Statement of Intent

2015-2018

RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Reserve Bank of New Zealand

Statement of Intent

2015-2018

ISSN 1175-6786

Reserve Bank of New Zealand Statement of Intent

For the period 1 July 2015 to 30 June 2018

Contents

Environmental setting and strategic priorities 2
What we do 4
SOI, Funding 4
Governance 4
Organisational structure 6
Strategic direction 7
Vision and values
Goal, outcomes, functions, success measures
Reserve Bank strategic priorities for 2015–2018 12
Functions – initiatives 15
Monetary policy formulation 15
Financial market operations 17
Macro-financial stability 19
Prudential supervision 21
Settlement services 24
Currency operations 25
Operations – enabling the Bank 26
Financial management 28

Environmental setting and strategic priorities

Environmental setting

New Zealand's economy continues to grow at an annual rate of around 3 percent, reflecting low interest rates, high net immigration, rising construction activity and a decline in fuel prices since mid-2014. However, headwinds to growth include a softening in the Chinese and Australian economies, a sharp fall in dairy incomes and the persistence of the New Zealand dollar at unjustifiable and unsustainable levels.

Lower fuel prices, a high exchange rate and low global inflation have seen annual CPI inflation fall below the Reserve Bank's 1 to 3 percent inflation target in the past year. Inflation is expected to pick up as the effect of lower fuel prices diminishes and economic growth gradually exhausts available capacity. The Bank's goal is to ensure future inflation is within the target band on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint. It seeks to do this while avoiding unnecessary volatility in output, interest rates and the exchange rate.

House price inflation has been elevated in Auckland and prices are stretched relative to incomes and rents. The Bank has proposed adjustments to loan-to-value restrictions in light of the increased financial stability risks if house prices were to drop sharply.

The prudential framework has evolved significantly since the Global Financial Crisis and the Bank is continuing to strengthen it. A stocktake of the prudential requirements relating to banks and non-bank deposit takers is underway with the aim of improving the efficiency, clarity and consistency of prudential requirements.

The Reserve Bank continually seeks to strengthen its performance and meet the challenges and demands of the environment in which it operates. The Bank has reached a new 5-year funding agreement with the Minister of Finance under which its funding level will increase by an average of just 1 percent a year over the next five years. The Bank has identified avenues for cost savings and for using its resources more effectively. This process has meant a small reduction in staff numbers and is leading to changes in the Bank's business processes and culture that will help it become more innovative and responsive in delivering on its objectives.

Strategic priorities

The Bank adopted 10 strategic priorities for 2015–18 to enhance its capacity to respond to this challenging environment. Many of these strategic priorities run across several functions and departments.

These strategic priorities, which are described in more detail on pages 12-14, are framed around three broad themes:

- continuing to strengthen the Bank's performance;
- developing a more integrated Bank approach to the Bank's policies; and
- improving infrastructure and reducing enterprise risk.

Informing Government

The Bank keeps the Minister of Finance regularly informed about its thinking on significant policy developments, especially where Cabinet decisions, legislation or regulation may be required. This involves providing substantive information and discussion of the rationale for any changes, and their potential economic and fiscal impacts at the earliest possible stages of policy development, including timely engagement with Treasury officials. The Bank also provides assessments of the expected regulatory effects of proposed policy developments.

This information includes:

- Macro-economic policy in the coming economic cycle, including the implications of global economic and financial market developments. It also covers issues relating to the Bank's implementation of monetary policy and policies directed toward financial stability, and their interaction with fiscal and wider policy settings as well as analytical contributions that deepen understanding of New Zealand's economic performance and macroeconomic imbalances.

- Macro-prudential policy and the effectiveness and development of macro-prudential tools, and consultation on developments in accordance with the Memorandum of Understanding agreed in 2013.

- Opportunities to improve the quality and effectiveness of regulations administered by the Reserve Bank.

- Activities that support a well-functioning financial system, including the ongoing suitability of prudential supervision and policies aimed at increasing the safety of the New Zealand financial system.

- Risks to the Crown balance sheet that might arise from the failure of a financial institution and the bedding in of reforms that mitigate the Crown's exposure to the financial sector, including Open Bank Resolution (OBR).

- Ongoing close collaboration with the Reserve Bank's Australian stakeholders on matters related to the financial system, supervisory oversight and prudential policies.

Graeme Wheeler
Governor

Grant Spencer
Deputy Governor

What we do

The Reserve Bank of New Zealand is New Zealand's central bank. A Crown agency, the Bank exercises powers across the financial sector that are derived from several pieces of legislation:

- Reserve Bank of New Zealand Act 1989.
- Insurance (Prudential Supervision) Act 2010.
- Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act).
- Non-bank Deposit Takers Act 2013 (NBDT Act).

These Acts can be viewed electronically on the New Zealand Legislation website. Regulations made under these Acts can be viewed on the same site.

Statement of Intent, Funding

Under section 162A of the Reserve Bank of New Zealand Act 1989 (the Act), the Reserve Bank must provide to the Minister a *Statement of Intent* (*SOI*) for that financial year and at least the next two financial years. The *SOI* is set in the context of the Bank's longer-term planning and funding. The Bank is funded through a five-year funding agreement between the Minister of Finance and the Governor, which has been ratified by Parliament. The funding agreement specifies how much of the Bank's income can be retained by the Bank to meet its operating costs.

This *SOI* covers the three years 2015–2016 to 2017–2018 under a new funding agreement for 2015–2016 to 2019–2020.

Governance

The Act provides day-to-day operational autonomy to the Bank under the management of the Governor, an important role for the Minister of Finance in some key decisions, and a robust accountability structure that involves formal roles for the Bank's Board, the Minister, and Parliament (via the Finance and Expenditure Committee). Transparency is an important feature of the framework. For a description of how the Bank's performance is monitored, see the Bank's *SOI 2012–2015*, pp. 33–35.

The Minister

The Minister of Finance has responsibility for: agreeing the monetary policy target with the Governor; approving any decision to place a failing bank into statutory management or to give directions to a registered bank; and seeking Cabinet approval for proposed regulations made under the Acts administered by the 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. A Memorandum of Understanding between the Minister and the Governor, dated 13 May 2013, requires the Bank to consult with the Minister and the Treasury before implementing macro-prudential tools.

