RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

ANNUAL REPORT
2011–2012

OUR VISION

WE PROMOTE A SOUND AND DYNAMIC MONETARY AND FINANCIAL SYSTEM.

We work towards our Vision by:

- Operating monetary policy to achieve and maintain price stability.
- Assisting the functioning of a sound and efficient financial system.
- Meeting the currency needs of the public.
- Overseeing and operating efficient payment systems.
- Providing effective support services to the Bank.

OUR VALUES

INTEGRITY

Being professional and exercising sound judgement.

INNOVATION

Actively improving what we do.

INCLUSION

Working together for a more effective Bank.

Reserve Bank of New Zealand *Annual Report* and Financial Statements for the financial year ended 30 June 2012, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2012.

ISSN 0110 7070

THE RESERVE BANK OF NEW ZEALAND

The Reserve Bank of New Zealand (the Bank) is the nation's central bank. It is wholly owned by the New Zealand government. Under the Reserve Bank of New Zealand Act 1989 (the Act), it has three main functions to enable it to contribute to New Zealand's prosperity and advancement:

1. MONETARY POLICY

The Bank has operational independence to manage monetary policy to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA). (See pages 24–25 for more detail on monetary policy activity in 2011–12.)

The Bank operates in the financial markets to support the implementation of monetary policy. (See pages 26–27.)

2. FINANCIAL STABILITY

The Act also directs the Bank to promote the "maintenance of a sound and efficient financial system" and to avoid "significant damage to the financial system that could result from the failure of a registered bank". To achieve these requirements, the Bank analyses macro-financial trends and the potential for macro-prudential tools to mitigate risks to the financial system. It also registers banks and operates a prudential supervision system designed to encourage banks, non-bank deposit takers (NBDTs) and insurance companies to manage their risks carefully. (See page 28 and pages 29–30.)

The Reserve Bank acts as banker to the banks, providing interbank settlement facilities and related payment services. (See pages 31–32.)

It advises the government on the operation of the financial system. The Bank manages foreign exchange reserves to enable intervention in the foreign exchange market, if required.

3. CURRENCY

The Reserve Bank issues New Zealand's currency. It controls the design and printing of the nation's currency, which it then issues to banks for their customers. The Bank also withdraws from circulation and destroys damaged or unusable currency. (See pages 30–31.)

These external functions are supported by six internal service departments. (See pages 33–35.)

Our internal organisation is illustrated in the chart on page 16. Details of the Reserve Bank Board of Directors are provided on pages 17. The role of the Board, and the governance and management of the Bank, are described on pages 18–20.

THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation fell from 5.3 percent for the year to June 2011 to 1.0 percent for the year to June 2012.
- The Bank left the Official Cash Rate (OCR) unchanged at 2.5 percent throughout the year. (The Bank held the OCR steady at 2.5 percent on 26 July 2012.)
- The Bank launched planning for the upgrade of New Zealand's banknotes.
- The Bank, the Financial Markets Authority (FMA) and the Department of Internal Affairs introduced a more stringent code for identity checks to prevent money laundering.
- A new Council of Financial Regulators, with the Bank and FMA as permanent members, was established to foster cooperation between financial sector regulators in New Zealand.
- Legislation was introduced to Parliament providing a legislative framework for covered bonds issued by New Zealand banks.
- The Bank initiated a framework for assessing potential financial imbalances in the economy and the potential use of macro-prudential tools, outlining four macro-prudential tools it could consider using if future credit conditions were to warrant doing so.
- The Bank consulted publicly on changes to capital requirements for registered banks as part of proposed changes under Basel III, which include arrangements for a macro-prudential counter-cyclical capital buffer.
- The Bank confirmed an increase in the core funding ratio for banks from 70 percent to 75 percent from 1 January 2013.
- The Bank received generally acceptable Implementation Plans from registered banks required to pre-position for the Open Bank Resolution policy.
- The Bank made an application for NZClear to be a designated settlement system.
- All insurers who required a licence were licensed by March 2012. Five solvency standards have been issued for different insurance sectors. The Bank has also issued further guide-lines for licensed insurers.
- The Non-bank Deposit Takers Bill passed through Select Committee and is expected to pass into law in 2012–13.
- The Bank implemented 'Settlement Before Interchange' to allow banks to settle the value of retail transactions at regular intervals each day.
- Governor Alan Bollard announced he would not seek a third term. The Finance Minister announced his intention to appoint Graeme Wheeler Governor and Chief Executive, effective from 26 September 2012, pending finalisation of a Policy Targets Agreement.
- The Bank spent a net $47.0 million on activities covered by its Funding Agreement, and a dividend of $160 million was paid to the Crown.

GOVERNOR'S STATEMENT

We look back on 2011–12 with a sense of both achievement and concern. The Bank has made pleasing progress on a number of fronts, including several important business priorities. But the environment has shown little if any improvement internationally, and only modest gains domestically.

The Official Cash Rate has remained unchanged for a record 12 reviews, with markets expecting more of the same ahead. This policy stability is in the face of a very unstable international economic situation and continuing gradual recovery in Canterbury.

The slow recovery in the US, and particularly the simmering Eurozone crisis have cast a shadow over world growth following the GFC. In New Zealand, recovery has been slower than we would have liked, with trading partners affected by Europe and bank funding enduring fragile periods.

We are coming to terms with a very different world, one with lower price pressures, very low or even negative interest rates, slow growth and recurrent crises. New Zealand businesses need to find ways of operating within such an ongoing environment. The Reserve Bank needs to ensure its monetary and financial policies are robust in such a world.

The other important area of uncertainty is the Canterbury earthquake rebuild. This will eventually provide a significant boost to nationwide activity for an extended period. However, the region has faced a number of significant challenges that have resulted in delays, including complex insurance issues. Nevertheless, we expect increases in activity in the region over the coming years: repair work has been gradually increasing over recent months, and the development of plans for reconstruction of the central city will assist with investment decisions.

These uncertainties apart, we see more positive signs ahead. Commodity prices have softened but remain reasonably strong. Our important markets in Asia have so far remained reasonably robust. We have just ended an excellent farm season. Banks have sufficient capital, funding and willingness to finance more economic activity. Interest rates are at historic lows.

In this environment, we have had several business priorities in place to promote resilience for the Bank, the economy and the financial system. This *Annual Report* tells of progress on those priorities for 2011–12, highlights of which are shown on the facing page.

These projects, and all the business-as-usual, have drawn heavily on the skills of our policy and industry analysts, and also our backroom operations teams, bringing expertise in information technology, financial services, human resource management, risk management, communications and property management.

To Chairman Arthur Grimes and the Board my deep gratitude for advice and assistance. I thank all our staff for playing their role in improving our country's future. I especially owe thanks to our group of senior managers, to my Deputy, Grant Spencer, and my assistant, Jo Lawrence, for all the guidance and support through challenging times.

I have had a turbulent but hugely rewarding decade as Governor and Chief Executive. On 25 September, I will leave the Reserve Bank in the capable hands of my successor, Graeme Wheeler. I wish him all the best in leading the Reserve Bank in its roles of helping promote economic growth for New Zealanders by maintaining price stability and a sound and efficient financial system.

Alan Bollard
Governor
20 August 2012

HIGHLIGHTS OF THE YEAR

- The Bank has developed an internal financial monitoring report, designed to measure financial imbalances within the economy. This is monitored quarterly by the Bank's Macro-Financial Committee, and the messages are reported in the *Financial Stability Report*.
- We have outlined four macro-prudential tools that we could consider using if future credit conditions were to warrant it. With credit conditions in New Zealand subdued, there has been no immediate need to deploy such tools. However, the Bank continues to research the efficacy of potential macro-prudential instruments.
- Despite subdued business conditions, New Zealand's banks continue to perform well, with lower non-performing loans; and funding channels have stabilised sufficiently to allow us to confirm a further rise in the core funding ratio to 75 percent from 1 January 2013.
- The non-bank deposit taking sector continues to consolidate after the implosion of finance companies in the past five years. A new statute establishes a licensing regime, which will be implemented over the coming year.
- Another product of the GFC experiences, the Basel III prudential requirements for banks, is expected to be finalised in 2012, and the banking industry will have to comply with the core capital requirements from the beginning of 2013. New Zealand's own quantitative liquidity requirements, earlier than, but consistent with, the Basel III liquidity requirements, are already in place.
- In late 2010, the Bank took on responsibility for prudential supervision of the insurance industry. This has been a significant addition to our powers to ensure a sound and efficient financial system. It is pleasing to report that we granted over 100 provisional or full licences by the deadline of March 2012. The Bank is now working with licensed insurers on their transitional path to obtaining a full licence by September 2013.
- The Bank is preparing to implement the anti-money laundering (AML) supervisory regime from 1 July 2013, in conjunction with other government agencies, in a way best suited for New Zealand.
- With significant initiatives throughout the Bank, including the new prudential responsibilities, we put in place programmes to develop staff, align objectives, and encourage collaborative work across departments.
- In the light of the post-GFC environment we have reviewed the structure of the Bank's foreign reserves, linking to a wider range of investment assets and the establishment of new benchmarks for assessing performance. This new benchmarking framework is now about to be implemented.
- Planning for a new series of banknotes is well under way. We have established requirements for the selection of security features, substrate, and the providers of design and print services. This is a major project, and is on schedule to deliver the first new notes in 2014.
- We also introduced systems to reduce risks in New Zealand's multi-billion-dollar payments system. We have added a new interface, Settlement Before Interchange, to our interbank settlement system, allowing banks to settle retail transactions at regular intervals during the day rather than once a day.

REPORT FOR THE YEAR ENDED 30 JUNE 2012

This report is made pursuant to section 53A of the Reserve Bank of New Zealand Act 1989.

The Reserve Bank's Board of Directors is responsible for keeping the performance of the Bank and of the Governor under constant review across all Bank functions. The Reserve Bank of New Zealand Act 1989 (the Act) sets out the Bank's responsibilities. The Governor, who is the Bank's Chief Executive, is responsible for decisions with respect to the Bank's functions. The Board has a major role to play in the appointment of a Governor and in ensuring that the Governor and the Bank carry out their mandated functions to a high standard.

The role of the Bank has expanded in recent years with additional responsibilities covering regulation of non-bank deposit-takers (NBDTs), licensing and prudential supervision of insurance companies, oversight of payments systems, designation of settlements systems, and anti-money laundering and countering the financing of terrorism. In addition, the global financial crisis (GFC) and the impacts of the Christchurch earthquakes have posed significant challenges for the Bank in conducting some of its traditional central banking activities. These activities include monetary policy, managing foreign exchange reserves, lender of last resort, registration and supervision of banks, provision of settlement account services and securities registry services, and issuance of currency (notes and coins).

The Board's role has expanded to cover the new functions of the Bank, and we have reviewed the Bank's performance in the light of the challenging global and domestic circumstances. Before presenting the Board's assessment of the Bank's performance over 2011–12, it is useful to outline how the Board performs its review role.

BOARD PROCESSES

The Board met nine times in the year to 30 June 2012. Traditionally, the Board holds three of its meetings outside of Wellington (one in Auckland, one elsewhere in the North Island and one in the South Island) so that we can discuss developments within the economy with local business people and other leaders, and receive their feedback. The remainder of the Board meetings are held in Wellington.

Section 53 of the Act specifies the duties of the Board, inter alia, as being to:

(a) keep under constant review the performance of the Bank in carrying out–
  (i) its primary function [monetary policy]; and
  (ii) its functions relating to promoting the maintenance of a sound and efficient financial system; and
  (iii) its other functions under this Act or any other enactment:

(b) keep under constant review the performance of the Governor in discharging the responsibilities of that office:

(c) keep under constant review the performance of the Governor in ensuring that the Bank achieves the policy targets agreed to with the Minister [the Policy Targets Agreement]:

(d) determine whether policy statements made pursuant to section 15 [*Monetary Policy Statements*] are consistent with the Bank's primary function and the policy targets agreed to with the Minister…:

(e) keep under constant review the use of the Bank's resources.

Section 53 also specifies that the Board may provide advice to the Governor on any matter relating to the performance of the Bank's functions and the exercise of its powers.

In carrying out these duties, the Board needs to be well informed about the Bank's activities in the context of economic and financial circumstances in domestic and international markets. The Board sources information internally from the Bank's staff and from external sources such as the IMF, OECD, commercial banks and visiting experts.

The Bank provides information to the Board during the development of new policies to enable the Board to advise the Governor in a proactive manner. For instance, the Board has been provided with relevant materials, and has provided advice, throughout the development of the Bank's Open Bank Resolution (OBR) proposals in relation to registered banks The proposed regime is designed to maintain a distressed bank's core banking services – in a manner that limits the cost to the taxpayer – during and after insolvency or other circumstances that pose a threat to the soundness of the financial system.

Other information is provided to the Board immediately after the Bank has announced a major decision. This is particularly the case following each *Monetary Policy Statement* (*MPS*) and interim Official Cash Rate (OCR) announcement by the Bank. The Board is not informed of monetary policy announcements prior to their public release but subsequently receives the entire pack of inputs that the Bank uses to assess monetary conditions and that inform the Governor's OCR decision. These materials normally amount to around 250 pages of detailed confidential information and assessments.

The Board's role is not to take part in the decision making, but rather to ensure the appropriateness of the Bank's processes and compliance with the Act. Directors consider: (a) the processes and frameworks used by the Bank in order to reach its decisions; (b) a retrospective assessment of the Bank's conduct of monetary policy; (c) a prospective assessment of whether the Bank's proposed policies are consistent with its monetary policy responsibilities under the Act; (d) communication and presentation of policy intentions; and (e) any other relevant matter. Directors resolve whether the *MPS* is in keeping with the requirements of the Act (section 15).

Directors follow a similar process after the issuance of each *Financial Stability Report* (issued under section 165A of the Act). The Board also provides advice to the Governor on drafts of the Bank's *Annual Report*, *Statement of Intent* and five-year Funding Agreement.

The Board has an Audit Committee that, over 2011–12, comprised four non-executive directors. The Committee receives detailed materials on the Bank's financial and risk position and proposed disclosures in the financial statements, and monitors external and internal audit processes. It reviews the Bank's performance in these areas, and provides advice to the Governor.

