- Complete the upgrade for the ESAS and Austraclear systems and supporting network infrastructure before 31 December 2007.⁵

⁵ See also 'Depository and settlement services', p13

Financial services

Objective statement

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

Scope of operations

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

Issues

- Eliminating settlement risk for the Bank's own foreign exchange transactions.
- Adopting International Financial Reporting Standards (IFRS).
- Maximising the benefits from investment in the new treasury system.

Initiatives and strategies

- Evaluate options for the Bank to access alternative means for utilising the services of CLS Bank, and implement the preferred option.
- Adopt IFRS from 1 July 2007.
- Progressively review and redesign workflows, reports, and processes for securities trading activities.
- Evaluate the merits of servicing other government entities' processing requirements using the Bank's treasury system.
- Review the Bank's balance sheet structure to ensure it is appropriate for meeting the Bank's statutory obligations.⁶

⁶ A joint initiative with Financial Stability Department

Communications

Objective statement

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

Scope of operations

- Developing communication and relationship strategies, plans, and programmes for the Bank's key external and internal stakeholder relationships.
- Managing the Bank's relationship with news media.
- Writing, editing and publishing Bank documents, and providing editorial oversight of the Bank's website.
- Sponsoring education initiatives.
- Coordinating responses to Official Information Act requests, ministerials, and public enquiries.
- Supporting the Board by providing Board Secretary and administrative services.

Issues

- Developing proactive external and internal communication strategies across the Bank to deliver the Bank's messages through appropriate channels, and to maintain the Bank's credibility and reputation.
- Supporting the introduction of the new 'silver' coins through a public awareness campaign.
- Providing communication through the public heritage museum in Wellington and an updated suite of brochures and information sheets.

Initiatives and strategies

- Deliver the Bank's communications to target audiences through the most appropriate channels, including web and hard-copy publication, news releases, press conferences, briefings, and day-to-day liaison with stakeholders.
- Provide the Bank with timely advice on reputational risks and opportunities, and with strategies for their mitigation or utilisation.
- Deliver a public awareness campaign for the new 'silver' coins.
- Provide communications support for the Bank's new public heritage museum.
- Update the Bank's suite of brochures and release a history of New Zealand coins.
- Further enhance internal communications.
- Further enhance crisis preparation.

Risk assessment and assurance

Objective statement

To assist in the evaluation of the effectiveness and efficiency of risk management, and to audit internal control systems.

Scope of operations

- Assisting line management with identifying and analysing sources of risks.
- Working with line management to design risk management systems and processes.
- Monitoring risk management implementation and providing risk management advice to Governors.
- Providing ongoing audit review and evaluation of the Bank's operations and internal control systems.

Issues

- Ensuring risks are being managed by line management in a proactive, coordinated, prioritised, and cost-effective manner.

Initiatives and strategies

- Review the Bank's approach to risk assessment and assurance.
- Continue to carry out a comprehensive internal audit programme to provide assurance on the Bank's internal control environment.

Property management and Security

Objective statement

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

Scope of operations

- Maintaining the Bank-owned building at 2 The Terrace, Wellington, and managing leases on eight of the 14 floors.
- Managing a number of Bank-owned carparks in an adjacent building, some of which are leased out.

Issues

- Planning and refurbishing the building to meet current and future needs for accommodation, including a public heritage museum and function area.
- Assisting in establishing and maintaining off-site accommodation for business continuity planning.

Initiatives and strategies

- Plan and refurbish the building to meet current and future Bank needs for accommodation.
- Provide appropriate space and fit-out for a public heritage museum and function area on the ground floor.
- Upgrade the security of the building and vaults to provide a continued safe and secure working environment.
- Assist in the establishment and maintenance of off-site accommodation for business continuity planning purposes.
- Maintain the building at the required standard, with fully-let tenanted areas.

Financial management

Financial management structure

The Reserve Bank is both a statutory agency and a financial institution. It receives no direct funding through the central government budgetary process. Instead, the Bank's main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the Government's equity contribution to the Bank. Currency in circulation is, in effect, an interest-free loan from the public, and the proceeds are invested by the Bank in government bonds.

Under the Act, the Minister of Finance 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 the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and does not become effective until ratified by a resolution of Parliament.

The Act makes provision 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 funding arrangements for the Bank are designed to strike an appropriate balance between providing the Bank with a high degree of effective operational independence, while also effectively managing the Bank's operating expenditure, and ensuring accountability for the Bank's use of resources. Capital expenditure is funded by the Bank from its own resources.