Board of Directors

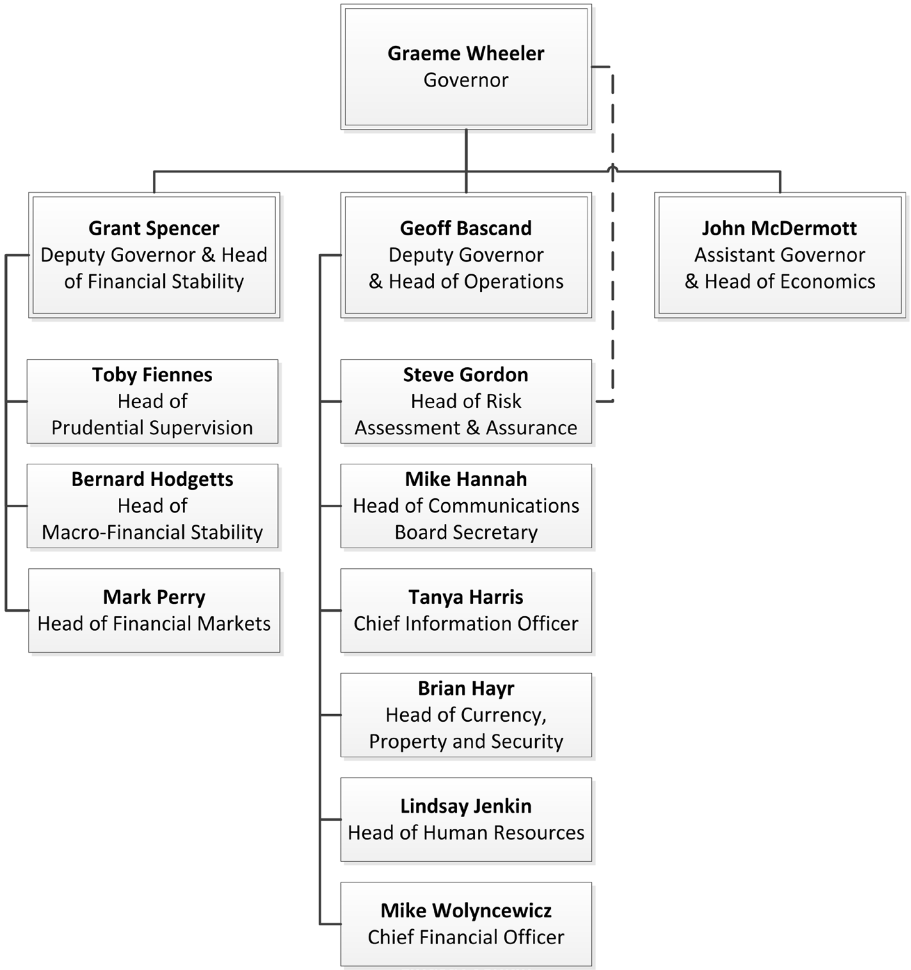
The Reserve Bank has a Board of Directors whose primary function is to keep under constant review the performance of the Bank and the Governor in carrying out their statutory functions. The Board meets at least nine times a year, with three of the meetings often taking place outside Wellington. The Board receives briefings on the Bank's activities, policies, decisions, performance indicators, financial and other risks, and about the performance of the Bank's statutory functions and the exercise of its powers. At these meetings, the Board may also provide advice to the Governor on the Bank's performance of its functions and the exercise of its powers.

Each year, the Board prepares a report setting out its 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*. Through its Audit Committee, the Board reviews the Bank's financial statements and internal and external audit.

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

At the time of writing, the Board has seven non-executive directors, and the Governor is an executive member of the Board. The current Board members are Dr Rod Carr (Chair); Mr Keith Taylor (Deputy Chair, and Chair of the Board's Audit Committee); Ms Bridget Coates; Professor Neil Quigley; Mr Jonathan Ross; Ms Kerrin Vautier CMG; Ms Tania Simpson; and Mr Graeme Wheeler (Governor). Board members are appointed for five-year terms and are eligible for reappointment.

Organisational structure



Strategic direction

Vision and values

The Reserve Bank's vision is to promote a sound and dynamic monetary and financial system. It seeks to achieve this vision by being a high-performing small central bank, with values of:

Integrity – Being professional and exercising sound judgement.
Innovation – Actively improving what we do.
Inclusion – Working together for a more effective Bank.

The Bank aims to develop and implement highly effective and efficient monetary, regulatory, and financial policies that are well suited for the New Zealand economy and financial system. It endeavours to ensure that the Bank's objectives and priorities are sound, clearly communicated, and understood; its business operations are well managed; and it invests wisely in the recruitment, training, development and retention of its staff. The Bank also invests heavily in reviewing and testing its policy frameworks and policy settings in light of domestic and international experience, and ensures that its independence is balanced by appropriate public disclosure and accountability.

Outcomes

The Bank contributes to the Government's goal of improving New Zealand's economic performance by targeting three statutory requirements designed to foster confidence and stability in New Zealand's financial system, by:

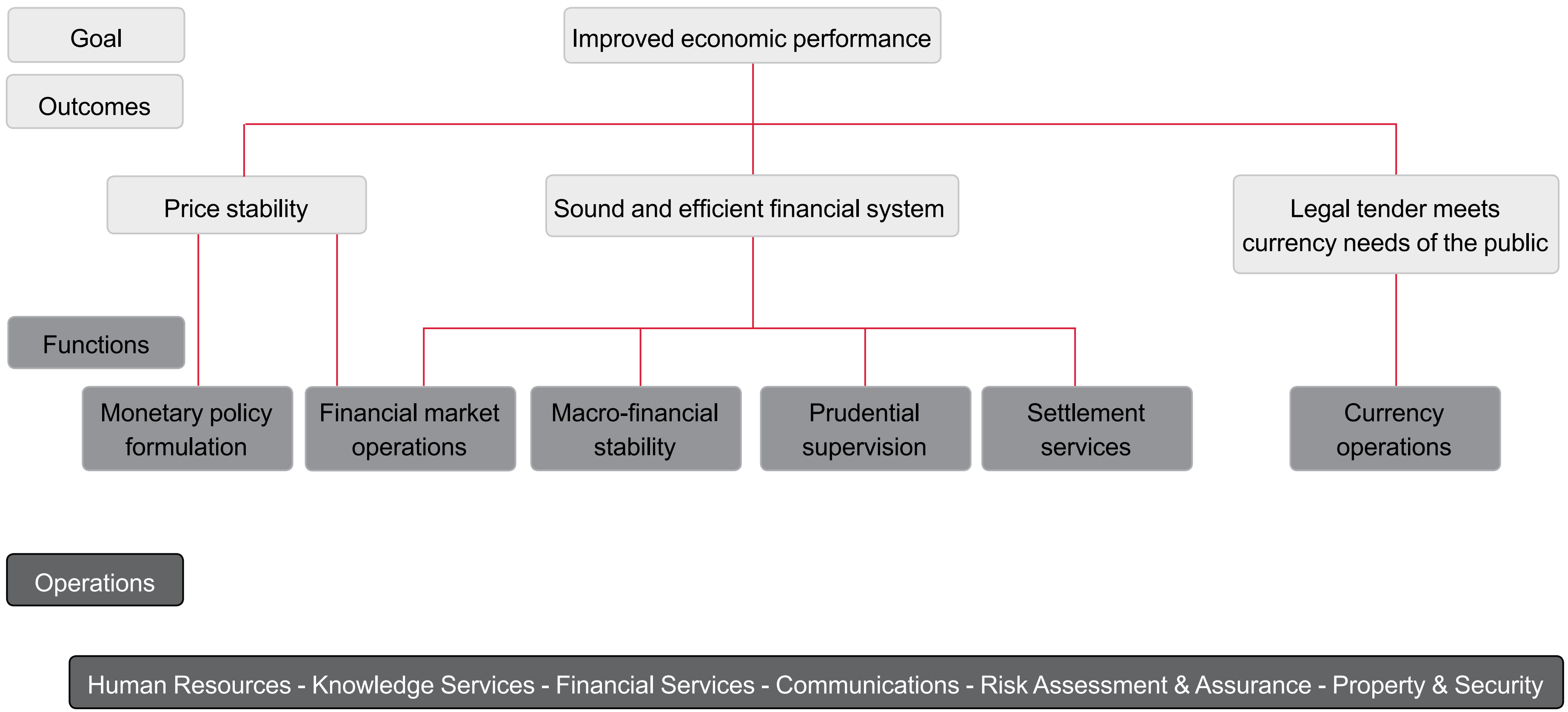
- maintaining stability in the general level of prices;
- maintaining a sound and efficient financial system; and
- providing legal tender to meet the currency needs of the public.

To achieve these outcomes, the Bank performs functions covering:

- monetary policy formulation;
- financial market operations;
- macro-financial stability;
- prudential supervision;
- settlement services; and
- currency operations.

The links between these functions and through the outcomes targeted, and the measures used to evaluate performance, are shown in the following tables.

The Reserve Bank – outcomes, functions and operations



Goal, organisation outcomes, functions, functional outcomes and success measures

Improved economic performance

Price stability maintained

	Monetary policy formulation	Financial markets
Function	Monetary policy formulation	Financial markets
Functional outcomes	Stability in the general level of prices	• Adequate banking system liquidity • Short-term interest rates consistent with monetary policy • Confidence in the efficient functioning of New Zealand financial markets • Foreign reserves available for efficient foreign exchange intervention and crisis management.
Success measures	• Reserve Bank forecasts of annual CPI inflation should be comfortably within the target range in the second half of the forecast horizon, and near the 2 percent target midpoint. • Measures of underlying inflation should generally remain within the target range. • Unnecessary instability in output, interest rates and the exchange rate should be avoided. • *Monetary Policy Statements* are informative and accurately assess the Bank's performance in meeting the objectives of the Policy Targets Agreement (PTA).	• Short-term wholesale interest rates are maintained at levels close to the OCR. • No evidence of payment disruptions due to a shortage of settlement cash in the system, e.g., persistent accessing of the Overnight Reverse Repo Facility. • Over the medium term, domestic market operations generate a positive return. • Foreign reserves are maintained at target levels, with liquidity and credit standards met throughout. • The Foreign Reserves Management portfolio yields a net return on assets that meets or exceeds the benchmark portfolio. • The foreign exchange open position is managed such that: (a) the bulk of active foreign exchange purchases (sales) are undertaken around peaks (troughs) in the exchange rate cycle; and (b) the net return on the non-core open foreign exchange position is positive over the cycle.

Improved economic performance

Sound and efficient financial system maintained

Function	Macro-financial stability	Prudential supervision
Functional outcomes	• A sound and efficient financial system that supports the functioning of the economy. **Macro-financial stability** • Financial stability, promoted by: - increased resilience of the domestic financial system and countering instability in the domestic financial system arising from credit, asset price or liquidity conditions; and - dampening of excessive growth in credit and asset prices.	• International and local confidence in New Zealand's financial system.
Success measures	• Significant risks to domestic financial system stability are identified and monitored. • Appropriate instruments to counter risks to financial stability are deployed in a timely and effective manner, and any potential impacts on monetary policy are understood. • An assessment of the soundness and efficiency of the financial system is published twice yearly in the *Financial Stability Report (FSR)*, including the reasons for, and the impact of, any use by the Bank of macro-prudential policy instruments. • Information on the risk assessment framework, including the macro-prudential indicators that are used to guide policy settings, is published in a manner that assists the assessment of financial stability. • Statistics are collected to enable an appraisal of the soundness and efficiency of the financial system, and are published in accordance with the principles and protocols of New Zealand's Official Statistics System.	• The bank, non-bank deposit taker (NBDT) and insurance regulatory regimes, and in particular the regulatory changes implemented during the year, promote the soundness and efficiency of the financial system in a cost-effective manner, as demonstrated by sound regulatory impact analysis. • The Reserve Bank's prudential oversight of banks, NBDTs, insurance companies and payment systems identifies emerging financial stresses in a timely manner; and the Bank is prepared, where necessary, to effectively resolve institutional failures in conjunction with Government. • The Bank demonstrates a consultative and transparent approach to its policy development, supported by robust analysis that is understood by regulated institutions and stakeholders. • In its decisions on whether to grant licences to new applicants, the Bank takes a consistent approach within the legislative framework, without successful challenges. • The Bank's AML/CFT supervisory activities demonstrate an appropriate risk-based approach to supervision of reporting entities within the Bank's sector.

Improved economic performance

Sound and efficient financial system maintained

Function: Settlement services

Functional outcomes:

- An efficient, reliable and secure payments system that supports the smooth functioning of the economy.

Success measures:

- Availability of ESAS/NZClear during core hours is at least 99.90 percent[1], as measured over a year.
- Customer satisfaction with operations and with system development is demonstrated through an annual customer survey in which an approval level of 90 percent or more is achieved.
- All risks are well managed, as demonstrated by external audits for ESAS and NZClear.
- International standards for payment and settlement systems (CPSS and IOSCO) are complied with, subject to variations for local New Zealand conditions.