The Board receives a monthly Chief Executive's Report and Balanced Scorecard. The latter includes key performance indicators on: monetary policy; financial stability; currency operations; settlement services; market operations and foreign reserves; financial risk; financial expenses; financial performance and position; operational risk; human resources; with quarterly updates on progress on the Bank's priorities as listed in the *Statement of Intent*.

As well as these regular reports, the Board requests and/or the Bank provides reports on specific topics that relate to the Bank's policy and operational functions. The Board obtains detailed external commentaries from bodies such as the IMF on their assessments of matters relevant to the Bank's responsibilities. From time to time, the Bank hosts visiting academics and/or central bankers, with these visitors attending monetary policy formulation rounds. The Board receives these visitors' assessments of processes followed by the Bank with respect to monetary policy. The Board therefore receives substantial in-house and independent materials to assess the Bank's performance on both operational and policy matters.

The Board notes the high standard of the materials provided for consideration, and the willingness and ability of officers to discuss the materials with directors. The openness of the Bank's senior management, allied to its quality, makes for a rigorous and positive environment for discussion and assessment of the Bank's performance. The wealth of materials received, coupled with the opportunity to discuss the issues directly with Bank officers, is a strength of this monitoring process of a key public body.

GOVERNOR APPOINTMENT

In addition to keeping the Bank's and Governor's performance under constant review, the Board has a major role in the appointment of the Bank's Governor. Section 40 of the Act states that the Governor shall be appointed by the Minister [of Finance] on the recommendation of the Board. Following the current Governor's decision not to seek a third term, the Board established a process to identify and interview candidates for the position in order to make a formal recommendation to the Minister.

In late 2011, the Board appointed a human resources firm to assist in this process. The role was advertised domestically and internationally, and a complementary search process was conducted. The Board was impressed with the high calibre of candidates available for interview, which is testament to the high regard in which the Reserve Bank of New Zealand is held internationally and at home.

The Board recommended the appointment of Mr Graeme Wheeler to the position of Governor, and the Minister made his appointment on the basis of this recommendation. The appointment is subject to the finalisation of a Policy Targets Agreement prior to Mr Wheeler assuming the position. Mr Wheeler has a distinguished record including Managing Director, Operations, and Treasurer, of the World Bank; Deputy Secretary of the New Zealand Treasury and Treasurer of the New Zealand Debt Management Office; Director of Macroeconomic Policy at the New Zealand Treasury; and an Economic and Financial Counselor at the OECD.The Board looks forward to Mr Wheeler commencing his duties on 26 September 2012.

MONETARY POLICY

The Act specifies (section 8) that: *The primary function of the Bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices*. To put it simply, the Bank's primary function is to keep the cost of living stable over time for New Zealanders. In practical terms, the PTA requires the Bank to keep inflation in the Consumers Price Index (CPI) within a range of 1 to 3 percent per annum on average over the medium term.

During times of world commodity price booms, and when there are domestic policy-induced price rises (caused, for example, by indirect tax increases), achievement of this target can be difficult. This combination of circumstances was experienced over the seven years to June 2011 when annual (headline) CPI inflation averaged 3.0 percent. Currently, however, the developed world economy is sluggish and domestic fiscal decisions are broadly neutral with respect to inflationary pressures. This environment has allowed the Bank to leave the OCR at a constant (record low) level of 2.5 percent throughout the year, with CPI inflation registering just 1.0 percent for the year to June 2012. Measures of underlying inflation are currently closer to the middle of the target band; for instance, the sectorial factor model recorded underlying inflation at 1.6 percent for the year. These outcomes are consistent with the Bank meeting its inflation target of keeping CPI inflation within a 1 to 3 percent range on average over the medium term.

The PTA also requires that the Bank "implement monetary policy in a sustainable, consistent and transparent manner and shall seek to avoid unnecessary instability in output, interest rates and the exchange rate." Amid a period of material global uncertainty, poor developed country growth and the aftermath of the Christchurch earthquakes, New Zealand's annual GDP grew by 2.5 percent for the year to March 2012. With a stable OCR, 90-day interest rates were comparatively stable averaging 2.73 percent with a range of 2.48 percent to 3.02 percent. The trade-weighted exchange rate also remained extremely stable throughout the year. It averaged 71.1, with a range of just 66.3 to 75.0; i.e. the range was less than ±7 percent at a time of highly volatile global exchange rates. Thus New Zealand had moderately stable interest and exchange rates over the year, coupled with a modest GDP growth rate. These outcomes indicate that the Reserve Bank is meeting the requirements specified in the PTA.

FINANCIAL STABILITY

Global financial developments over the past five years have emphasised the need for central banks to maintain a vigilant watch on matters of financial stability. Furthermore, they must be prepared to act when major financial imbalances are likely to occur. The Board welcomes the Bank's implementation programme relating to the Basel III regime in a manner consistent with New Zealand's circumstances and needs.

The Board also welcomes the Bank's initiatives in outlining a range of macro-prudential tools that it may use if financial and credit conditions warrant their application. The core funding ratio (CFR), which will be set at 75 percent from 1 January 2013, is one instrument that is already in place. Additional instruments, at least in theory, give the Bank the ability to ameliorate financial excesses and economic imbalances while meeting its primary monetary policy function of keeping a stable cost of living. In practice, the efficacy of certain macro-prudential instruments is still to be proven. The Board will continue to engage with Bank officers on the potential to use one or more of these instruments to contain imbalances while still meeting the inflation target.

The Board considers it imperative that a procedure is in place to deal with a situation – however unlikely – in which a major bank could be about to fail. In this respect, the Board supports adoption of the Open Bank Resolution (OBR) regime and is pleased to see progress in pre-positioning for it. This is a policy development that the Board will be monitoring closely over the coming year since its success, in the event of a major bank failure, will depend on processes having been clearly determined ex ante. Given the sudden

INVESTING IN OUR FUTURE

ESAS/NZCLEAR SYSTEM

The Reserve Bank provides a banking service for institutions that need to make regular high-value payments with each other. This is the Exchange Settlement Account System (ESAS). The Bank also operates a real-time settlement system, NZ Clear, providing the financial markets with clearing and settlement services for high-value debt securities and equities transactions.

Investment in upgrading the ESAS/NZClear system has been part of a strategy by the Bank to improve system resilience, reduce operational risk, and enhance performance and services.

514,650 HOURS/YEAR
The ESAS/NZClear system is available 23½ hours per day, seven days per week throughout the year.

30 BILLION
Amount in NZ dollars processed through the system each day.

nature of many bank failures internationally (and historically in New Zealand) the Bank must be in a position to implement the process swiftly before a major bank run or contagion sets in. This requires detailed and robust decision-making processes to be established in "good times" so that they are immediately operational and effective when required.

The importance of the insurance sector was highlighted by the effects of the Christchurch earthquakes both on claimants and on insurance firms. The Board considers that the Bank has responded effectively to the new insurance supervisory regime. It has issued solvency standards, and has licensed insurance firms. Not all pre-existing firms applied for a licence, but all those who did apply were granted either a provisional or full licence (or, in three cases, a run-off licence). This is a regulatory area that is new to the Bank and given the Reserve Bank's prior lack of expertise in the insurance field, the organisation has done exceedingly well to get up to speed as it begins to implement the new regulatory regime.

OTHER FUNCTIONS

New Zealand's banknotes are of a high quality and, by international standards, rates of counterfeiting are low. However, technological advances mean that the Bank must ensure that security features are continually updated. The Bank launched an upgrade of banknotes during the year, which will result in new banknotes being introduced to the country progressively from 2014. This initiative was foreshadowed in the five-year funding agreement that governs the Bank's budgeted resource use.

The Bank's payments and settlements systems (ESAS and NZ Clear) worked effectively during the year. The Bank has implemented its part of the 'Settlement Before Interchange' system, which reduces intra-day exposures for commercial banks; and, following year-end, an application for designation of NZClear as a designated settlement system has been in the final stages of the approval process. These are crucial components of New Zealand's financial architecture that we are satisfied are efficiently and effectively run by the Reserve Bank.

RESOURCES

The five-year funding agreement that began in July 2010 specified a budgeted net expenditure of $50.2 million for the Bank over the 2011–12 year. Net operating expenses came in well below this figure and, at $47.0 million, were just $0.2 million higher than in 2010–11. This outcome reflects continued restraint within the Bank in its expenditures.

Despite a high exchange rate at year-end, which resulted in recorded losses on the Bank's holdings of unhedged foreign exchange reserves, the Bank made a profit of $118 million for the year. The Board accepts that the Bank's profit outcomes will be volatile as a result of its holding unhedged foreign exchange reserves, a policy adopted to allow effective intervention to support the New Zealand dollar at times of downward stress. The Board supported the Bank's payment of a $160 million dividend to Government for the year.

The Board maintains a close watch on risks faced by the Bank. Risks include financial risks (such as foreign exchange risks associated with the foreign reserves portfolio and trading risks associated with domestic liquidity operations), currency counterfeiting risks, and policy risks (such as making policy decisions that are subsequently shown to have been incorrect or ineffective). The Bank is currently reviewing its risk management framework, and the Board is actively involved in this review. The Bank has been developing an explicit benchmarking model for foreign exchange reserves management which will be implemented over the first half of the 2013 year. This will assist the Board in monitoring returns and risks arising from the management of the foreign exchange reserves.

FINAL COMMENTS

The 2011–12 year is the last full year for which Dr Alan Bollard is Governor of the Reserve Bank. He finishes a decade in the role on 25 September 2012. The Reserve Bank was created, in 1934, at the height of the Great Depression. Since that time, there has been no greater global financial and economic crisis than that experienced since 2007. With its strong institutions that focus on maintaining effective policies over prolonged periods, New Zealand has weathered the global crisis remarkably well.

However, strong institutions are not the sole reason for New Zealand's successful navigation through the GFC. The country has been extremely fortunate to have had a central bank Governor of the experience and ability of Dr Bollard. Prior to joining the Reserve Bank as Governor, Dr Bollard had already held leadership roles as Director of the New Zealand Institute of Economic Research, Chairman of the Commerce Commission and Secretary of the Treasury. His experience in these roles meant that when the global economy fell into crisis – followed by the economic and financial effects of the crippling Christchurch earthquakes – the Reserve Bank had a Governor who could deal calmly and capably with all that was thrown at the New Zealand financial sector. The Board considers that Dr Bollard's outstanding performance during this time caps off an extraordinary contribution to New Zealand public policy over multiple decades. We wish him well in his future endeavours.

The Governor could not have performed as he has without the strength of the team that exists throughout the Bank. The Board is consistently impressed with the calibre of the Bank's staff from the most newly recruited officers through to the Deputy Governor, Mr Grant Spencer. The Bank places a great deal of emphasis on staff and management training, both in specific and generic organisational skills, and the payoff to such training is apparent in the quality of staff contributions throughout the institution. The Board commends all staff on a successful year during what continue to be extremely challenging times.

Finally, we acknowledge the contribution of departing director, Deputy Chair, and Chair of the Audit Committee, Mr Hugh Fletcher. Mr Fletcher served 10 years as a director and was responsible for many insightful contributions within the Board. With his departure, Ms Sue Sheldon has been appointed Deputy Chair and Mr Keith Taylor appointed Chair of the Audit Committee. Mr Fletcher's successor, Dr Rod Carr – a former Deputy Governor of the Bank – joined us as a Director in July 2012, and we welcome him back to the Bank in a new role.

Arthur Grimes	**Sue Sheldon**
Chair	Deputy Chair
20 August 2012	*20 August 2012*

PLANNING AND REPORTING FRAMEWORK

This *Annual Report* refers back to the *Statement of Intent 2011–14* (*SOIs* are published annually covering a three-year period). It covers the second year of the Funding Agreement with government for the five years ending 30 June 2015. The Funding Agreement provided funding of $50.2 million for 2011–12.

	2010–11	2011–12	2012–13	2013–14	2014–15
(i) Planning	*FIVE-YEAR FUNDING AGREEMENT*				
		STATEMENT OF INTENT			→
		Annual - KPIs - Budget - Strategic Priorities	→		
(ii) Reporting		ANNUAL REPORT			
	MONETARY POLICY STATEMENT (quarterly)				
	FINANCIAL STABILITY REPORT (six-monthly)				

Table 1

BUSINESS PRIORITIES AND OUTCOMES 2011–12

The Bank adopts a number of Business Priorities in addition to its business-as-usual activities. Last year, we adopted a number of priorities, which we report on here. Priorities for the 2012–13 year are on page 43.

PRIORITY 1	OUTCOME
Canterbury earthquakes Assess the impact of the Canterbury earthquakes and the implications for the Bank's monetary policy.	The Bank has met regularly with authorities in Christchurch, insurance companies, and companies involved in the reconstruction effort. The conclusions of this analysis have been communicated in the *Monetary Policy Statements* (*MPSs*), in *Financial Stability Reports* (*FSRs*), and in speeches by the Governor. Incorporating updated information on the rebuild has been firmly embedded as an integral part of the policy process.
PRIORITY 2	**OUTCOME**
Macro-prudential policy tools Develop an implementation framework for macro-prudential policy tools in New Zealand and consider the inter-relationship with monetary policy.	The Bank's Macro-Financial Committee now makes a quarterly assessment of indicators of potential financial imbalance, and whether macro-prudential policy adjustments should be considered. With credit conditions in New Zealand having been subdued, there has been no immediate need to deploy such tools. The Bank continues to research the efficacy of potential macro-prudential instruments.
PRIORITY 3	**OUTCOME**
Insurance licensing Ensure that insurers are on the path to obtaining a full licence by September 2013, meeting at least the provisional licensing requirements by March 2012.	All entities carrying on insurance business in New Zealand were granted either a provisional or a full licence by 7 March 2012. The Reserve Bank issued over 100 licences and is now working with licensed insurers on their transitional path to obtaining a full licence by September 2013.
PRIORITY 4	**OUTCOME**
Basel III implementation Develop a plan for the implementation of Basel III prudential requirements for banks, suitably adapted for New Zealand conditions.	The final Basel III capital requirements are expected to be in place in 2012, and the banking industry will have to comply with the core requirements from the beginning of 2013. Quantitative liquidity requirements, in substance the same as Basel III liquidity requirements, are already in place for locally incorporated banks.