If operating expenditure (net of specified revenue) in any year exceeds the amount provided in the funding agreement, the Bank is required to fund that excess from equity. Where actual net expenditure is less than the amount provided in the funding agreement, the amount of that underspending is retained by the Bank and added to equity.

The Act requires the Bank to calculate the amount of income that is available for distribution, which is known as notional surplus income. The Minister of Finance, after consulting the Bank's Board, decides whether the notional surplus income should be added to the Bank's reserves or paid to the Government. An amendment to the Act in 2004 changed the formula for calculating the amount for distribution. The new formula excludes unrealised valuation gains from the amount available for distribution. This change has resulted in the amount of surplus available to be paid as dividend (or credited to the Bank's reserves) becoming more volatile, even where the balance sheet structure is unchanged. We are therefore exploring whether there might be better ways to handle any unrealised foreign currency gains and losses in the calculation of notional surplus income.

Drivers of financial performance

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

- the amount of equity retained by the Bank;
- the value of currency in circulation;
- interest rates earned on the Bank's investment in government securities;
- the performance of the Bank's foreign reserve management and market operations functions; and
- operating expenditure incurred by the Bank.

Many of these areas have undergone significant change in recent years, and further changes can be anticipated as the economy and financial markets evolve. Significant changes include:

- Receipt of additional equity of \$1 billion on 1 July 2004 to enable the Bank to absorb the risks from any foreign exchange intervention undertaken at its discretion. The Bank will continue to invest its equity and proceeds from issuing currency by investing in New Zealand government securities. It intends to hold those securities to maturity.
- Steady growth in currency in circulation from \$2.5 billion in 2001 to \$3.4 billion in 2006. We expect this growth to continue.
- Agreement with the Minister to increase the Bank's holdings of foreign reserves that can be liquidated at short notice to support the functions of the Bank, including monetary policy objectives and the maintenance of orderly markets. The Bank is steadily increasing the amount of its reserves for crisis management purposes to the equivalent of SDR2.45 billion⁷. Most asset positions are held passively, and limited discretionary foreign exchange and interest rate positions are able to be undertaken. Foreign currency assets held in passive portfolios are funded by long-term foreign currency loans from The Treasury. The annual cost of holding reserves has been falling as a result of accessing funding for reserves at reduced rates.
- The Bank has announced its intention to change the way it manages its New Zealand dollar liquidity management operations, significantly increasing the level of settlement cash held by banks. The changes to liquidity management operations will not significantly change the Bank's net income, although a small increase in the degree of year-to-year volatility is expected.
- An increase in operating expenditure reflecting significant capital expenditure in renewing or replacing existing systems; improvement of business continuity capabilities; and additional staff to respond to financial stability policy and operational development. This has been offset to some degree by the lower cost of issuing new 'silver' coins. Net expenditure will be lower in 2006/07 due to the receipt of salvage proceeds from scrapping demonetised coins.

A Bank priority for 2006/07 is the completion of a comprehensive review of the Bank's balance sheet to ensure that the Bank's financial structure and operations best meet the statutory requirements of the Bank. The Bank will adopt New Zealand International Financial Reporting Standards from 1 July 2007. The Bank's Audit Committee is monitoring the progress of the implementation programme.

⁷ The SDR (Special Drawing Right) serves as the unit of account of the International Monetary Fund and some other international organizations. Its value is based on a basket of key international currencies.

Principal risks and financial management strategies

As a financial institution with more than \$16 billion in assets, the Bank faces a wide range of financial risks. These arise mainly because of the Bank's operations in the domestic financial system and because of the Bank's holdings of foreign exchange reserves. The risks include:

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

More detailed information on these risks, and the Bank's approach to managing these risks, are outlined on pages 78–91 in the 2004/05 *Annual Report*.

Financial projections

The following table outlines the Reserve Bank's budgeted income and expenditure for 2006/07. The budgeted income and expenditure have been prepared using the accounting policies used in the preparation of the Bank's financial statements for the year ended 30 June 2005. Those accounting policies are disclosed on pages 54–59 of the Bank's 2004/05 *Annual Report*.

The key assumptions underlying the budget for the year ended 30 June 2007 are that:

- the Bank's current functions will continue;
- there will be continued growth in the level of foreign reserves and implementation of changes to the Bank's liquidity management operations;
- interest and exchange rates will be those prevailing as at 22 April 2006; and
- the Bank has no material open foreign currency positions during the year.