Currency operations

Function: Currency operations

Functional outcomes:

- Legal tender that meets the currency needs of the public.

Success measures:

- All orders for notes and coins from banks that meet the Reserve Bank's guidelines are supplied within agreed times.
- Notes and coins in general circulation are of a good quality as indicated by surveys of the condition of currency in circulation.
- The number of counterfeit notes in circulation should be fewer than 10 per million notes in circulation.
- Stakeholders are well informed and prepared for the introduction of Series 7 banknotes.
- Currency is available to the public to meet planned and unplanned demand.

1 This is the target availability specified in the ESAS terms and conditions.

Reserve Bank strategic priorities for 2015-18

I. Continuing to strengthen the Bank's performance

1. Leading change and business improvement

The Bank is changing its business models and internal allocation of resources to achieve its goals. A change management programme has been established with a strong focus on change leadership skills and manager and staff support, in order to achieve successful business transformation and maintain a motivated, highly performing workforce.

2. Continuing to improve performance culture

Managers will use the Bank's competency framework, and performance and development process, to lead and develop staff and connect staff objectives and team visions to the Bank's aspirational goal of being the Best Small Central Bank. Remuneration and performance links will continue to be strengthened and the annual Staff Engagement Survey will help shape the Bank's approach to being a high-performing workplace. The Bank will develop a consistent framework to measure performance benchmarks for business plans, so that senior management can improve the way they monitor and manage resources.

3. Engaging and communicating with stakeholders

The Bank will extend its engagement, accessibility, relevance and dialogue with stakeholders to enhance mutual understanding. Its approach will be guided by feedback, especially its external stakeholder engagement surveys. The Bank will communicate broadly on its policies, its reasoning, and the impact of its activities, through its proactive on- and off-the-record speech programme, briefings, media engagements, and online channels. The production and release of a new series of banknotes will be supported by clear, effective and proactive communication.

II. Developing a more integrated approach to the Bank's policies

4. Exploring macro-prudential policy options to manage the financial stability implications of housing cycles

The Bank will explore macro-prudential policy options for managing the financial stability implications of housing market cycles. It will continue to investigate the interactions between monetary policy, prudential policy and the objectives of price and financial stability. The Macro-Financial department will lead work through the Macro-Financial Committee and Governing Committee, with support from the Economics and Prudential Supervision departments.

5. Updating the prudential policy and supervision frameworks.

The Bank will implement changes arising from the regulatory stocktake and will review other key policy settings. These will include outsourcing requirements on banks, and capital and liquidity settings in light of the revised Basel standards.

6. Developing a comprehensive stress-testing framework for the New Zealand banking system

The Macro-Financial and Prudential Supervision departments are developing a comprehensive stress-testing framework to gauge the resilience of the banking system to adverse shocks. The Reserve Bank will work with the banks to identify and implement improvements to the banks' technical stress-testing frameworks and processes. In addition, the Bank will ensure that stress tests become a centerpiece of banks' internal risk management, and are regularly scrutinised by senior management and boards.

III. Improving infrastructure and reducing enterprise risk

7. Implementing the payments system review

The Bank will select a replacement for the ESAS technology system and begin implementation. The Bank will decide whether to continue to provide securities settlement (NZ Clear) services. If the decision is made to exit the business, then the Bank will ensure a smooth transition to an alternative provider, and will reshape the way it provides remaining services. If the Bank decides to continue to provide securities settlement services, it will begin selection and implementation of a replacement securities system.

8. Finalising and implementing the roadmap and architecture for the Bank's financial management

Treasury systems support two key policy functions: foreign reserves management (including currency intervention), and the implementation of monetary policy (liquidity management). Systems requirements have evolved significantly since the Global Financial Crisis, and the Bank needs to update key functionality. The Bank will finalise and implement an agreed Treasury Systems (Roadmap) Strategy to provide market-standard trade valuation, position and collateral management, alongside enhanced risk and performance reporting, to aid effective decision-making, and reduce key operational and market risks.

9. Delivering New Zealand's new banknotes

The release of Series 7 banknotes (Brighter Money) is scheduled for the end of 2015 and in 2016. A successful release will require continued extensive interaction with the Canadian Banknote Company, and increased engagement with the public, the financial services industry, and other key stakeholders.

10. Developing a plan for future custody and distribution arrangements for currency

The Bank will review its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future. The review will assess the current operating model, and identify options for the custody and distribution of currency. The Bank will consult and collaborate with key stakeholders during 2015-16 to ensure that the review's recommendations are understood and supported.

Functions – initiatives

Monetary policy formulation

Objective

To achieve and maintain stability in the general level of prices.

The current PTA between the Minister of Finance and the Governor requires that the Bank “keep future CPI inflation outcomes between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint”. 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

The Bank undertakes research and analysis of macro-economic conditions to enable it to:

- Set the Official Cash Rate (OCR) eight times a year, or as required, with the aim of keeping inflation near the mid-point of the target band of 1 to 3 percent.
- Publish a quarterly *MPS* each quarter at the same time as four of the OCR decisions. The *MPS*s set out the Bank’s views on the economy and the balance of inflationary pressures, and the basis for the OCR decision.
- Announce the other four OCR decisions, each about six weeks after an *MPS*.
- Where appropriate and feasible, intervene in the foreign exchange market to influence the level of the exchange rate, consistent with the objectives of the PTA.

Environment and policy issues

New Zealand’s economy has expanded at an average 2.3 percent per year since the beginning of 2010. This expansion has been underpinned by high export commodity prices in 2013–2014, continued growth in construction sector activity, large net immigration flows, and stimulatory interest rates. During the same period, inflation has remained in the lower half of the target band of 1–3 percent. With recent petrol price falls, inflation is expected to remain below the target band throughout 2015. Over recent years inflation expectations had remained stubbornly high despite the low inflation environment. However, expectations measures have gradually fallen to be more consistent with the 2 percent inflation target.

The fall in petrol prices will continue to boost households' real income, and the terms of trade. Consequently, economic activity will strengthen further. At the same time, the fall in petrol prices will have direct transitory effects on inflation in the near term.

Monetary policy cannot offset these direct and transitory effects on inflation. Trying to offset such short-term influences on inflation with monetary policy would be inconsistent with the medium-term focus of the PTA. However, the projected increase in economic activity is expected to increase inflation to around the target midpoint as resource use intensifies.