PRIORITY 5	OUTCOME
Staff development Develop cross-functional capabilities among our staff to support the Bank's wider range of responsibilities.	Capabilities have been developed to handle the expanded prudential supervision and macro-financial responsibilities. Engagement and learning across the Bank is being encouraged by an emphasis on collaborative work and project methodology, rotations and secondments.
PRIORITY 6	**OUTCOME**
Foreign reserves management benchmarking Implement a new asset allocation and performance benchmarking framework for foreign reserves.	The benchmarking framework for the foreign reserves portfolios will be implemented shortly, including the revision of the Bank's strategic allocation of foreign reserve assets across high-grade markets.
PRIORITY 7	**OUTCOME**
New banknotes Undertake initial planning and consultation for a new (Series 7) issue of banknotes.	The Bank has completed the planning phase of the project and announced the project with a press release. The Bank has established frameworks for the selection of security features, substrate, and the providers of design and print services. Further, the Bank issued a request for information as the first step in the procurement process.

RESERVE BANK ORGANISATIONAL STRUCTURE

GOVERNORS			DEPARTMENT/HEADS		FUNCTIONS	INTERNAL SERVICES
		Assistant Governor/ Head of Economics **John McDermott**		Economics	• Monetary policy formulation	
 Governor **Alan Bollard**[2]		Deputy Governor/ Head of Financial Stability **Grant Spencer**		Financial Markets **Bernard Hodgetts** (Acting Head)	• Domestic market operations • Foreign reserves management • Macro-financial stability	
				Prudential Supervision **Toby Fiennes**	• Prudential Supervision	
		Assistant Governor/ Head of Operations **Don Abel**		Currency and Property Services **Alan Boaden**	• Currency operations	• Property management • Security
				Financial Services **Mike Wolyncewicz**	• Settlement services	• Accounting services • Treasury services
				Knowledge Services **Tanya Harris**		• Library services • Technology services • Project management • Web publishing
				Human Resources **Lindsay Jenkin**		• Human resources strategy and services
				Communications/ Board Secretary **Mike Hannah**		• Communications strategy and services • Reputation management • Board secretariat
				Risk Assessment and Assurance **Steve Gordon**		• Risk assessment and assurance • Audit services • Legal services

2. Dr Bollard completes his second term as Governor of 25 September 2012. The Minister of Finance has announced his intention to appoint Mr Graeme Wheeler as Governor and Chief Executive from 26 September 2012, pending the finalisation of a PTA.

BOARD OF DIRECTORS


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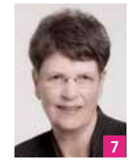
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NON-EXECUTIVE

Dr Arthur Grimes 1

Chair Reserve Bank of New Zealand Board of Directors

Economist

Corporate interests

- The Hugo Group Ltd – Chair

Other interests

- Financial Markets Authority – Associate member of the Board
- GT Research & Consulting – Principal
- Motu Economic & Public Policy Research Trust – Senior Fellow
- Postal Network Access Committee – Chair
- Reserve Bank Superannuation Fund – Trustee
- University of Auckland – Adjunct Professor of Economics[3]. (University of Waikato – Adjunct Professor of Economics[4].)
- Wellington Jazz and Music Festival Trust – Trustee

First appointed 13 March 2002 – current term expires 12 March 2017

Sue Sheldon CNZM 2

Deputy Chair Reserve Bank of New Zealand Board of Directors – from 10 June 2012

Company Director

Corporate interests

- Chorus Limited – Chairman[5]. (Telecom Corporation of New Zealand Ltd – Director[6].)
- Contact Energy Limited – Director
- FibreTech Holdings Limited – Director
- FibreTech New Zealand Limited – Director
- Freightways Limited – Chairman
- Paymark Limited – Director

Other interests

- Sue Sheldon Advisory Limited

First appointed 1 May 2009 – current term expires 30 April 2014

Hugh Fletcher 3

Deputy Chair Reserve Bank of New Zealand Board of Directors – to 9 June 2012

Chair Reserve Bank of New Zealand Board of Directors' Audit Committee – to 9 June 2012

Company Director

Corporate interests

- Fletcher Building Limited – Director
- Insurance Australia Group Limited – Director
- IAG New Zealand Holdings Limited – Chair
- IAG New Zealand Limited – Chair
- IAG Finance (New Zealand) Limited – Director
- NGC Holdings Limited – Director
- NZI Staff Superannuation Fund Nominees Limited – Director
- Rubicon Limited – Director
  - Group includes: Rubicon Forests Ltd, Rubicon Forests Investments Ltd
- Vector Limited – Director
  - Group includes: Vector Communications Ltd, Vector Metering Data Services Ltd

Other interests

- Dilworth Trust – Trustee
- L.E.K. Consulting – Member Australian and New Zealand Advisory Board
- The New Zealand Portrait Gallery – Trustee
- The University of Auckland Foundation – Trustee

First appointed 10 June 2002 – term expired 9 June 2012

Dr Chris Eichbaum 4

University Lecturer

Victoria University of Wellington – Reader in Government, School of Government

First appointed 1 August 2008 – current term expires 31 July 2013

Professor Neil Quigley 5

Deputy Vice-Chancellor (Research), Victoria University of Wellington

Corporate interests

- Victoria Link Limited – Chair
  - Group includes: iPredict Ltd, Predictions Clearing Ltd, Magritek Ltd, Pacific Nanofibres Ltd, Te Puni Village Ltd, Wetox Ltd

Other interests

- New Zealand Qualifications Authority – Board member
- Adam Art Gallery Funding Trust
- Adam Art Gallery Trust
- Education New Zealand Trust – Trustee[7]
- New Zealand Tertiary Education Consortium – Chair[8]
- Wellington College Board of Trustees – Chair
- Wellington College Foundation – Trustee

First appointed 1 February 2010 – current term expires 31 January 2015

Keith Taylor 6

Chair Reserve Bank of New Zealand Board of Directors' Audit Committee – from 10 June 2012

Company Director

Corporate interests

- Butland Management Services Limited – Director
  - Group includes: Butland Holdings Ltd, Stratford Properties, Stanway Properties
- Gough Gough & Hamer Limited – Director
  - Group includes: Gough Gough & Hamer Investments Ltd, Gough Gough & Hamer Properties Ltd, Gough Holdings Ltd, Gough Transport Supplies Ltd, Transport Specialties Ltd, Transport Wholesale Ltd
- Port Marlborough Limited – Director
  - Group includes: Waikawa Marina Trustee Ltd, PMNZ Marina Holdings Ltd, Marlborough Sounds Maritime Pilots Ltd
- Speirs Group Ltd – Chair[9]

Other interests

- Earthquake Commission – Deputy Chairman
- Government Superannuation Fund Authority – Chair[10]
  - Annuitas Management Ltd – Director
- New Zealand Qualifications Authority – Board member
- Southern Cross Healthcare – Director
- Takeovers Panel – Member
- NZ Fire Services Superannuation Scheme – Trustee

First appointed 1 July 2009 – current term expires 30 June 2014

Kerrin Vautier CMG 7

Consulting Research Economist

Corporate interests

- Fletcher Building Ltd – Director[11]

Other interests

- High Court – Lay Member under the Commerce Act
- Auckland City Mission – Chair
- Musica Sacra Trust – Chair

First appointed 9 February 2010 – current term expires 8 February 2015

***Note Dr Rod Carr** has been appointed a Director, effective 16 July 2012 to 15 July 2017.

EXECUTIVE

Dr Alan Bollard, Governor

SECRETARIAT

Mike Hannah, Board Secretary

3. From January 2012
4. To January 2012
5. From 1 December 2011
6. To 30 November 2011
7. To December 2011
8. To 31 December 2011
9. From 28 November 2011
10. Chair from 1 August 2011
11. To 31 August 2011

GOVERNANCE

AUTHORITY AND ACCOUNTABILITY

The Reserve Bank of New Zealand is wholly owned by the New Zealand government. The Bank's authority, funding and accountability are based on:

- the **Reserve Bank of New Zealand Act 1989**, which specifies the Reserve Bank's functions and duties;
- the **Insurance (Prudential Supervision) Act 2010**, which provides the Bank's powers to licence and impose prudential standards on insurers;
- the **Policy Targets Agreement (PTA)**, a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve;
- the **Bank's Funding Agreement**, a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs;
- the ***Statement of Intent***, an annual three-year statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the three years, and projected income and expenditure for the first financial year; and
- the ***Annual Report***, an annual accountability document, including presentation of financial statements.

The Reserve Bank also subscribes to a statement of its Vision and Values. These can be found on page one of this *Annual Report*.

THE GOVERNOR

The Reserve Bank Act makes the Bank's Chief Executive – the Governor – accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor. The Governor is appointed for a five-year term. The Act sets specific criteria for the appointment, reappointment, and dismissal of a Governor. The current Governor, Dr Alan Bollard, took up his appointment in September 2002 and was reappointed in May 2007 to a further term expiring on 25 September 2012. Mr Graeme Wheeler has been appointed as Governor for a five-year term from 26 September 2012.

MANAGEMENT STRUCTURE

The Bank's senior management team is made up of the Governor, Deputy Governor, Head of Financial Stability, Head of Operations, Head of Economics, and heads of the Bank's various departments, as outlined on page 18. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, the Head of Operations and the Head of Economics are currently designated Assistant Governors.

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

- the Senior Management Group, which meets weekly to consider the management and day-to-day operation of the Bank;
- the Monetary Policy Committee, which meets fortnightly to advise the Governor on economic and financial market conditions to assist monetary policy deliberations;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions, typically eight times a year;[12]
- the Financial Systems Oversight Committee, which meets fortnightly to consider policy issues relating to prudential regulation and supervision of the financial system;
- the Macro-Financial Committee, which meets fortnightly to advise the Governor on macro-financial stabilisation policies and tools;
- the Asset and Liability Committee, which meets monthly to consider strategic management of the Bank's assets and liabilities; and
- the Communications Committee, which meets weekly to consider external communications issues and the Bank's credibility and reputational interests.

BOARD OF DIRECTORS

The Reserve Bank has a Board of Directors, the membership of which is shown on page 17. Under the Act, the Board of Directors must comprise not less than five and not more than seven non-executive members, who are appointed for five-year terms by the Minister of Finance. In addition, the Governor is a Board member. The Chair must be a non-executive member, and is appointed by the non-executive directors for a renewable term of 12 months. The current Chair is Dr Arthur Grimes.

The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. The Board provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 8–12. It has the responsibility to confirm that *MPSs* are consistent with the PTA, and it monitors the six-monthly *FSRs*. It offers its view to the Minister on the amount to be paid as a dividend. The Board performs its role through 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 does not direct Bank policy, monetary or otherwise.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. If it believes that the Governor's performance, in meeting the requirements of the PTA or in carrying out his or her other duties, has been 'inadequate', then it can recommend to the Minister of Finance that the Governor be dismissed. The Board also appoints the Deputy Governor on the recommendation of the Governor.

The Board of Directors' Audit Committee monitors the external and internal audit functions. The Committee also receives reports from the Bank's external auditor and reviews the Bank's annual financial statements. Directors on that committee during the year were Hugh Fletcher (Chair to 9 June 2012), Sue Sheldon, Keith Taylor (Chair from 10 June 2012) and Kerrin Vautier.

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12. This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of narrow information sources. During the year, the two external advisers were Mr Earl Rattray and Mr Luke Moriarty.

The Board of Directors held nine scheduled meetings and the Audit Committee three scheduled meetings, as well as considering and advising on additional information during the year.

PARLIAMENTARY SCRUTINY

The Bank's activities are scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, hearings are held covering the quarterly *MPSs*, the six-monthly *FSRs* and the Bank's annual financial performance.

PUBLIC ACCOUNTABILITY

An important aspect of the governance of the Bank is its transparency. The Bank publishes an annual *Statement of Intent* and an *Annual Report*, which report on the Bank's governance, objectives, strategies, key performance indicators and performance. It releases a quarterly *MPS*, which explains current monetary policy and provides detailed economic projections. It also publishes a six-monthly *FSR*, assessing the robustness of the New Zealand financial system. On our website (rbnz.govt.nz), a *Statement of Principles* summarises our bank registration and supervision policies.

We also make information on our policies and activities widely available via an extensive website, quarterly *Reserve Bank Bulletins*, research papers, discussion papers, speeches, media interviews and brochures.

FINANCIAL MANAGEMENT

FINANCIAL MANAGEMENT OVERVIEW

Foreign reserves management, New Zealand dollar liquidity management and currency operations materially impact on the size and structure of the Bank's balance sheet as well as its financial performance. The nature and extent of the Bank's principal financial activities are described in more detail in the financial statements on pages 49-97.

The Governor is responsible for the Bank's financial management. He decides on its financial management strategy and he makes all key financial management decisions after consulting the Bank's Asset and Liability Committee. Implementation of strategic decisions is delegated to the Financial Markets department. The Board's role is to provide advice to the Governor and to monitor the Bank's financial performance.

The Bank's financial performance is primarily impacted by:

- The size and performance of the Bank's foreign reserves management and market operations functions. This includes management of the Bank's open foreign exchange position, as well as provision of New Zealand dollar liquidity to participants in the domestic financial system.
- Changes in both foreign exchange rates and interest rates.
- The extent of available funds in the form of equity.
- Currency in circulation[13].

The Bank's reported net income will fluctuate from year to year, primarily because the Bank's unhedged foreign currency reserves will generate profits and losses as foreign exchange rates change.

FUNDING OF THE BANK'S OPERATIONS

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.

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 expenses in each financial year. The funding agreement comes into force only after it is ratified by Parliament. The Act provides for each funding agreement to apply for a period of five consecutive financial years.

The Bank's funding arrangements are designed to strike an appropriate balance between providing a high degree of operational independence, and providing strong incentives for effective management of operating expenditure, while ensuring accountability for use of resources. Capital expenditure is funded by the Bank, with depreciation of fixed assets included in annual operating expenses.

The funding agreement requires that the Bank include in its *Annual Report* a comparison of expenditure against the specified amount of net operating expenses for each year, together with a comparison of cumulative expenditure against the cumulative specified amount of net operating expenses for the term of the agreement.

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

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

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

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

13. No interest is paid on currency in circulation. When notes and coins are issued to a registered bank, the registered bank will pay for the currency that is issued by paying funds to the Reserve Bank from that bank's exchange settlement account with the Reserve Bank. The Reserve Bank invests the proceeds it receives, and the earnings on those investments are known as 'seigniorage'.