Key changes from the budget for 2005/06 are:

- increased personnel costs due to additional staff employed, principally in the Financial Stability and Economics departments; and
- increased currency costs due to the issue of new 'silver' coins. The Bank will receive funds from the sale for scrap of demonetised 'silver' coins.
- The Bank has budgeted for the cost of joining CLS Bank to manage the risk of settling foreign currency transactions.

Projected financial performance 2006–2007

<i>For the year ended 30 June</i>	Budget	Estimated Actual*	Budget
	2006/07	2005/06	2005/06
	\$m	\$m	\$m
Operating income:			
Foreign currency investment margin	26.4	29.1	15.6
Local currency investment margin	320.0	322.5	296.5
Net investment income	346.4	351.6	312.1
Other income**	20.0	8.4	6.8
Total operating income	366.4	360.0	318.9
Operating expenses:			
Personnel	22.1	21.1	20.1
New currency issued	10.1	6.2	6.6
Asset management	6.7	5.5	5.9
Administration	1.9	1.5	1.6
Other***	12.5	9.6	10.1
Total operating expenses	53.3	43.9	44.3
Operating surplus	313.1	316.1	274.6
Net expenditure under the Funding Agreement	33.4	35.5	37.5
Funding Agreement Under-Expenditure	0.6	3.5	1.5
Funding Agreement	34.0	39.0	39.0

* Estimated Actual figures for 2005/06 incorporate actual results to 31 March 2006, together with an estimate of results for the three months ended 30 June 2006. The Bank is reviewing the assumptions used to determine the fair value of its financial instruments and, accordingly, these figures may change at balance date.

** Other income includes income from scrapping of 'silver' coins.

*** Increase in Other is principally due to publicity costs for the 'silver' coin modernisation programme, costs of accessing CLS Bank, legal costs and software maintenance.

Net expenditure by function

	Net Expenditure*	
	Budget	Estimated Actual
<i>For the year ended 30 June</i>	2006/07	2005/06
	\$000	\$000
Functions:		
Monetary Policy Formulation	9,267	8,825
Market Operations	4,927	4,425
Financial System Surveillance	8,952	7,495
Currency Operations**	984	7,867
Foreign Reserves Management	8,452	6,882
Settlement Services	630	539
Registry and Depository Services	(636)	(1,017)
Overseas Investment Commission Secretariat***	0	18
Other Outputs	731	519
Net Expenditure	33,307	35,553

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

** The material reduction in Currency Operations in 2006/07 is a function of expected proceeds to be received from salvaging demonetised coins.

*** On 25 August 2005, the secretariat services and funding provided by the Bank to the Overseas Investment Commission were discontinued.

Monitoring the Bank's performance

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

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

- the six-weekly OCR decisions, quarterly *MPSs* and six-monthly *Financial Stability Reports*;
- the Bank's *SOI*, *Annual Report* and financial statements;
- the quarterly *Bulletin*;
- the Bank's website (www.rbnz.govt.nz);
- occasional publications such as the *Briefing to the Incoming Minister*, and issue-specific books and brochures; and
- addresses given by the Governor and other senior Bank staff.

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

The Reserve Bank's Board reviews the Bank's performance and the discharge of its statutory obligations. In addition to providing the Governor with ongoing advice and feedback, the Board is also required to report annually on the Bank's performance. The Board's report is published in the Bank's *Annual Report*.⁸

The Reserve Bank publishes its *SOI* at the commencement of each financial year. The *SOI* sets out the Bank's principal functions and objectives for the next three years; comments on strategies for managing organisational health and capability; and sets out projected income and expenditure for the first year of that three-year period.

The Reserve Bank's *Annual Report* includes an assessment of the performance of the Bank's various functions, in terms of both the day-to-day responsibilities and progress against priorities set previously.

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

The Reserve Bank's financial statements are audited by an external auditor who is the agent of the Controller and Auditor-General. The Audit Committee of the Board reviews those financial statements and provides advice to the Governor before the Governor and Deputy Governor sign the related management statement. The critical payment systems operated by the Bank are subject to review by external auditors quarterly, in respect of the Austraclear depository system, and annually, in respect of the Exchange Settlement Account System.