There are two key policy issues. First is that monetary policy settings need to sufficiently stimulate demand so that inflation moves back to the target without causing a boom-bust cycle. Second is that the Bank communicates with the public regularly that the actual annual inflation rate may vary due to temporary factors, as stated in Clause 3(a) of the PTA, and the Bank's focus is on the future medium-term inflation.

Within this environment, key developments the Bank will be monitoring are:

- the recent oil supply shock, and how oil prices will move over the medium term;
- whether inflation expectations could fall further as a result of the recent weak inflation and become embedded in price- and wage-setting behaviour;
- normalisation of US monetary policy and its effects on global interest rates, the New Zealand dollar exchange rate, and global commodity prices;
- the demand and supply imbalances in the Auckland housing market;
- global dairy prices and their effects on farm incomes and the wider economy; and
- developments in the Chinese and Australian economies, particularly the latter as they have direct effects on the New Zealand economy through trade, the exchange rate and labour movements.

Initiatives and strategies

The Bank's Economics Department has four key work streams for 2015.

1. *Macroprudential and monetary policy interface*: undertake analysis and develop frameworks to better understand the interaction between macroprudential and monetary policy.

2. *Support the formulation of monetary policy*: understand how events such as a construction and housing boom, fiscal consolidation, and international developments will shape the next business cycle.

3. *Monetary policy research*: undertake analysis to improve the Bank's understanding of the New Zealand economy and key monetary policy issues.

4. *Exchange rate analysis*: reviewing the Bank's frameworks for assessing the long-term sustainable level of the exchange rate and analysis of the cyclical impact of the exchange rate on New Zealand economic activity and inflation.

Success measures

See page 9.

Financial market operations

Objectives

To support the implementation of monetary policy; to assist in the efficient functioning of New Zealand's financial system; to manage official foreign reserves; to implement the Bank's foreign exchange market intervention policy; to manage the Crown's financial liquidity; and to maintain crisis intervention capability.

Scope of operations

The Bank:

- provides advice on financial market issues and developments for the formulation of monetary policy;
- implements monetary policy through market operations to ensure that market interest rates are consistent with the OCR;
- manages official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes;
- manages liquidity in the banking system;
- manages the Crown Settlement Account; and

- acts as lender of last resort to the financial system if necessary, as well as assisting in the resolution of any financial market or banking crisis.

Environment and policy issues

While volatility in global financial markets has increased significantly over the past year, it is still low by historical levels. Divergence in monetary policy stances between the major economies has led to large exchange rate moves as well as substantial moves in underlying interest rates. Returns in asset markets, particularly equity, bond and property, have increased substantially across most regions, raising concerns about emerging asset bubbles. This has also led to benign funding conditions for New Zealand banks and institutions in both domestic and offshore markets.

Historically low interest rates are expected to gradually increase in some advanced economies (in the US and UK) albeit with significant uncertainty over timing, while the rest of the developed economies are generally expected to have lower or static rates.

Financial regulators are still pushing ahead with wide-ranging financial market reforms emanating from the G20 Financial Stability Board's new regulatory framework to make the financial system more resilient. New Zealand banks are increasingly required to comply with these global rules, in addition to the Bank's domestic regulatory framework.

The key policy issues facing the Bank's Financial Markets function are:

- Providing robust liquidity facilities for New Zealand banks, in the context of a global regulatory environment that requires full collateralisation and/or central clearing and trade reporting of over-the-counter (OTC) derivatives.

- Improving returns on the Bank's foreign reserves, where the yields from core reserve currency investments are at historical lows (or even negative in many European countries). The value and increasing volatility of the New Zealand dollar is influenced by bouts of international risk-seeking/ risk aversion and aggressive yield-seeking behaviour.

Initiatives and strategies

- Supporting two key policy functions, foreign reserves management (including currency intervention) and the implementation of monetary policy (liquidity management), treasury systems requirements have evolved significantly since the GFC, and the Bank is required to update key functionality gaps.

- Finalising and implementing an agreed Treasury Systems (Roadmap) Strategy to provide market standard trade valuation, position and collateral management, alongside enhanced risk and performance reporting, will aid effective decision making and reduce key operational and market risks.

- Performance improvements in Financial Markets Research will be achieved through an expanded and refocused market intelligence function (with increased emphasis on offshore NZD activity), adding additional research capability in international markets, and increasing connectivity and policy collaboration between wider Bank policy teams.

- Develop and implement further financial tools and instruments to improve management of the financial risks that the Bank is exposed to, with specific consideration of whether to set up a stand-alone collateral management desk.

Success measures

See page 9.

Macro-financial stability

Objectives

Promote the financial stability of the domestic financial system by:

- identifying and assessing emerging system risks in a timely manner;
- deploying macro-prudential instruments, subject to the Memorandum of Understanding with the Minister of Finance, to help reduce system risks, including those arising from extremes in credit cycles, asset prices and liquidity conditions;
- evaluating the effectiveness of macro-prudential policy instruments and their impact on financial system efficiency;
- analysing and reporting on the soundness and efficiency of the financial system; and
- collecting and publishing high quality, relevant and timely statistics that enable informed decision making.

Scope of operations

The Bank:

- identifies, monitors and reports on the risks facing the financial system, including those arising from credit cycles, asset prices and liquidity conditions;

- publishes an *FSR* twice a year, and other reports, assessing the soundness and efficiency of the financial system;
- implements macro-prudential policy, considers its interactions with monetary policy, and assesses and reports on the effectiveness of the instruments deployed; and
- produces and publishes high quality, relevant and timely statistics on the financial system to support the Bank's policy functions.

Environment and policy issues

Macro-prudential policy, in the form of loan-to-value ratio restrictions (LVRs), has been effective in containing financial system stability risks in the housing sector. However, house prices are continuing to rise rapidly in Auckland as a result of supply shortages and growing demand due to strong population growth, low mortgage interest rates, and increased investor participation. These conditions, which could pose a risk for financial stability, will continue to present challenges for macro-prudential policy and its interaction with monetary policy.

The Bank has been working with the banks to develop a comprehensive stress-testing framework to gauge the resilience of the banking system to a range of adverse shocks. The intention is to identify and implement improvements to technical stress-testing frameworks and ensure stress tests become a centerpiece of the banks' internal risk management.