ANNUAL DISTRIBUTIONS PAID BY THE BANK

The Act requires the Bank to publish in its *Statement of Intent* a 'statement of dividend principles'. The Bank's statement of dividend principles is shown here.

Each year, the Bank makes a recommendation to the Minister of Finance of the amount to be paid as a dividend. The Minister decides how much should be paid having regard for the recommendation of the Bank, the views of the Board of the Bank and any other relevant matters.

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

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

STATEMENT OF DIVIDEND PRINCIPLES

RISK MANAGEMENT

The Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is making policy errors in relation to monetary policy, or the financial or banking systems, thereby causing damage to the economy and to the Bank's reputation and credibility. Other more specific risks include:

- credit and interest rate risks associated with our day-to-day liquidity management in domestic financial markets;
- risks associated with holding foreign currency reserves, including credit, interest, and exchange rate risks;
- risks associated with processing and storing currency, including risks of forgery, theft and robbery;
- risks associated with the operations of payments systems, which can arise from technical faults; and
- risks associated with being a small and concentrated organisation, such as the loss of key staff or primary business operations.

The Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management.

The Bank has two units with specific responsibilities relating to monitoring and managing risk. These are:

- The Bank's Risk Assessment and Assurance department, which is responsible for providing advice on and monitoring the Bank's risk management frameworks (as well as the internal audit role).
- A Risk Unit within the Bank's Financial Markets department, which provides specialised advice on financial market risk management. This includes recommendations on interest rate, credit and liquidity risk limits, and the reporting of specialised measures of financial risk.

In addition, succession planning is a management priority. A Business Continuity Planning strategy exists and includes an Auckland office to mitigate business operations risk in the event of a regional disaster in Wellington.

The Board and its Audit Committee also contribute to the review of the Bank's risk management processes.

CONFLICTS OF INTEREST

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank personnel, including Governors and directors. The policy requires that all personnel act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that personnel must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts.

Governors and departmental managers are required to provide the Bank with regular updates as to their personal interests, so that any potential conflict of interest is recorded. This is done quarterly. If any other personnel have a particular concern, they can also record their interests in the same way.

Personnel must not be involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. This includes domestic wholesale money, bond and foreign exchange markets, interest and exchange rate futures, options and swaps markets, and instruments linked to shares of regulated entities. At no time can Reserve Bank personnel own or control shares in entities (or their parent companies) that the Reserve Bank regulates. The policy states that personnel must not use inside information to benefit when depositing or withdrawing funds from financial institutions, or purchasing or selling bonds or shares, or when changing between fixed and floating rates for a loan. It is unacceptable to use inside information, whether to avoid losses or to make gains.

Under sections 56 and 61 of the Reserve Bank Act, the Minister must have regard to the likelihood of conflict of interest in appointing a director to the Board, and directors must disclose their interests in any contract with the Bank. On appointment to the Board, directors sign a declaration that they will observe confidentiality in relation to the affairs of the Bank and will not make use of any confidential information they may acquire regarding Bank operations. They also provide lists of their other directorships and major interests to enable the Governor to determine whether any Board papers should be withheld from them.

GOVERNORS' INTERESTS

The Governor, Deputy Governor and Assistant Governors note the following related interests. In each case, appropriate steps have been taken to ensure that no conflicts arise:

Dr Bollard: The interests of his wife, Jenny Morel, in No. 8 Ventures Management Limited and family interests in forestry.
Mr Spencer: None.
Dr Abel: None.
Dr McDermott: None.

MANAGEMENT AND MONITORING PROCESSES

Within the Bank, all activities and expenditure must be authorised and in accordance with a comprehensive set of Bank policies and procedures. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Departments are required to provide regular reports that describe progress to date on outputs and projects, and to explain any significant variances. The expenses of the Governor are reviewed by the Chair of the Board of Directors' Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are monitored closely.

The internal audit function within the Bank is performed by its Risk Assessment and Assurance department. The Bank is audited externally by the Auditor-General, who has contracted Chris Barber, using the staff and resources of PricewaterhouseCoopers, as her agent. In addition, the Minister of Finance can order a performance audit.

INVESTING IN OUR FUTURE

UPS

Given the critical role played in New Zealand's financial system by the Bank's business and information technology systems, it is vital that these systems are robust enough to cope with potential power supply disruption to its Wellington building.

The Bank has upgraded its Uninterrupted Power Supply system. With battery-stored energy, the UPS provides the Bank with immediate power when mains power fails, prior to the start-up of diesel-fuelled generators. In addition, the UPS protects the Bank's network and systems from power surges, preventing the loss of critical systems.

MONETARY POLICY AND MONETARY CONDITIONS 2011–2012

GRAPH 1

21 JULY

The Bank launches planning for an upgrade of New Zealand's banknotes.

28 JULY

The OCR is left unchanged at 2.5 percent.

AUGUST

The Bank releases an analysis of the potential economic effects of this year's Rugby World Cup tournament, later won by New Zealand.

1 SEPTEMBER

A new AML identity code is released.

13 SEPTEMBER

A new Council of Financial Regulators is established.

15 SEPTEMBER

The OCR is left unchanged at 2.5 percent.

26 OCTOBER

The Co-operative Bank Limited (formerly PSIS Ltd) is registered as a bank.

27 OCTOBER

The OCR is left unchanged at 2.5 percent.

8 NOVEMBER

The Bank issues a consultation paper on the implementation of Basel III capital adequacy requirements in New Zealand.

10 NOVEMBER

The Reserve Bank releases its November *FSR*.

8 DECEMBER

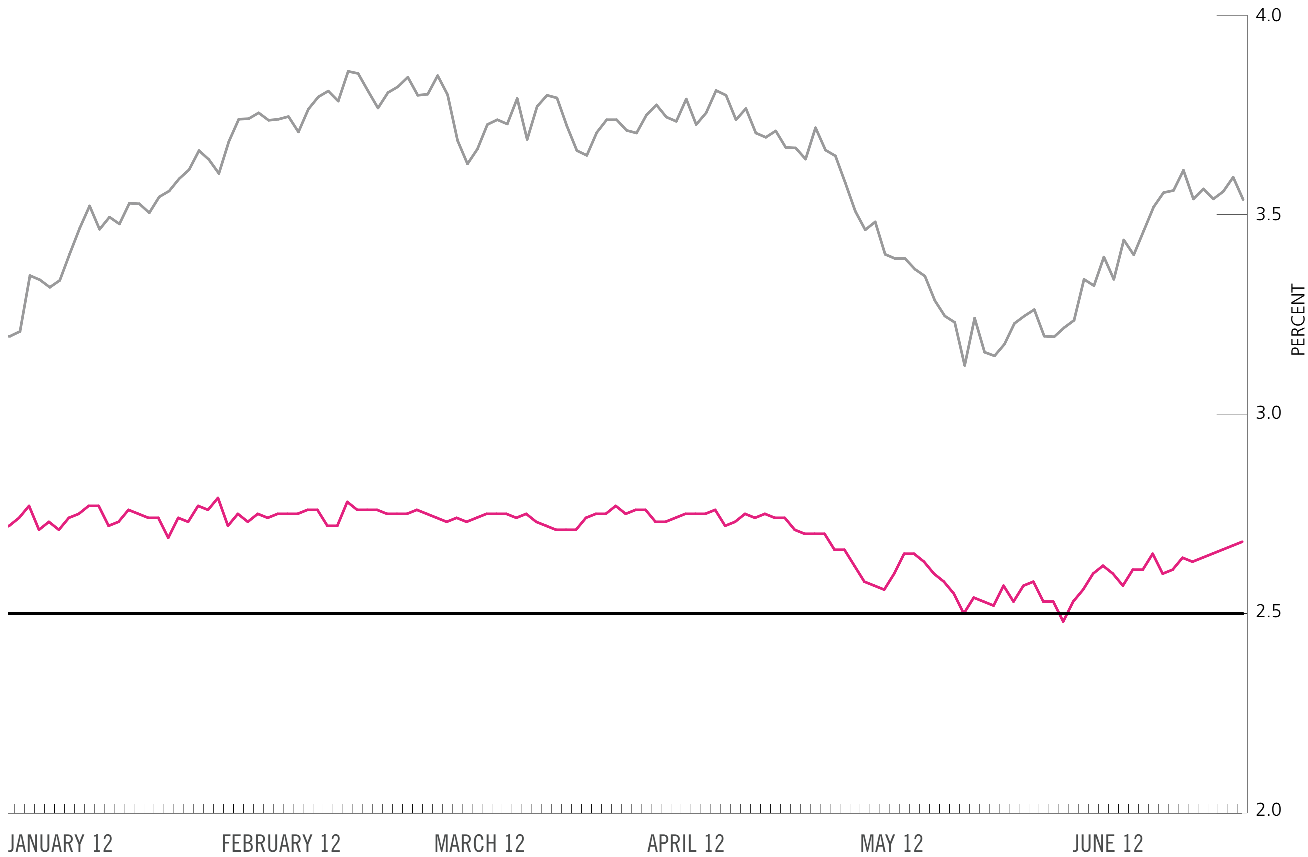
The OCR is left unchanged at 2.5 percent.

9 DECEMBER

The Bank issues a consultation paper proposing a legislative framework for covered bonds issued by New Zealand banks.

20 DECEMBER

The Bank introduces a new policy applying to significant acquisitions undertaken by locally incorporated banks.



26 JANUARY

The OCR is left unchanged at 2.5 percent.

30 JANUARY

Dr Alan Bollard announces he will not seek a third term as Governor.

24 FEBRUARY

Settlement Before Interchange is fully implemented, allowing banks to settle retail transactions at regular intervals each day.

8 MARCH

The OCR is left unchanged at 2.5 percent.

9 MARCH

The government reappoints Reserve Bank chairman, Dr Arthur Grimes, to a third term as a Director of the Bank.

BY MARCH

All insurers who required a licence were licensed.

5 APRIL

The Bank grants AMI Insurance (Operations) Limited a full insurance licence, after completing its assessment of the proposed restructure of AMI, and approving the change of control of AMI Insurance (Operations) Limited to IAG.

26 APRIL

The OCR is left unchanged at 2.5 percent.

9 MAY

The Reserve Bank releases its May *FSR*.

14 JUNE

The OCR is left unchanged at 2.5 percent.

26 JUNE

The Minister of Finance announces his intention to appoint Graeme Wheeler Governor and Chief Executive, effective from 26 September 2012, pending finalisation of a PTA.

27 JUNE

The Reserve Bank releases its *Statement of Intent* 2012–15.

JULY

16 JULY

Dr Rod Carr is appointed a Director of the Reserve Bank.

26 JULY

The OCR is left unchanged at 2.5 percent.

THE YEAR IN REVIEW

MONETARY POLICY FORMULATION

ECONOMY

The recovery from the global financial crisis has been slow, and fraught with setbacks. Economic and political stresses in the euro area have injected considerable uncertainty into the international economic environment over the past year. Commodity prices declined, and activity in New Zealand's trading partners slowed. New Zealand's trade balance has consequently dipped into negative territory.

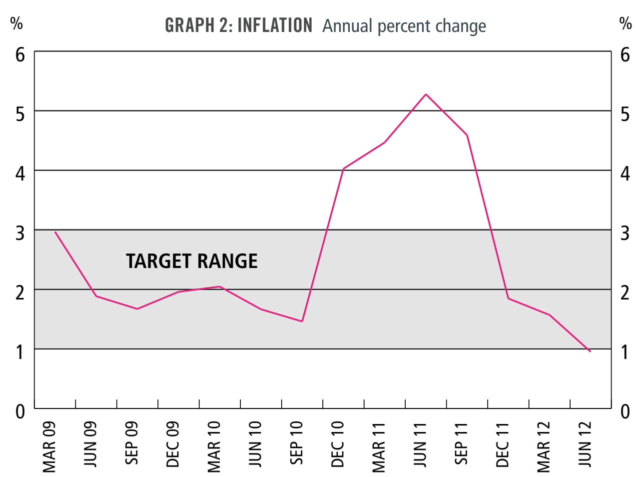
The other important area of uncertainty is the Canterbury earthquake rebuild. Reconstruction following the significant shocks in 2010 and 2011 will result in our nation's largest-ever construction project, requiring considerable amounts of resources. Although widespread reconstruction of houses and other buildings is yet to begin, repairs are occurring. In addition, the development of plans for reconstruction in the central city is a welcome development and is expected to assist with businesses' investment decisions. Households and businesses in the region still face a number of challenges, including a shortage of housing and several complex insurance issues. Furthermore, reconstruction will require an extended period of time. Nevertheless, we have some confidence that we will see construction and economic activity more generally in the region lift over 2012–13.

Construction activity elsewhere in the economy also remains subdued. New Zealand households and firms continue to pay down debt. This has resulted in restrained expenditure on major household purchases and capital investment. Domestic GDP growth has consequently been sluggish: 2.4 percent in the year to March 2012. The recovery from the 2008–09 recession has been markedly slower than previous recoveries.

While this performance may be disappointing in an absolute sense, it remains markedly better than most other OECD countries. There are signs of a recovery in housing market activity, with house sales, prices and residential consents increasing. Climatic conditions in early 2012 were favourable for agriculture, boosting milk production and improving stock condition. Business confidence also points to continued, albeit modest, expansion. The high New Zealand dollar in part reflects this relatively favourable economic performance as international investors seek refuge from renewed recession in Europe.

Given the current outlook for inflation, the Bank believes the level of support provided by the OCR at 2.50 percent remains appropriate and has not changed the OCR over the course of the year.

GRAPH 2: INFLATION Annual percent change



Sources: Statistics New Zealand, Reserve bank New Zealand.

THE OBJECTIVE OF THE MONETARY POLICY FORMULATION FUNCTION IS:

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

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcome

- Stability in the general level of prices.