From time to time the Reserve Bank engages experts to assess the Bank's processes, research, and technical performance. In the past, assessments have been provided in the fields of monetary policy development;

⁸ For example, see pages 44–47 in the 2004–2005 Annual Report.

financial system policy; forecasting processes; bank-failure management; computer systems and network security; management; and leadership assessment and development. The Bank funds a Professorial Fellowship in Monetary and Financial Economics at Victoria University of Wellington. The programme aims to promote wider discussion of, and constructive challenge to, the Bank's thinking in monetary economics and financial-system policy; and encourage debate among university academics and policy advisers in the monetary and macroeconomic fields and in the financial stability field. Also, two external advisers assist in the provision of advice to the Governor regarding his interest rate decisions. During the week prior to the release of the *MPS*, these two advisers fully participate in the deliberations leading to the formulation of the *MPS*.

The Reserve Bank's performance is also subject to international scrutiny. Every 12–18 months, the International Monetary Fund (IMF) undertakes an 'Article IV' assessment of the New Zealand economy, which includes sections on monetary policy and financial system stability. The resultant report is made public. Likewise, every two years, the Organisation for Economic Co-operation and Development undertakes a similar assessment, which is also published. The recent IMF Financial Sector Assessment Programme investigation is expected to be repeated in New Zealand every six or seven years.

Appendix A

Key document references

Title	Purpose	Location
<i>Annual Report*</i>	Key accountability document, plus presentation of financial statements	www.rbnz.govt.nz/about/whatwedo/0094054.html
Board of Directors' Annual Report	Board of Directors' report on the Reserve Bank's performance	Reproduced in the Reserve Bank's <i>Annual Report</i>
<i>Briefing on the Reserve Bank of New Zealand*</i>	Description of the role and functions of the Reserve Bank, prepared for an incoming government	www.rbnz.govt.nz/about/whatwedo/0122541.html
<i>Central Banking in New Zealand*</i>	Brochure about the Reserve Bank and its governance arrangements	www.rbnz.govt.nz/publications/index.html
<i>Financial Stability Report*</i>	Six-monthly publication of the Bank's view on the soundness and efficiency of the New Zealand financial system	www.rbnz.govt.nz/publications/finstab/
Funding Agreement	Basis of Bank's funding, setting how much of the Bank's net operating surplus can be retained by the Bank	www.rbnz.govt.nz/about/whatwedo/1846117.html
Letter to Minister of Finance on foreign exchange market intervention policy	Description of how the Bank may intervene in the foreign exchange market under section 16 of the Reserve Bank of New Zealand Act to 1989 to influence the exchange rate	http://www.rbnz.govt.nz/foreignreserves/intervention/index.html
Letter from Minister of Finance to the Bank on foreign exchange intervention	Provision of delegated authority for the Bank to intervene in the foreign exchange market under section 17 of the Reserve Bank of New Zealand Act 1989, should that market become dysfunctional.	http://www.rbnz.govt.nz/foreignreserves/intervention/0148293.html
Mission Statement and Values	Expression of the Bank's modus operandi	Inside front cover of <i>Annual Report</i>
<i>Monetary Policy Statement*</i>	Quarterly publication of the Bank's view of how the Bank proposes to meet its monetary policy targets, including extensive economic projections	www.rbnz.govt.nz/monpol/statements/index.html
Policy Targets Agreement	Agreement between the Governor and the Minister of Finance specifying the inflation target in detail.	www.rbnz.govt.nz/monpol/pta
<i>Reserve Bank Bulletin*</i>	Quarterly publication of articles relevant to central banking in New Zealand	www.rbnz.govt.nz/research/bulletin/index.html
Reserve Bank of New Zealand Act 1989	Reserve Bank's statutory authority	www.rbnz.govt.nz/about/ourlegislation/
<i>Statement of Intent*</i>	A statement of what the Bank intends to achieve over the next three years, with forecast income and expenditure for one financial year	http://www.rbnz.govt.nz/about/whatwedo/1764296.html
Statement of Principles*	Explanation of the Reserve Bank's approach to bank registration and supervision	http://www.rbnz.govt.nz/finstab/banking/regulation/bs1.pdf
<i>This is the Reserve Bank*</i>	Introductory brochure about the Reserve Bank	www.rbnz.govt.nz/about/whatwedo/0109157.html

* Also available in print from: The Librarian, Reserve Bank of New Zealand, PO Box 2498, Wellington, New Zealand.
rbnz-info@rbnz.govt.nz
www.rbnz.govt.nz