In recent years, the Bank has broadened and enhanced its collection of financial data to reflect its wider prudential supervision mandate and ensure coverage of the full range of risks to financial stability. The Bank is well advanced in the implementation of a data collection for the insurance sector and is re-developing its banking sector statistics. Existing collections are also being reviewed against the needs of users and the costs to reporting entities.

The key policy issues for macro-financial stability are:

- understanding the risks and threats facing the financial system and assessing the resilience of the system in the light of those risks;
- keeping abreast of developments in the housing market, monitoring the effect of LVRs and identifying any further policy measures that may be required to promote financial stability;
- understanding the interface between monetary and macro-prudential policies so that each policy coordinates with the other while focusing on its primary objective; and
- expanding and reshaping financial system data collections to meet current and future prudential policy and statistical needs.

Initiatives and strategies

To address these issues, the Bank will:

- explore additional macro-prudential policy options for managing the financial stability implications of housing market cycles;
- work with the banks to ensure that stress-testing models and processes are robust and a core centrepiece of the banks' internal risk management;

- continue to assess the linkages between monetary and macro-prudential policy to ensure that complementary or opposing effects between the two policy areas are properly taken into account;
- continue to enhance the reporting of financial system stability and efficiency, and policy assessments, contained in the *FSR* and other reports;
- review its current suite of financial statistics in consultation with stakeholders to ensure they remain fit for purpose; and
- complete the implementation of a new data collection for the insurance sector, a new balance sheet data collection for the banking sector, and a new New Zealand securities database.

Success measures

See page 10.

Prudential supervision

Objectives

To provide prudential supervision so as to promote a sound and efficient financial system; to limit damage to the system that could arise from institutional failure or other financial system distress; and to contribute to public confidence in the financial system.

Scope of operations

The Bank:

- registers and supervises banks, setting and applying appropriate prudential criteria;
- licenses and supervises insurers, setting and applying appropriate prudential criteria;
- licenses and monitors NBDTs, setting and applying appropriate prudential criteria;
- sets and oversees criteria for designation of payment and settlement systems;
- implements the prudential regulatory framework for NBDTs and insurers;
- supervises reporting entities within the Bank's sector under the AML/CFT legislation; and

- applies a framework for undertaking enforcement action in the event of identified non-compliance.

Environment and policy issues

New Zealand's financial system is presently sound and well placed to support growth in the economy. New Zealand's banks are well capitalised and have adjusted to new, tougher Basel III prudential requirements.

New Zealand's financial system relies heavily on the four major Australian banking groups, and we maintain a close relationship with the Australian financial regulatory authorities.

The NBDT Act, which introduced licensing and further prudential requirements for NBDTs, has been implemented. Insurers are now fully subject to the Bank's regulatory and supervisory regime. Reporting entities within the bank, insurance and NBDT sector, supervised by the Bank, must now formally comply with statutory AML/CFT obligations.

The key policy issues facing the Bank's Prudential Supervision department are:

- assessing the scope for better streamlining and improving the prudential regulatory framework for banks and NBDTs, as identified in the regulatory stocktake, a current initiative to review our stockpile of prudential regulation with industry collaboration;
- maintaining the Bank's supervisory activity to improve risk analysis within and across the banking sector;
- moving towards regular system-wide stress tests, and promoting international best practice within the stress-testing programmes of New Zealand banks, a joint initiative with the Macro-Financial department;
- ensuring capital and liquidity requirements for registered banks remain appropriate;
- strengthening the Bank's capacity to respond to financial crises, including targeted refinements to crisis policies and processes;
- develop and, as necessary, consult on proposals for a modified framework for the oversight of systemically important financial market infrastructures; and
- continuing to coordinate with other AML/CFT supervisors to ensure consistency in approach and guidance, and preparedness for mutual evaluation of the Financial Action Taskforce (FATF), the intergovernmental body developing and promoting policies to combat money laundering and terrorist financing.

Initiatives and strategies

To address these issues, the Bank will:

- publish a stress-testing guide with a view to improving the stress-testing practices of New Zealand banks, and continue to develop a comprehensive stress-testing framework for New Zealand banks, a joint initiative with the Macro-Financial department;
- complete the regulatory stocktake by consulting on and implementing initial enhancements to improve the efficiency, clarity and targeting of

prudential standards for banks and NBDTs, and identifying separate areas for further work;

- maintain supervisory engagement with executives and directors of regulated banks;
- complete a review of, and consult on, the outsourcing arrangements that currently apply to 'large banks';
- work closely with banks to ensure timely compliance with new outsourcing requirements;
- review the Bank's existing liquidity policy against finalised international liquidity standards;
- review the Bank's broad suite of capital requirements;
- consult on a range of amendments to the statutory management powers in the Reserve Bank of New Zealand Act 1989 to clarify aspects of the legislative framework for the Open Bank Resolution policy;
- promote legislative changes recommended by the review of the prudential regime for NBDTs that was completed in 2013;
- finalise policy to strengthen the Bank's oversight of financial market infrastructures; and
- implement the business-as-usual supervisory framework for licensed insurers.

Success measures

See page 10.

Settlement services

Objective

To ensure that payments system infrastructure services support the smooth functioning of the economy, are provided efficiently and reliably, and meet international standards.

Scope of operations

The Bank:

- operates the Exchange Settlement Account System (ESAS) and the New Zealand central securities depository system (NZClear); and

- operates the infrastructure required for settlement of interbank payments (Settlement Before Interchange), and that required for foreign exchange transactions through CLS Bank.

Environment and issues

The Bank operates payments systems that are critical to the operation of the economy. Maintaining these systems involves responding to developments in international settlement norms, changes in the settlements landscape in New Zealand and rapid technological change.

Two key issues face the Bank's Settlement Services:

- The need to determine the potential future provision of services and investment in systems.
- The need to plan to upgrade payment systems. Technology is changing quickly and existing systems are complex and need to be upgraded in order to support developments in the payments industry. A project has been initiated to ensure systems are developed to meet evolving requirements.

Initiatives and strategies

To address these issues, the Bank will progress the Payment Systems Replacement project.

This involves procurement and implementation of software to replace the current system used to provide exchange settlement account services, and the potential for securities settlement services to be provided by parties in the private sector, thus allowing the Bank to stop providing the NZClear service.

Success measures

See page 11.

Currency operations

Objective

To meet the currency needs of the public by ensuring, as the sole issuer of currency, the supply and integrity of banknotes and coins.