Initiatives and strategies

- Provide up-to-date, comprehensive analysis of economic events to inform monetary policy deliberations.
- Investigate and understand the economic impacts of the Canterbury earthquakes: the size of recovery expenditure, the near-term negative impacts on economic growth, the ability of the construction sector to meet reconstruction demand, and the impact on household and Crown balance sheets.
- Develop and improve the analytical frameworks used to guide monetary and macro-prudential policies. Improve analysis of the exchange rate, the terms of trade, and wage and price setting.
- Investigate the feasibility of developing flow-of-funds and sectoral financial accounts and balance sheets for New Zealand, in order to provide new statistics on wealth, help improve the quality of existing saving statistics and provide an analytical link between the financial sector and the real economy.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- Reserve Bank forecasts of CPI inflation should be comfortably within the target range in the second half of our forecast horizon.
- 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* assess the Bank's performance in meeting the objectives of the PTA.
- The quality of the *MPSs* attracts net positive comment from monetary policy experts.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

Monetary policy formulation has focused on ensuring price stability while avoiding undue volatility in output, interest rates and the exchange rate. As part of that focus, the Bank has devoted considerable attention to understanding the economic consequences of the earthquakes in Canterbury. In addition, the Bank is carrying out research on how economic relationships may have changed following the global financial crisis.

More data has become available to aid our understanding of the magnitude of the damage caused by the earthquakes in Canterbury and the actions that need to take place before the reconstruction can start in earnest. The Bank meets regularly with interested parties to help improve its understanding of the likely timing and economic impact of the rebuild. This information is incorporated into the regular internal policy discussions and has been communicated externally via speeches and publications.

In forming its judgement of the current economic environment, the Bank used its contacts with other central banks and international institutions to gain better insight into developments in the international environment. This has been supplemented domestically by the regular quarterly meetings with businesses across the country.

The Bank's research programme has concentrated on understanding how economic relationships may have changed since the global financial crisis. The results to date of this research have been presented to conferences both domestically and internationally. In addition, the Bank hosted a workshop on macroeconomic policy post-crisis. Published *Discussion Papers* over the past year include: investigations of how the effectiveness of monetary policy can be affected by the financial sector, the implications of the zero lower bound for interest rates, and using data-driven models for forecasting.

The Bank introduced a new publication series that aims to communicate the background papers prepared by Bank staff on topical issues to a wider audience. The first of these *Analytical Notes* studied the impact of the Rugby World Cup. The most recent *Analytical Notes* studied the drivers of the exchange rate and the outcomes of recent international currency interventions. These latter *Notes* form part of the Bank's continuing research into understanding the exchange rate.

The Bank's multi-department work on analytical frameworks used to guide monetary and macro-prudential policies is described elsewhere in this *Annual Report* (see page 28).

The Bank, with support from Statistics New Zealand, has investigated the feasibility of producing sectoral financial accounts and flow-of-funds tables for the New Zealand economy. These accounts would provide additional information on saving by the different sectors of the economy, including households and businesses. The accounts would also show the financial exposures of each sector relative to other sectors, including the rest of the world. This is often summarised as 'who borrows from whom'.

The Bank's initial work tentatively concluded that it would be possible to produce accounts for annual periods. Recently, the Bank has been working on its own data to produce balance sheets for the central bank and for registered banks in the necessary format. The Bank plans to work with Statistics New Zealand to try and produce robust data for the remainder of the financial sector. This would be a significant step towards producing a full set of national financial accounts and flow-of-funds tables.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

The *MPS* is the full assessment and accountability document for our monetary policy key performance indicators.

The October 2010 increase in GST affected the headline rate of CPI inflation through the early part of the year. Headline annual CPI inflation fell once this increase dropped out of the annual rate, reaching 1.0 percent in the year to June 2012. Excluding the GST increase, the margin of spare capacity in the economy has helped contain non-tradable inflation. In addition, the elevated level of the New Zealand dollar has made imports cheaper and put downward pressure on tradable inflation.

Inflation expectations appear anchored within the Bank's target range. Underlying measures of inflation remained effectively within the band throughout the past year, despite the GST-driven breach by CPI headline inflation. This anchoring of expectations has translated through to wage claims, which remain contained.

As the impulse from the Canterbury rebuild and house-building activity more generally lifts economic activity in the domestic economy, CPI inflation is forecast to increase towards the centre of the target band over the medium term.

The Bank's judgement of economic conditions and the level of inflationary pressure within the economy is set out in the *MPS*, which is published every three months. The four *Statements* published over the past year have attracted positive external commentary, notably around the clarity with which the Bank has explained its assessment.

FINANCIAL MARKETS

DOMESTIC MARKETS
FOREIGN RESERVES MANAGEMENT

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

We have commenced a key initiative to review the Reserve Bank's domestic market operations. It is expected that final recommendations will be considered and implemented from late 2012. The review has already considered the types of securities that we accept in our various operations and the changes to global prudential liquidity standards under Basel III.

The Reserve Bank actively participated in encouraging the creation of the Local Government Funding Authority (LGFA) as part of an initiative to benefit the development of New Zealand debt capital markets. Legislation enabling the formation of the LGFA was passed in late 2011 and the Authority commenced issuing debt on behalf of local authorities in February 2012. To date, the LGFA has conducted four bond tenders since it commenced operations, issuing $835 million of securities.

Progress has been made on developing a benchmarking framework for the Foreign Reserves portfolios. Development has included a revision of the Bank's strategic allocation of foreign reserve assets across high-grade markets. As is the practice of other central banks, asset allocation modelling is subject to a range of constraints placed on diversification and liquidity to ensure reserves meet stringent credit and market risk criteria. Benchmarks in this context are necessary to facilitate performance measurement of the Foreign Reserves function versus the constrained strategic asset allocation as well as alternative allocation possibilities.

The Reserve Bank operates regularly in the financial markets to implement monetary policy, to manage the New Zealand government's foreign reserves and to ensure an adequate level of liquidity in the banking system.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

DOMESTIC MARKETS

It was expected that the 2011–12 year would see a gradual return to more normal market conditions. However, with the deterioration of financial conditions in Europe, this was not the case. Short-term interest rates were relatively volatile over 2011–12 (see Graph 3). The effective implied interest rates in the forward foreign exchange market were especially volatile. This was due to an oversupply of US dollars combined with exchange rate volatility.

Our Domestic Markets team made use of the range of liquidity tools at their disposal to ensure that short-term money market rates were maintained at levels consistent with the OCR.

Across the financial system, demand for settlement cash was relatively muted, averaging about $7.2 billion through the year, the same as in 2010–11. This was despite an anticipated increase in demand for settlement cash with the implementation of the Settlement Before Interchange (SBI) process for retail payments. The extra demand for liquidity, as a result of the introduction of SBI, appears to have been met from an increase in very short-term interbank borrowing and lending, which has risen from a daily average of about $400 million to $1,200 million.

In part due to the Reserve Bank's prudential liquidity policy, the banks have significantly increased their holdings of New Zealand government securities. These securities have been used as collateral in the interbank borrowing market and have placed the banks in a far stronger liquidity position than at any time in the past decade or so.

The Reserve Bank's balance sheet was relatively volatile over the year with the Crown holding more cash in the run-up to bond maturities. As

THE OBJECTIVES OF THE DOMESTIC MARKETS AND FOREIGN RESERVES MANAGEMENT FUNCTIONS ARE TO:

- Support the effective implementation of monetary policy.
- Assist in the efficient functioning of the New Zealand financial system.
- Manage official foreign reserves.
- Provide effective support and execution for the Bank's foreign exchange market intervention policy.
- Manage the Crown's financial liquidity.
- Maintain an effective crisis intervention capability.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcomes

- 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.

Initiatives and strategies

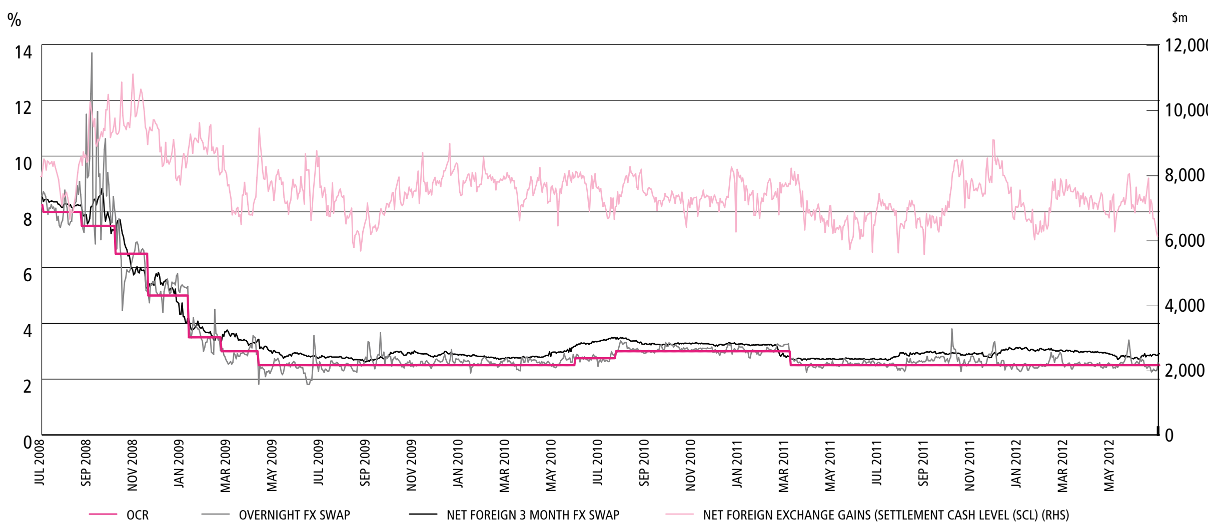
- Initiate a review of the Reserve Bank's liquidity facilities and eligible collateral categories such that facilities can meet the financial system's needs in the new Basel III environment.
- Implement the recent review of foreign reserves asset allocation and management approach, including the implementation of independent benchmarks for the foreign reserves assets.
- Promote the development of capital markets in areas where the Bank has powers and responsibilities (i.e., in money, bond and foreign exchange markets).

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- Short-term wholesale interest rates should be relatively stable and maintained at levels consistent with the OCR.
- There is no evidence of payment failures due to shortage of cash in the banking system.
- Domestic market operations are expected over the medium term to generate a positive return for the Domestic Markets function, as an indicator that operations are running effectively.
- Foreign reserves are held at the level agreed with the Minister.
- Foreign reserves are held in a liquid and secure form, suitable for foreign exchange market intervention.
- The Foreign Reserves Management portfolio is managed efficiently; yielding a net return that meets or exceeds that of its benchmark.

GRAPH 3: OCR vs KEY MARKET RATES AND THE SETTLEMENT CASH LEVEL



a result, the Reserve Bank's balance sheet expanded until the maturity of the November 2011 government bond. Since then, the Crown has been accumulating cash in preparation for the maturity of the April 2013 bond.

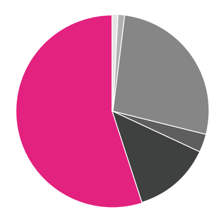
FOREIGN RESERVES MANAGEMENT

As with the 2010–11 financial year, our foreign reserves management team has faced the challenge of maintaining a highly liquid, high quality, foreign reserves portfolio in a low interest rate environment. This task has been made more complex by the overall market volatility posed by the ongoing European sovereign debt crisis.

The Reserve Bank's portfolio will continue to be dominated by holdings of short-term government and near-government securities of the highest credit quality and liquidity, albeit with the yields on these types of investments remaining at historically low levels.

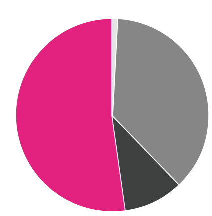
As the sovereign fiscal situation deteriorated in several euro-zone countries and a number of agencies and supranational entities were downgraded, we diversified the foreign reserves portfolio across currencies (see graphs 4 and 5) and types of assets. We significantly increased the levels of government securities and cash, in place of supranational, agency debt and other investments.

Over the last year, we have incurred reported net cost in holding foreign reserves. This is due to the Bank's unhedged FX position and related overall strengthening of the NZD, as well as global interest rate movements, which have resulted in accounting valuation losses for the long-term financial instruments which are used to fund most of our foreign reserves. The Bank's unhedged foreign reserves position was maintained throughout the year at approximately SDR1.1 billion, modestly above the long-term benchmark of SDR1.0 billion. During the coming financial year we will implement an assessment of foreign reserves management performance against benchmarks.



GRAPH 4: PERCENTAGE OF HOLDINGS BY CURRENCY AS AT 30 JUNE 2012[14]

USD 55%
EUR 27%
OTHER 1%
GBP 3%
CAD 1%
JPY 13%

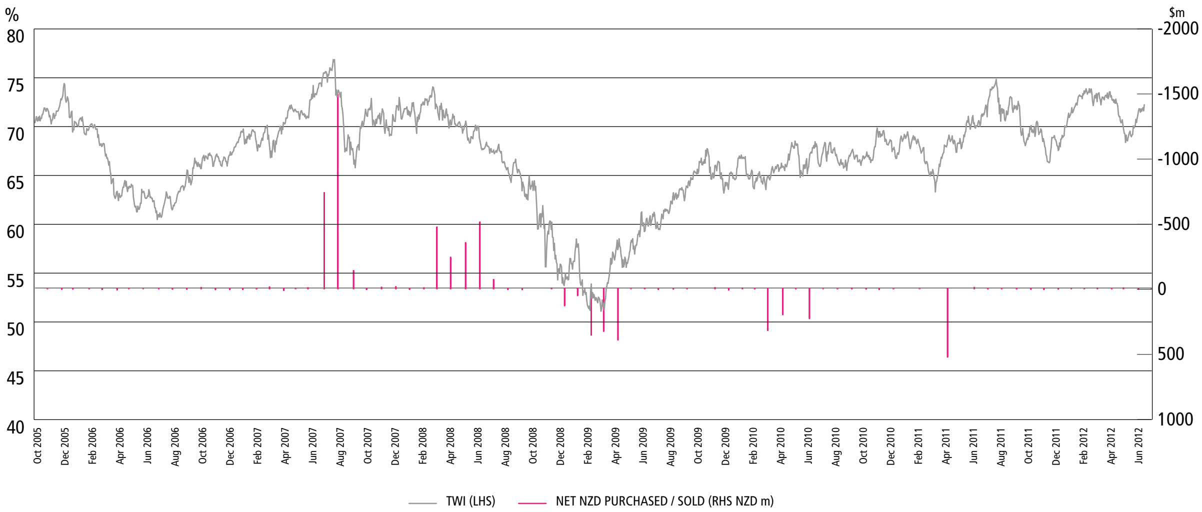


GRAPH 5: PERCENTAGE OF HOLDINGS BY CURRENCY AS AT 30 JUNE 2011

USD 52%
EUR 37%
OTHER 1%
JPY 10%

14. Graphs 4 and 5 show the currencies in which foreign reserve assets are denominated. This differs from the net foreign currency exposure by currency on page 85, because the net exposures also take into account foreign currency liabilities and foreign currency swap transactions.

GRAPH 6: TWI vs RBNZ NZD TRANSACTIONS



MACRO-FINANCIAL STABILITY

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Bank has created an internal report monitoring indicators of potential financial imbalances in the economy. The report is considered quarterly by the Bank's Macro-Financial Committee, which draws members from several departments. The messages from this report are summarised in the *FSR*, and the Bank's other external communications.

We have continued our work to understand how macro-prudential tools can influence the credit cycle and help build resilience in the face of a credit market downturn. We have also been considering the framework under which such tools might be deployed, including arrangements for their governance and accountability. This work has been undertaken in conjunction with the Treasury.

We have undertaken public consultation on changes to capital requirements as part of proposed changes under Basel III, which include arrangements for a macro-prudential counter-cyclical capital buffer. We have outlined four macro-prudential tools in speeches and the *FSR* that we would consider using if future credit conditions were to warrant doing so. The Bank's decision to delay the increase in the core funding ratio for banks from 70 percent of loans and advances to 75 percent from June 2012 to 1 January 2013 partly reflected macro-prudential consider-ations and prompted further work on the dynamic operation of the core-funding ratio through time.

We have continued to keep abreast of international developments in macro-prudential policy, which is a fast-moving area. In December, we hosted a conference where international researchers and Reserve Bank economists presented relevant research.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

Our *FSRs*, which are required under the Reserve Bank of New Zealand Act, assess the performance of New Zealand's financial institutions and payments systems, the risks and vulnerabilities facing the financial system and the measures we are taking to help promote its soundness and efficiency.

Recent *FSRs* have devoted considerable attention to the developing European sovereign debt crisis and its implications for the New Zealand financial system. We have also considered the state of local lending markets. While New Zealand financial institutions appear willing to lend, terms and conditions for the supply of credit appear to be tighter than prior to the global financial crisis, partly reflecting conditions in global credit markets, from which our banks source much of their funding requirements. Our *FSRs* have also reported on a range of prudential and macro-prudential policy initiatives, including most of the developments covered under the Prudential Supervision outcome.

In a survey of readers conducted following our May 2012 *FSR*, responses about its success in reporting on the soundness and efficiency of the financial system were generally favourable. A majority of readers felt the *FSR* is informative, sufficiently in-depth and relevant to the interests of most readers. We are currently considering suggestions for improvement.

THE OBJECTIVE OF THE MACRO-FINANCIAL STABILITY FUNCTION IS:

- To promote a sound and efficient financial system that facilitates the effective performance of the economy by:
  - analysing and reporting on the soundness and efficiency of the financial system; and
  - where possible, reducing or managing risks to the financial system arising from extremes in the credit cycle or developments in liquidity conditions and global funding markets.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcomes

- A sound and efficient financial system that supports the functioning of the economy

Initiatives and strategies

- Continue research into the effectiveness of macro-prudential instruments identified as having a potential role to play in New Zealand.
- Develop an implementation framework for macro-prudential policy tools in New Zealand, including a system of indicators of financial risks and imbalances.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- The Bank maintains, publishes and monitors a comprehensive set of indicators to assess risks and imbalances in the financial system.
- Any measures taken to reduce financial system risks, including the use of macro-prudential instruments, are explained and assessed in the *FSR* and their net benefits for financial system stability are demonstrated.
- The quality of the *FSRs* attracts net positive comment from financial system experts.

PRUDENTIAL SUPERVISION

FINANCIAL SYSTEM ENVIRONMENT

Financial institutions remain exposed to global financial instability and New Zealand's sluggish economic recovery, with households and businesses focused on reducing high levels of debt. Housing market activity continues to improve gradually after a sustained period of weakness.

Nevertheless, the New Zealand banking sector remains well capitalised and continues to perform well. Non-performing loans have begun to edge down, consistent with the gradual recovery. With credit growth modest, banks have been able to maintain adequate levels of funding through a combination of increased household deposits, and through access to international debt markets during periods of reduced global market stress. Accordingly, the Reserve Bank has confirmed its intention to increase the minimum core funding ratio from 70 percent to 75 percent from 1 January 2013, after initially delaying the rise from June 2012.

The NBDT sector has reduced in size in the wake of the finance company failures that have occurred in recent years. The bulk of the failures were in the deposit-taking finance company sector, and the sector's share of total non-bank assets has fallen significantly over the past four years. However, some parts of the non-bank sector have experienced stronger trading conditions and have fared relatively well.

The insurance sector remains sound. Reinsurance cover remains high. Capital buffers held by non-life insurers have absorbed retained losses arising from the Canterbury earthquakes, as well as the additional reinsurance premiums required to reinstate cover or purchase further cover. The Insurance (Prudential Supervision) Act 2010 required all insurers carrying on insurance business in New Zealand to be provisionally (or fully) licensed by 7 March 2012 and includes a transitional period to 7 September 2013 to phase in the insurance prudential regime.

New Zealand's financial market infrastructure continues to operate effectively. The Settlement Before Interchange arrangements have been fully operational since late February 2012, and are designed to reduce settlement risk in the retail payment system. Implementation of the new arrangements has generally worked well. One significant disruption tested the industry's preparedness for disruptions under the new arrangements, and the Reserve Bank and industry have been thoroughly reviewing this incident to ensure the necessary measures are taken to minimise risks to financial stability.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Reserve Bank is proposing to collect additional prudential data from registered banks to enhance its monitoring and analysis of risks to bank balance sheets and profitability. As part of our Banking Data Strategy project, the Bank is keen, subject to consultation, to enhance prudential data collection before the end of this year.

The Reserve Bank has received acceptable Implementation Plans from the banks required to pre-position for the Open Bank Resolution policy, and is working closely with the banks in question.

The Non-bank Deposit Takers Bill has passed through Select Committee and is expected to pass into law in 2012. The Reserve Bank is required to complete a review of the regime by September 2013, and now intends undertaking that review in 2013, to enable further experience with the sector – including the licensing process – to be factored into our analysis.

The Reserve Bank has made good progress on the development of Basel III capital requirements, with final requirements being put in place in 2012, and industry expected to comply with the core requirements from the beginning of next year. Quantitative liquidity requirements that are in substance the same as Basel III liquidity requirements are already in place for locally incorporated banks (see also page 26 for the impact on the interbank borrowing market).

The Reserve Bank has continued to refine its crisis preparedness, and has worked closely with New Zealand and Australian financial authorities to enhance the effectiveness of multi-agency coordination in a crisis.

Since the passage of the Insurance (Prudential Supervision) Act 2010, good progress has been made on the supervisory framework, including the issuing of five solvency standards that cover different sectors within the insurance industry. The Reserve Bank has also issued further guidelines for licensed insurers.

THE OBJECTIVES OF THE PRUDENTIAL SUPERVISION FUNCTION ARE:

- To register and supervise banks so as to promote the maintenance of a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.
- To regulate non-bank deposit takers (NBDTs) and to regulate and supervise the insurance sector. This will be done in a manner that will be relevant to New Zealand and that delivers a cost-effective balance between regulatory requirements and self- and market-discipline.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcomes

- A sound and efficient financial system in New Zealand.
- International and local confidence in New Zealand's financial system.

Initiatives and strategies

- Enhance the Bank's monitoring of risks to bank balance sheets and profitability.
- Consult with banks on pre-positioning for the Open Bank Resolution initiative, and work towards full implementation.
- Continue implementing regulations for the NBDT sector, and review the effectiveness of these by the end of 2012.
- Implement Basel III capital and liquidity standards, in a way that is fit for New Zealand conditions.
- Refine our crisis preparedness, focusing on trans-Tasman coordination.
- Develop the supervisory framework for the insurance sector.
- Process insurers' provisional and full licence applications so all insurers are licensed by March 2012.
- Develop and implement the AML/CFT supervisory regime.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- The bank, 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.
- The prudential oversight function for banks, NBDTs, insurance companies and payment systems: shows vigilance in its monitoring activities; is capable of identifying emerging financial stresses; and is prepared to effectively resolve institutional failures in conjunction with government.
- The Bank demonstrates a consultative and transparent approach to its supervision of the financial system, supported by robust analysis that is accepted by supervised institutions and stakeholders.
- Develop and implement the new data collections required to fulfil the Bank's regulatory responsibilities.

All insurers who required a licence were licensed by March 2012. As at 7 March 2012, the Bank had issued 99 provisional licences, four 'run-off' licences and three full licences. One 'run-off' licence was cancelled before 7 March 2012. Three insurers that required licences were unlicensed at 7 March 2012 – two insurers received licences later in March 2012 and one insurer was exempted from the prudential regime in April 2012. Some insurers, covering a very small proportion of the industry, ceased operation and so did not require a licence.

The Reserve Bank has begun engaging with the entities that it will be supervising under the Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act. This will continue in the lead-up to the AML/CFT regime coming into force on 30 June 2013, in order to help entities understand both their obligations and the Bank's expectations.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

The regulatory changes implemented during the year for the bank, NBDT and insurance regulatory regimes were carried out in a manner that promotes the soundness and efficiency of the financial system in a cost-effective manner. The regulatory regimes mitigate risk within each sector, while keeping compliance costs as low as possible.

The Reserve Bank continues to exercise prudential oversight of banks, NBDTs, insurance companies and payment systems to provide early warning of emerging financial stresses. The Bank has worked effectively with government to resolve issues at institutions, particularly following the Canterbury earthquakes.

The Reserve Bank has maintained a high degree of active engagement with registered banks and stakeholders throughout the year. The Bank continues to emphasise the importance of a consultative and transparent approach to its supervision – as illustrated on our website – in order to encourage wide acceptance of a robust framework of rules.

An extensive review of the Reserve Bank's data requirements was conducted in the first phase of the Banking Data Strategy project. This made clear that major gains in efficiency and a lower collection burden would be achieved by integrating the collection of prudential data from banks with data collected for statistical purposes. Accordingly, a high-level consultation paper aimed at banks and other users of Bank prudential and statistical data was published, with submissions closing on 29 June 2012. Following consideration of submissions and further consultation with banks, the collection of enhanced prudential data will be implemented later this year as the first phase of the integrated multi-year Banking Data Strategy project.

CURRENCY OPERATIONS

The Bank meets the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand bank notes and coins, as well as maintaining the quality, and verifying the authenticity, of currency in circulation.

Cash remains an important means of undertaking transactions in New Zealand. The value of currency in circulation grew by 4.9 percent to $4.37 billion in the year to 30 June 2012. Over the 10 years to June 2012, currency in the hands of the public rose by 59 percent.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The new management information system has been used to improve the electronic tracking of currency through note-processing operations, enhance security and upgrade reporting capabilities.

The Bank completed the planning phase of the new banknote series project, and subsequently announced its start publicly. The Bank has established frameworks for the selection of security features, substrate, and the providers of design and print services. Further, the Bank issued a request for information as the first step in the procurement process. The Bank is continually liaising with relevant external stakeholders to ensure technical requirements are considered during the design phase.

The Bank issued 2.4 million new $5 banknotes to two cash-in-transit companies, as part of a 'Five Dollar Swap Programme'. The objective was to improve the quality of $5 banknotes in circulation, given that they are used more frequently for change than other note denominations. The

THE OBJECTIVE OF THE CURRENCY FUNCTION IS:

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

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcomes

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

Initiatives and strategies

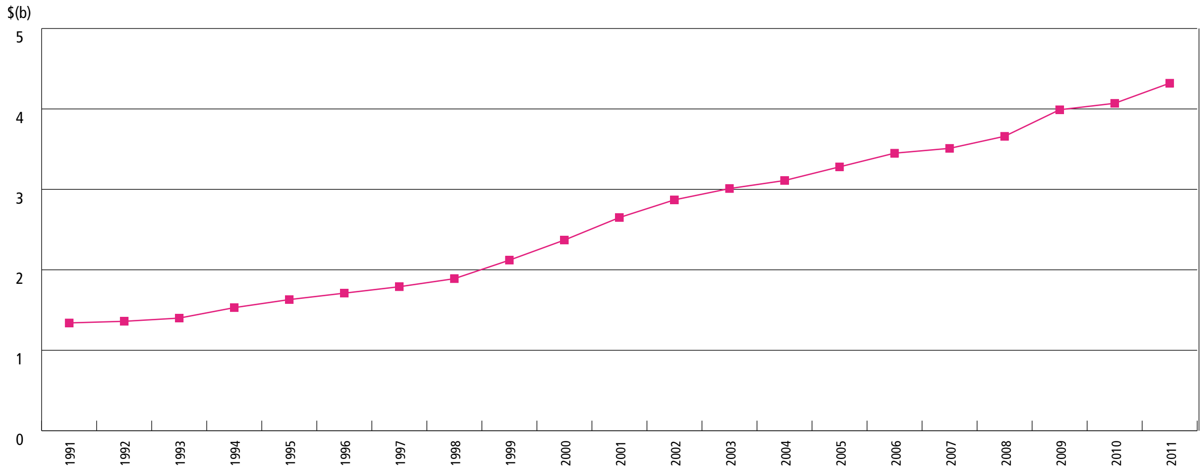
- Further develop and fully utilise the new information management system for the management of currency operations.
- Undertake planning for the development of a new bank note series.
- Lift the quality of $5 notes in circulation through a 'swap' programme.
- Review the levels and location of currency reserves held for contingency purposes.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- 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.

GRAPH 7: CURRENCY IN CIRCULATION (ANNUAL AVERAGES)



two companies issued the new notes to their customers and returned used notes to the Bank, where they were sorted by quality and all unfit notes destroyed.

The Bank completed a review of the level of currency reserves, and is undertaking a review of possible secondary locations.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

During 2011–12, the Reserve Bank received 1,109 orders for currency for a total value of $1,870 million. The Bank met all these orders on schedule and in the denominations requested. This helped ensure that the public's needs for currency were met during the year.

A survey of the general public indicated that most people were happy with the design and quality of New Zealand bank notes, except for the quality of $5 notes in circulation.

The number of counterfeit banknotes in New Zealand is low by international standards. In 2011–12, there were 134 counterfeits found in circulation by the Reserve Bank, cash-in-transit companies, banks and the Police. This represented 1.0 counterfeits per million notes in circulation. This was a decline below the rate of 3.4 recorded in 2010–11 and was well below the upper limit of 10 specified in the key performance indicator.