Scope of operations

The Bank:

- procures, stores, processes and issues banknotes and coins to the banking system;
- monitors the quality, and verifies the authenticity, of currency in circulation; and
- issues legal tender collectors' currency through an outsourcing arrangement.

Environment and issues

Demand for notes and coins continues to grow each year. Cash remains an important means of making payments in New Zealand. Given the heavy use of cash as a medium of exchange, the issues facing Currency Operations are the need to:

- avert counterfeiting risks, given the current polymer banknote series is 15 years old and the rapid innovation in copying and printing;
- manage a significant change programme as the Bank prepares to launch Series 7 banknotes and readies its existing facilities and external stakeholders;
- ensure that the security, safety and operational efficiency of the cash operations are not compromised during a period of significant activity (2015-2018); and
- ensure appropriate domestic long-term secure premises for the Bank's currency holdings.

Initiatives and strategies

To address these issues, the Bank will:

- continue to plan for the release and distribution of the new banknote series;
- communicate and engage with stakeholders on the release of the Series 7 banknotes;
- undertake a review of its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future; and
- consult and collaborate with key stakeholders during 2015/16 to ensure that the review's recommendations are understood and supported.

Success measures

See page 11.

Operations – enabling the Bank

People and culture

The Bank has initiated a period of transformation in response to a tighter five-year funding envelope. This change will be underpinned by the principles of continuous improvement, collaboration, leadership and engagement, and will be aligned with the Bank's vision of being a high-performing small central bank. The success of the change programme will be observed through business results, staff engagement and financial performance. The Bank will engage with staff on ways they can contribute to positive change at the Bank.

The Bank's vision requires excellence in its people, processes and resources. The Bank is committed to continuing to improve and measure its performance culture.

The quality of management is a critical factor in strengthening the Bank's performance. The Bank will continue building leadership and management competencies through specific development programmes for managers and emerging leaders; and staff will have structured training and development opportunities.

A high level of staff engagement is a key indicator of a high-performing organisation. An annual engagement survey measures the level of staff engagement with the Bank. The Bank will continue to focus on keeping staff well connected, providing growth opportunities, and recognising performance and contribution. The link between performance and reward will continue to be strengthened to encourage appropriate competencies and behaviours.

Communications

The Bank will continue its broader communications programme and seek to extend its engagement, guided by the insights gained in the External Stakeholder Engagement Survey. The Bank will seek to increase its accessibility, relevance and dialogue with stakeholders, to enhance mutual understanding.

The Bank will continue to communicate the reasoning for and impact of its activities through its proactive on- and off-the-record speech programme, briefings for diverse stakeholders, media engagements, online channels, and the Bank's Museum & Education Centre.

The production and release of a new series of banknotes will be supported by clear, effective and proactive communication.

Knowledge services

The Bank requires technology that provides a high level of uninterrupted service, functionality and security, as well as easy access to a broad range of relevant information sources.

Key initiatives for the department this year will be to:

- finalise the Treasury systems roadmap and lead implementation;
- support the review of the payment systems;
- continue developing the Bank's IT security systems to maintain industry best practice and manage the increasing threat from a range of sources;

- refresh the operating system and other software on the Bank's desktop environment to maintain an innovative and flexible user environment; and
- provide project management support for the introduction of the new Series 7 banknotes.

Internal financial services

High-quality financial systems and processes are needed to manage the Bank's complex balance sheet. These systems support workflows, reports, and processes for operations in financial markets and currency operations.

The Bank will develop a consistent framework to measure performance benchmarks for business plans so that senior management can improve the way they monitor and manage resources.

In 2014–2015, the Bank developed a roadmap for the design and architecture of its treasury systems. The Bank will:

- begin to implement the roadmap and architecture for the treasury systems environment; and
- upgrade its financial management information system.

Risk assessment and assurance

The Bank faces a wide range of risks, some general and others unique to central banks. Identifying, managing and monitoring these risks is key to maintaining a sound and dynamic monetary financial system. In addition, there continue to be developments in the global environment and within the Bank in terms of new initiatives and project activity. These introduce new risks that need to be effectively managed.

The Bank's approach to addressing enterprise risks is to ensure they are being identified and managed in a proactive, coordinated, prioritised and cost-effective manner. The Risk Assessment and Assurance department will focus strongly on financial and payment systems architecture, delivering New Zealand's new banknotes, and optimising the facilities management and logistics for currency.

The Internal Audit function will deliver assurance for control frameworks over the Bank's operations, through the completion of the annual audit plan. The legal function seeks to oversee the broad range of legal risks facing the Bank from both a prudential and operational perspective.

Property, security

The Bank will review its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future. The review will assess the current operating model and identify different approaches for the custody and distribution of currency. The Bank will consult and collaborate with key stakeholders during 2015–2016 to ensure that the review's recommendations are understood and supported.

For security reasons, the Bank operates and maintains modern, reliable security access and control systems. For efficiency and environmental reasons, the Bank will continue to seek to maintain and extend energy-saving and recycling programmes.

Financial management

Financial structure

Balance sheet overview and funding of the Bank's operations

The Bank 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.

The nature and extent of the Bank's principal activities that affect its balance sheet are described in the *Annual Report 2013–2014* (pages 62 to 63). Foreign reserves management, New Zealand dollar liquidity management, and currency operations materially affect the size and structure of the Bank's balance sheet.

Under the Reserve Bank Act, the Minister and the Governor are required to enter into a five-year funding agreement to specify the amount of the Bank's income that may be used to meet operating expenses in each financial year. The Bank reports its expenditure against the Funding Agreement in its *Annual Report*.

The 2010–2015 Funding Agreement ends on 30 June 2015. The Governor and the Minister of Finance have signed a new funding Agreement for the next five years beginning 1 July 2015. At the time of writing, the new Funding Agreement is still to be ratified by Parliament.

Annual distributions paid by the Bank

The Bank's annual dividend is determined using the following principles, which are a combination of what is required under the Reserve Bank Act and this *Statement of Intent*:

Statement of Dividend Principles

The Bank should maintain sufficient equity for the financial risks associated with 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.

The amount of the dividend to be paid to the Crown is determined by the Minister of Finance each August on the recommendation of the Bank, having regard to the views of the Board of Directors and any other relevant matters.

Accounting standards

From 1 July 2014, the Bank stopped applying New Zealand International Financial Reporting Standards (NZ IFRS) and adopted Public Benefit Entity International Public Sector Accounting Standards (PBE IPSAS). This change was mandated by the New Zealand Accounting Standards Board of the External Reporting Board.