SETTLEMENT SERVICES

SETTLEMENT ACTIVITY

The Bank provides specialised financial services, mainly to financial institutions. These services comprise operation of the Exchange Settlement Account System (ESAS) and operation of the NZClear securities settlement system.

Most major financial institutions have a New Zealand dollar cash account with the Reserve Bank. These are known as exchange settlement accounts, and those financial institutions use those accounts, which comprise the ESAS system, to make payments to each other in real time. ESAS is a designated payment system under the Reserve Bank Act. Once a payment has been processed in ESAS, it cannot be reversed. This provides certainty to the recipients of those payments, which is very important given that in excess of $25 billion is paid through this system each day.

One of the account holders in ESAS is Continuous Linked Settlement Bank (CLS). CLS is an international institution that processes the majority of foreign exchange payments made in major economies. By making payments through CLS, financial institutions can achieve simultaneous settlement of both legs of foreign exchange transactions. When the CLS service is used, it eliminates settlement risk for foreign exchange transactions – the risk that one party makes a payment to purchase one currency, but the other party fails to meet its obligation to pay the other currency.

The NZClear service allows buyers and sellers of securities to settle transactions efficiently and securely. The system provides for buyers of New Zealand dollar-denominated equities and bonds to receive those securities at the same time as payment of cash is made for those purchases. Each transaction is settled individually – there is no netting of obligations. NZClear also allows financial institutions to make payments of cash to each other. Once a settlement is effected in NZClear, the NZClear Rules provide that the settlement may not be reversed. The Bank administers securities on behalf of members of the NZClear system, with a value totalling more than $160 billion, and each day settlements with a value totalling more than $8 billion are made by members of NZClear.

ESAS and NZClear, together with CLS, provide certainty to financial institutions in processing their high-value transactions, which is particularly important during periods of financial instability.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

Under the Reserve Bank Act, settlement systems are able to apply to become designated. Designation provides statutory backing to the rules of the settlement system and provides additional legal certainty to settlements effected through those systems. As noted above, ESAS is a designated settlement system. The Bank has made an application for NZClear to be a designated settlement system. The application has been going through the final stages of the approval process.

The Bank has added a new interface to ESAS to allow banks to effect the inter-bank settlement of retail transactions. The new interface is called Settlement Before Interchange (SBI) and, after a testing phase, this commenced full operation in February this year. This development allows SBI participants to settle the value of retail transactions at regular intervals each day and update their customers' records. Previously, customer records were updated once each day, generally overnight, with interbank settlement early the following morning. SBI increases certainty and reduces the risks to the financial system and other participants when an institution experiences financial difficulties.

Over the last year we undertook a major project to replace the hardware for the payment systems. With this hardware upgrade, the ESAS and NZClear systems are more resilient because there are more computer environments that act as back-up in the event of a major system failure or environmental disruption.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

Tables 2–4 set out key statistics for the operation of ESAS and NZClear.

With the introduction of SBI the number of transactions passing through ESAS each day has increased, although the daily average value of all transactions passing through ESAS has declined. This decline reflects reduced New Zealand dollar dealing activity by financial institutions. Transaction volumes passing through NZClear have increased markedly, reflecting higher volumes of equities traded across the New Zealand stock exchange during the year.

The system was available to users 99.94 percent of core hours, narrowly under the target of 99.95 percent. No major system disruptions occurred during the year.

In the annual customer survey, users of ESAS and NZClear have continued to report very high levels of satisfaction. In 2012, the satisfaction rating was 100 percent (2011: 100 percent).

On the Auditor-General's behalf, PricewaterhouseCoopers undertakes reviews of the NZClear system. Under the NZClear Rules, the external auditor performs an audit of the internal controls for NZClear once each year, and each quarter PricewaterhouseCoopers performs a review of the Bank's securities reconciliation processes for NZClear. Also once each year, the auditor performs an external audit of the internal controls for ESAS. All external audit reports are reviewed by the Bank's Audit Committee. All opinions expressed by PricewaterhouseCoopers were unqualified. Improvements designed to enhance the management of risk associated with operating these systems are made on a regular basis.

The Bank will complete a formal assessment of compliance with new international standards for payments and settlements systems over the next financial year and this will be published on the Bank's website.

THE OBJECTIVE OF THE SETTLEMENT SERVICES FUNCTION IS:

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

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Outcome

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

Initiatives and strategies

- Continue to enhance NZClear and ESAS as agreed with industry.
- Complete establishment of the Bank's Auckland office and its disaster recovery capability.
- Implement Settlement Before Interchange functionality within ESAS to replace the retail settlement function performed by ISL, so reducing payment settlement risk.
- Working together with NZX Limited via a joint industry council to improve the operation of New Zealand's clearing and settlement infrastructure.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

Key performance indicators

- Availability of ESAS/NZClear during core hours is at least 99.95 percent, 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 quarterly 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.

KEY ESAS STATISTICS

	2008	2009	2010	2011	**2012**
Average daily transaction volumes	7,024	7,156	6,929	7,383	**8,518**
Average daily transaction values	$38.9bn	$36.8bn	$28.6bn	$26.6bn	**$25.1 bn**

Table 2

KEY NZCLEAR STATISTICS

	2008	2009	2010	2011	**2012**
Average daily transaction volumes	1,119	973	899	854	**963**
Average daily transaction values	$6.3 bn	$6.8 bn	$7.0 bn	$7.6 bn	**$8.9 bn**

Table 3

KEY ESAS–NZCLEAR STATISTICS

	2008	2009	2010	2011	**2012**
ESAS–NZClear System availability during core hours	99.23%	99.77%	99.93%	99.91%	**99.94%**

Table 4

HUMAN RESOURCE STATISTICS[15]

	2007	2008	2009	2010	2011	**2012**
Total staff at 30 June (FTE)	221	223	237	243	250	**250**
Average years of service at 30 June	7.4	7.6	7.6	7.9	8.0	**8.8**
Annual staff turnover	12.3%	17.4%	9.3%	12.5%	12.4%	**13.7%**

HUMAN RESOURCES

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The development of staff is critical to the performance of the Bank, particularly during times of growth and change. Hiring, development and retention strategies are all aimed at retaining and developing highly skilled people. Once people enter the Bank, their skills are enhanced through training, courses and special assignments. These factors are routinely rated highly in the biennial staff satisfaction surveys. The 2011 survey was no exception, with training and development being rated positively, along with the quality of leadership. Overall, the staff satisfaction rating in 2011 continued to be above average when compared with benchmarked organisations.

Leadership development remains a high priority for the Bank. During the year managers attended both individually targeted and Bank-centralised developmental training, while potential leaders participated in programmes aimed at preparing them for management roles.

The online performance management system has been in use for a full 12 months and all staff have had the opportunity to discuss their development with their manager. This has fed into the central training programme and the Bank key-role risk planning.

The Bank's business continuity office in Auckland has now been running for 18 months. The teams link virtually to Wellington through video and desktop technology and work side by side with their colleagues in the key areas of financial markets, treasury accounting, settlements and systems support. There is an ongoing testing programme to provide assurance that the Auckland office can maintain critical operations in the event of a major disruption in Wellington.

REMUNERATION

STAFF

The Reserve Bank spent $28 million on personnel in 2011–12. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 6 shows the number of staff who received over $100,000 in total remuneration[16], in bands of $10,000.

NON-EXECUTIVE DIRECTORS' REMUNERATION

Non-executive directors' remuneration consists of directors' fees. Directors' fees represent consideration for services provided to the Bank for acting as directors of the Bank. Certain non-executive directors receive additional remuneration due to their involvement in Board committees or special review tasks. All remuneration paid to non-executive directors is included in the following table. There are no fees paid to the Governor, who is an executive director of the Bank and is remunerated by way of salary.

15. Increased staff numbers in 2009 and 2010 were due to expanded Prudential Supervision functions. The 2011 increase relates mostly to the establishment of Auckland office.
16. Total remuneration includes the annual cost to the Reserve Bank of all elements of contracted remuneration (salaries, any benefits provided, fringe benefit tax, superannuation), plus any bonuses or redundancy payments. The information in Table 6 sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Minister of Finance following a recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governor. The Bank's remuneration policy is to pay all staff on the basis of performance on the job, while having regard to prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.

REMUNERATION IN 2011–12

Total remuneration	Staff numbers
100,000 to 109,999	16
110,000 to 119,999	19
120,000 to 129,999	9
130,000 to 139,999	6
140,000 to 149,999	7
150,000 to 159,999	9
160,000 to 169,999	10
170,000 to 179,999	2
180,000 to 189,999	7
190,000 to 199,999	2
210,000 to 219,999	2
240,000 to 249,999	2
280,000 to 289,999	3
290,000 to 299,999	1
320,000 to 329,999	1
350,000 to 359,999	1
410,000 to 419,999	1
600,000 to 609,999	1
Total staff receiving $100,000 or more	**99**

Table 6

NON-EXECUTIVE DIRECTORS' REMUNERATION

Non-executive directors	2011 $	**2012 $**
A Grimes (Chairman)	51,000	**51,000**
C Eichbaum	27,500	**27,500**
H Fletcher (Deputy Chair)	37,875	**35,690**
S Sheldon (Deputy Chair)	27,500	**27,870**
K Taylor	27,500	**27,730**
K Vautier	27,500	**27,500**
N Quigley	31,500	**31,500**
TOTAL	230,375	**228,790**

- The term of appointment for Hugh Fletcher expired on 9 June 2012.
- Sue Sheldon replaced Hugh Fletcher as Deputy Chair of the Board from 10 June 2012 at the expiry of the term for Hugh Fletcher.
- Keith Taylor replaced Hugh Fletcher as Chair of the Audit Committee from 10 June 2012 at the expiry of the term for Hugh Fletcher.

Table 7

INSURANCE AND INDEMNITY ARRANGEMENT

Section 179 of the Reserve Bank Act provides that every officer, employee or director of the Bank is not personally liable for acts done or omitted to be done in the exercise or performance in good faith of that person's functions, duties or powers under the Act. Under section 179A of the Act, the Crown provides an indemnity to every officer, employee or director of the Bank and certain other persons for any liability arising as a result of exercising or failing to exercise any power conferred under the Act, unless the exercise or failure to exercise the power was in bad faith.

The Bank also provides income protection insurance to specified senior executives, and for other staff it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

KNOWLEDGE SERVICES

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

Over the past year our technology strategy has ensured Knowledge Services supports evolving business projects. In particular, this has included the development of the Bank Organisation Relationship Information System to support the new prudential supervision framework, and supporting implementation of a new asset and performance benchmarking framework for foreign reserves.

Knowledge Services also provided support for the introduction of Settlement Before Interchange for the payments systems, and refresh of the NZClear/ESAS hardware to improve resilience and maintain continuity of support. Work continued on the implementation and development of the Financial Sector Information System, and IT security monitoring and awareness. Business continuity planning and monitoring continues to be a focus across the Bank.

The Bank continues to invest in its infrastructure in order to reduce costs, standardise processes, streamline workflows and automate manual tasks.

INTERNAL FINANCIAL SERVICES

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Bank's Financial Services Group is responsible for financial control of the Bank's activities. Financial Services Group processes transactions for the Bank's foreign reserves and liquidity management operations, as well as providing transactional services for other Bank functions. The group also provides management and financial reporting, and internal accounting services, such as compliance reporting against limits, expenditure control reports and planning and budgeting services.

The Bank's core treasury system continued to be enhanced, and changes were made to the reporting infrastructure required to implement benchmarking of performance of the foreign reserves management function. Actual reporting against the benchmark will commence in the 2012–13 year and further reporting and workflow enhancements will continue to be made during that period.

The Bank implemented a new financial management information system, which commenced operation on 1 July 2011. Budget and forecasting functionality was added to the core system during the year and several legacy systems were retired. The new system improved reporting and internal control.

THE OBJECTIVE OF KNOWLEDGE SERVICES IS:

- To provide core technology and information platforms that give a high level of uninterrupted service in a secure environment.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Initiatives and strategies

- In conjunction with the Bank's Financial Services Group, provide a system to give effect to changes to foreign reserves asset management.[17]
- Continue the implementation of the Financial Sector Information System project integrating the Bank's statistical data.
- Implement a common platform to support supervisory functions across the insurance, NBDT and banking sectors, and for our role across these sectors in AML and CFT.
- Develop systems to make the management of the IT environment more efficient.
- Ensure the Bank's IT security systems are maintained at industry best practice and are capable to respond to an increasing threat from external sources.
- Enhance the electronic delivery of information to the Bank through collaborative tools.
- Improve management and archival processes around document, email, network drive files and physical records in accordance with the Public Records Act.
- Develop museum services as part of a wider public education programme.
- Enhance the Bank's business continuity infrastructure for critical functions.

THE OBJECTIVE OF INTERNAL FINANCIAL SERVICES IS:

- To provide financial control for the Bank's activities. Services provided include financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Initiatives and strategies

- Continue to enhance workflows, reports, and processes for financial operations, currency operations and securities transactions.
- In conjunction with the Bank's Knowledge Services Group, revise reporting for financial market operations to give effect to portfolio management changes, including implementing a new asset allocation and performance benchmarking framework.
- Replace the Bank's own financial management information system during 2011.

17. See Initiatives in Foreign Reserves Management (pages 26–27) and Internal Financial Services (this page).

COMMUNICATIONS

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Communications department provides strategic and operational support for the Bank's public and internal relationships. It supports the Bank's Communications Committee, policy committees, and special projects – such as the new Series 7 banknotes – with advice on external communications strategies and activities. It provides internal communications strategic advice and services, as well as editorial and publishing services for all the Bank's online and hard copy publications. The department also manages responses to Official Information Act requests and public inquiries, and provides secretariat services to the Board.

While the Bank communicates through 'set pieces' such as the *MPSs* and *FSRs*, it also communicates frequently through off-the-record speeches, allowing us to explain our activities to general audiences while ensuring markets are not confused by repeated messages.

Prudential responsibilities continue to be a larger part of the Bank's business, and we assisted the communication of supervisory and regulatory developments.

We continued to support our Museum and to sponsor education initiatives, including the Bank's annual 'Monetary Policy Challenge' for senior secondary school students. Teams compete to deliver their own 'Official Cash Rate decision'. The competition was won by Saint Kentigern College (Auckland), ahead of Waikato Diocesan School for Girls (Hamilton) and Havelock North High School.