The change in financial reporting framework will not have a significant impact on the Bank's financial reporting, although IPSAS and IFRS could diverge over time.

Drivers of the Bank's financial performance and financial position

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

- *The value of currency in circulation.* Currency in circulation is a non-interest-bearing liability for the Bank. Trading banks are charged for the face value of currency issued to them and the Bank earns interest, known as seigniorage, on investment of these amounts paid by trading banks. At 30 April 2015, currency in circulation was $5.3 billion.

- *The size of the Bank's open foreign exchange position and related changes in foreign exchange rates.* The Bank has a policy of holding some of its foreign currency reserves on an unhedged basis. This allows it to more effectively respond to a foreign exchange crisis, and to smooth more extreme exchange rate movements. The Bank has a benchmark holding of SDR 1.0 billion unhedged foreign currency reserves, with the ability to hold more or less than the benchmark over the exchange rate cycle.

Holding unhedged foreign reserves means that the Bank's net equity will fluctuate with changes in the exchange rate: foreign exchange 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.

At 30 April 2015, the Bank held an open foreign exchange position of SDR1.7 billion (NZ$3.2 billion). At 30 June 2014, the open foreign exchange position was SDR1.4 billion (NZ$2.5 billion).

- *Interest rates earned on the Bank's investment in government securities and other securities.* 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, and realised gains and losses on disposal of New Zealand government securities are booked to 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. Foreign reserves are valued at market value. Changes to foreign exchange rates and international interest rates will affect the market value of those reserves, and valuation changes are booked to the Bank's Income Statement.

At 30 April 2015, the Bank had a foreign exchange intervention capacity of SDR5.1 billion (NZ$9.3 billion).

- *New Zealand government deposits held at the Bank.* The Bank provides a settlement account facility to the Crown. The size of New Zealand government deposits held in the Crown Settlement Account (CSA) is a big driver of the Bank's balance sheet. Larger CSA deposits are swapped into foreign currency and invested by the Bank offshore. But net earnings are not materially affected by this activity.

At 30 April 2015, the Bank held New Zealand government deposits of NZ$3.1 billion.

- *Operating expenditure incurred by the Bank*. The five-year Funding Agreement specifies the amount of the Bank's income that may be used to meet operating expenses in each financial year.

- *The level of equity available for investment and the dividend paid by the Bank.* The Bank requires equity to absorb any losses that may arise from carrying out its functions, and equity is reviewed annually to determine the annual dividend. The dividend for the 2013–2014 year was $20 million, and reported equity at 30 April 2015 was $2.9 billion.

Principal financial risk management considerations

With more than $20 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 its holdings of foreign currency reserves. The risks include:

- credit risks and market risks associated with day-to-day dealings with financial institutions, while 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 the transactions and processing areas of the Bank.

More detailed information on the Bank's approach to managing these risks is outlined on pages 75-86 in the *Annual Report 2013–2014*.

Financial projections

The following table outlines the Bank's budgeted income and expenditure for 2015–2016. The key assumptions underlying the budget for the year ended 30 June 2016 are that:

- the Bank's current functions will continue;

- there are no material changes to the structure of the Bank's balance sheet between 31 January 2015 and 30 June 2016;

- projected interest and exchange rates are those advised by the Treasury for the purposes of preparing the Government's Budget for 2015–2016;

- there will be no change in the credit worthiness of the Bank's counterparties; and

- there will be no material changes to the Bank's liquidity management operations.

Projected financial performance

Projected financial performance 2015–2016

For the year ending 30 June	Budget 2015–2016 $m
Operating income:	
Net investment income	231.0
Other income	11.5
Total operating income	**242.5**
Operating expenses	
Bank operations:	
Personnel	33.9
Asset management	7.5
Professional and contract services	7.1
Other	12.0
Total operating expenses bank operations	**60.5**
Direct currency issue expenses:	
Net currency issued	12.8
Delivery expenses	0.5
Series 7 banknote transition expenses	1.0
Total direct currency issue expenses	**14.3**
Operating surplus	**167.7**

The budget is based on the key assumptions outlined above. It is important to note that the Bank's assets and liabilities are sensitive to changes in interest rates and exchange rates, and that actual financial results could differ materially from those budgeted.

As at 31 January 2015, a 10 percent appreciation in the value of the New Zealand dollar would reduce the Bank's comprehensive income[2] by $300 million, and conversely a 10 percent depreciation in the value of the New Zealand dollar would add $366 million to comprehensive income. A 1 percent across-the-board increase in interest rates would reduce comprehensive income by about $197 million, and a 1 percent across-the-board reduction in interest rates would increase comprehensive income by about $215 million.

2 Comprehensive income includes earnings booked to the Bank's Income Statement and also changes booked directly to Equity. The majority of sensitivity to changes in foreign exchange rates is booked to the Income Statement, whereas the majority of interest rate sensitivity arises on the Bank's portfolio of New Zealand government securities and is booked directly to Equity. Refer to page 80 of the Bank's *Annual Report 2013–2014* for a detailed sensitivity analysis as at 30 June 2014.

Net expenditure[3] budget 2015-2016

For the year ending 30 June	Net expenditure Budget 2015–2016 $000s
Monetary policy formulation	10,071
Domestic market operations	5,404
Macro-financial stability	7,805
Prudential supervision	12,963
Foreign reserves management	6,236
Settlement services	33
Currency operations	20,807
Net operating expenditure	**63,319**

Budgeted net operating expenditure for 2015–2016 is $63.3 million. The budget includes provisions for the costs associated with significant changes in the critical systems and processes that are needed in order to achieve the Bank's strategic priorities. These priorities include delivering the Series 7 bank notes, optimising facilities management and logistics for currency, and establishing future investment requirements to support New Zealand's payments systems and the Bank's internal decision-making and accounting system for its financial assets and liabilities.

Funding Agreement

	Net expenditure Budget 2015–2016 $000s	Funding Agreement 2015–2016 $000s	Funding Agreement under-expenditure $000s
Net operating expenditure excluding direct net currency issue expenses	49,019	49,600	581
Direct net currency issue expenses[4]	14,300	14,400	100
Total net operating expenditure under Funding Agreement	**63,319**	**64,000**	**681**

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

4 Under the Funding Agreement, external demand-driven direct net currency issue expenses are shown separately from underlying core operating expenses to improve transparency of the Bank's underlying baseline operating expenses.