THE OBJECTIVE OF COMMUNICATIONS IS:

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

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Initiatives and strategies

- Monitor media, maintain communication relationships, and provide timely information and strategies to ensure the Bank's key messages are delivered and understood, and to address credibility risks and opportunities.
- Develop appropriate communication vehicles for the Bank's expanded roles in regulating and supervising non-bank financial institutions, the insurance sector, and AML and CFT.
- Provide and implement a communications strategy for the new Series 7 banknotes.
- Enhance financial literacy through support for relevant programmes.
- Refresh the Internal Communications Strategy with the introduction of new channels and activities.

RISK ASSESSMENT AND ASSURANCE

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Risk Assessment and Assurance unit continued to provide risk-related advice to managers and Governors on the various issues that arose in the operation of the Bank during the year. In addition, an initiative was established for the year ahead to implement a new operating model for risk management and assurance.

The year's internal audit programme was undertaken as planned and issues identified were reported to the appropriate level of management. Further, a refreshed internal audit plan for 2012–13 was developed to provide comprehensive risk-focused coverage of the Bank's control environment.

The annual update of Bank-wide risk maps was undertaken, providing a useful opportunity for management, Governors and the Board to focus on the risks facing the Bank.

The Bank continues to make extensive use of services provided by in-house legal counsel in support of all its functions. In this regard, legal counsel capacity was increased during the year to ensure the function continues to meet demand.

THE OBJECTIVES OF RISK ASSESSMENT AND ASSURANCE ARE:

- To assist in the identification of risk and the maintenance of efficient risk management; to provide assurance over operations, procedures and internal control systems; and to provide legal advice.

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Initiatives and strategies

- Monitor the Bank's approach to risk management, utilising the enterprise-wide risk map.
- Continue a comprehensive internal audit programme to provide assurance on the Bank's control environment.
- Continue to provide quality legal advice.

PROPERTY MANAGEMENT AND SECURITY

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Bank maintains its own building in Wellington. It leases a small office in Auckland. The Bank also manages security operations to ensure it has secure and appropriate accommodation at both sites.

The upgrading of the Bank's passenger lift control system is under way. It is scheduled to be completed early in 2012–13. Ongoing investigations into building energy efficiency initiatives are being undertaken.

The Security Team has maintained the required high level of security, particularly in relation to cash operations, the safe custody of currency reserves and a secure working environment.

Three floors of the Bank building became vacant. Two floors have subsequently been leased to a new tenant, and the remaining floor has undergone a full refurbishment.

The rented accommodation for the Wellington business continuity site was relinquished on 30 November 2011 following the opening of the Auckland office.

THE OBJECTIVE OF THE PROPERTY MANAGEMENT AND SECURITY INTERNAL SERVICE IS:

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

IN OUR 2011–14 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

Initiatives and strategies

- Replace the Bank building's lift control systems and cooling towers.
- Implement cost-effective measures to further enhance energy efficiency.

INTERNATIONAL ACTIVITIES

The Reserve Bank regularly engages with a wide number of international organisations, central banks, prudential regulators and other multilateral organisations in order to further the work of the Bank.

The Bank also continues its engagement with EMEAP (Executive Meeting of East Asia Pacific) central banks and monetary authorities. The BIS (Bank for International Settlements) continues to be an active partner for liaison across macro-prudential, micro-prudential, monetary policy and other central banking issues globally, specifically within the Asia-Pacific region and with attention to the concerns of small open economies like New Zealand. The Bank learns from these engagements, and also promotes New Zealand's interests through a number of direct relationships, including interaction with the IMF constituency office and secondment of Bank staff to the IMF, BIS and other relevant organisations. The Reserve Bank also maintains formal and informal relationships across the global central banking and regulatory communities.

In the South Pacific area, the Bank plays a significant role through its involvement with the South Pacific Governors' annual meeting, collaboration with PFTAC (Pacific Financial and Technical Assistance Centre) and supporting the development of financial capability via the moneyPACIFIC project. This is a financial literacy programme focused on making it easier for Pacific people to be informed about the cost of remittances and other financial products. It is about engaging people, building their awareness about finance, and increasing their ability to make good financial decisions.

GLOSSARY

AML/CFT

Anti-Money Laundering and Countering the Financing of Terrorism

Under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, the Reserve Bank is one of three supervisors tasked with ensuring firms comply with new obligations designed to help deter and detect money laundering and terrorist financing.

BASEL III

New global regulatory standards on bank capital adequacy and liquidity, published by the Basel Committee on Banking Supervision in December 2012.

BIS

Bank for International Settlements

An international financial institution based in Switzerland, owned by about 50 central banks and providing a range of financial services to central banks, international financial institutions and governments.

CFR

Core Funding Ratio

The ratio of a registered bank's total core funding to its total loans and advances. Core funding is the sum of all funding with more than one year remaining to maturity, plus varying percentages of shorter-term funding.

CLS

Continuous Linked Settlement

An international system run by CLS Bank International aimed at reducing foreign exchange settlement risk (Herstatt risk). CLS does this by providing for payment of both currencies in a foreign exchange transaction to be made simultaneously and irrevocably.

CPI

Consumers Price Index

The All Groups Consumers Price Index published by Statistics New Zealand. The CPI measures the rate of price change of goods and services purchased by New Zealand households.

CPSS

The Committee on Payment and Settlement Systems

A forum for 25 central banks to monitor and analyse developments in domestic payment, settlement and clearing systems, and cross-border and multicurrency settlement schemes. The Committee also focuses on standard-setting activities.

EMEAP

Executive Meeting of East Asian and Pacific central banks and monetary authorities

A cooperative organisation of central banks and monetary authorities in the East Asia and Pacific region, comprising Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.

ESAS

Exchange Settlement Account System

The Reserve Bank's banking service for institutions that need to make regular high-value payments with each other.

FSIS

Financial Sector Information System

The Reserve Bank's central database for time-series data.

FSR

Financial Stability Report

A six-monthly report assessing the soundness and efficiency of the New Zealand financial system.

IOSCO

International Organisation of Securities Commissions

A worldwide organisation of securities regulators, including the New Zealand Securities Commission.

ISL

Interchange and Settlement Limited

A non-real time switch system that enables the settlement of transactions from the processing of cheques, direct debit, direct credits, automatic payments and EFTPOS.

MPS

Monetary Policy Statement

A quarterly assessment, accompanying an OCR Review, of how the Reserve Bank proposes to achieve its monetary policy target (see PTA); how it proposes to formulate and implement monetary policy during the next five years; and how monetary policy has been implemented since the last *MPS*.

NBDTs

Non-bank deposit takers

Finance companies, building societies and credit unions, which take deposits from the investing public.

NZCLEAR

A real-time settlement system providing the financial markets with clearing and settlement services for high-value debt securities and equities.

OCR

Official Cash Rate

The interest rate set by the Reserve Bank to meet the inflation target specified in the PTA.

PTA

Policy Targets Agreement

A contract, negotiated between the government and the Governor of the Reserve Bank, defining the Bank's price stability target.

SDR

Special Drawing Right

Unit of account of international reserve assets created by the International Monetary Fund (IMF) to supplement the reserves of IMF member countries. Its value is based on a basket of key international currencies.

SBI

Settlement Before Interchange

The process, operated under Payments New Zealand Ltd's rules, by which any two banks prepare and process files containing details of their customers' bilateral transactions. The net value of the transactions is settled by one bank making a payment from its ESAS account to the other bank's ESAS account. Once settled, the file containing details of the customers' transactions is delivered to the destination bank, which will then update its customers' records.

TWI

Trade-Weighted Index

A measure of the value of the New Zealand dollar relative to the currencies of New Zealand's major trading partners.

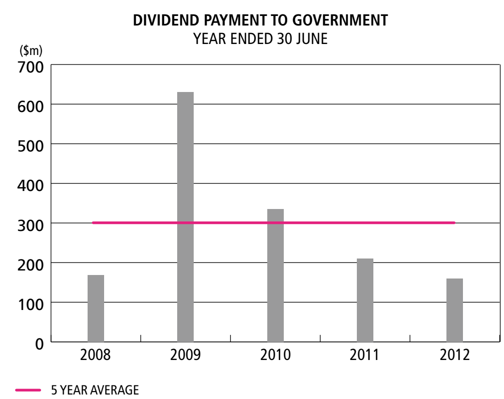
OUR FINANCIAL STATEMENTS

KEY FINANCIAL STATISTICS FOR 2011–12 ARE:

	2012 $M	2011 $M
Dividend payment to government	**160**	210
Net interest income	**280**	302
Net profit/(loss)[18]	**118**	144
Net operating expenses[19]	**47.0**	46.8
Funding Agreement expenditure	**50.2**	47.8
Total assets	**26,744**	31,090
Foreign reserves intervention capacity	**8,920**	9,130
Total equity[20]	**2,602**	2,509

DIVIDEND PAYMENT TO GOVERNMENT

	2012 $M	2011 $M
Dividend payment to government	**160**	210



The dividend payment to government for the financial year to 30 June 2012 will be $160 million.

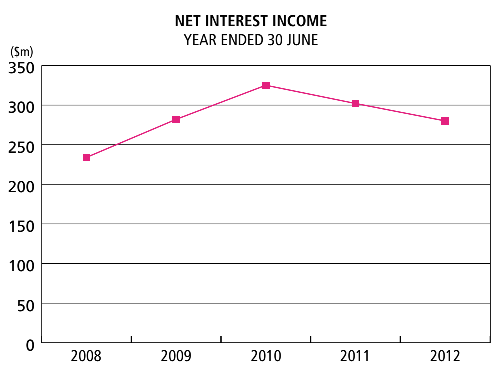
The dividend is not directly related to net profit, due to the timing of realisation of revaluation gains and losses arising from changes in foreign exchange rates and interest rates.

An unusually large dividend was paid in 2009 when substantial foreign exchange gains were realised. Since that time, the Bank's earnings available for distribution have been lower, mainly due to lower interest rates feeding through to lower interest earnings, and also because of overall appreciation of the New Zealand dollar, which results in reported losses on foreign exchange.

18. After accounting revaluations due to changes in foreign exchange and interest rates.
19. Net operating expenses stated in this table exclude actuarial gains and losses on the Bank's defined benefit superannuation scheme. Actuarial gains and losses are not included in net operating expenses subject to the Funding Agreement.
20. After provision has been made for dividend payment.

NET INTEREST INCOME

	2012 $M	2011 $M
Net interest income	**280**	302

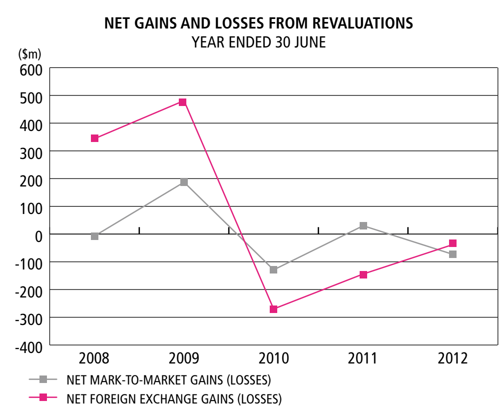


Notes and coins issued to the public and the Bank's equity create a pool of funds that the Bank invests to generate interest income. These funds are invested either in New Zealand government securities or in swaps, which earn interest at short-term rates. These swaps assist the Bank to fund a part of the holdings of foreign reserves.

Some of the Bank's holdings of government securities, which were purchased at times when interest rates were higher have matured in the past few years. The funds received upon maturity are largely being reinvested in swaps at lower short-term rates. With the decline in interest rates following the global financial crisis, this has significantly affected the Bank's interest income.

REVALUATIONS

	2012 $M	2011 $M
Income includes:		
Foreign exchange gains (losses)	**(38)**	(144)
Gains (losses) from changes in the market value of financial instruments	**(73)**	31
Total	**(111)**	(113)



The Bank has a policy of holding some of its foreign reserves on an unhedged basis to allow it to deliver a more effective response in the event of a crisis affecting the country's foreign exchange market, and to smooth more extreme exchange rate movements. This means that changes in exchange rates will have more impact on the Bank's profit than if its foreign reserves were completely hedged.

Additionally, the Bank's profit is affected by changes in the value of financial instruments that are due to changes in interest rates. This past year has seen significant volatility in interest rates, which largely arose from changes in sentiment due to instability in offshore markets. The Bank has no direct exposure to the more susceptible markets such as Greece, Portugal, Italy, Spain and Ireland.

CORE OPERATING EXPENSES

	2012 $M	2011 $M
Staff expenses	**28.4**	27.3
Net currency-issued expenses	**5.2**	6.7
Asset management expenses	**6.4**	7.3
Other operating expenses	**15.0**	13.3
Underlying operating expenses	**55.0**	54.6
Actuarial loss (gain) on defined benefit superannuation scheme	**6.3**	0.4
Total operating expenses	**61.3**	55.0

Operating expenses, excluding actuarial losses and gains, increased by $0.4 million from $54.6 million in 2011 to $55.0 million in 2012.

Higher staff expenses reflect an increase in staff numbers required to support new prudential and regulatory responsibilities.

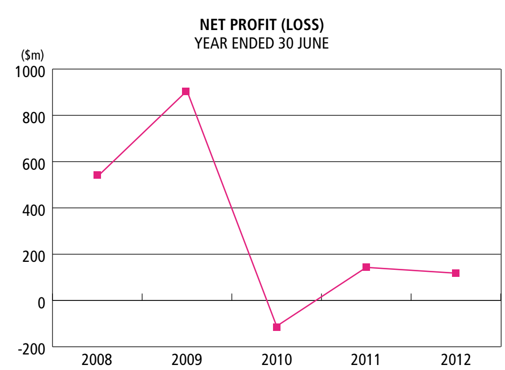
Currency issuance costs returned to expected levels after a one-off change in commercial banks' cash distribution arrangements resulted in elevated costs in 2011. Asset management expenses reflect lower annual depreciation charges for software purchased in prior years.

Other operating expenses were higher, in part due to the new responsibilities, including higher technology and professional services costs.

The actuarial loss of $6.3 million on the defined benefit superannuation scheme was due to a fall in the 10-year New Zealand government stock rate during the year, which resulted in an increase in the accounting value of the scheme's obligations to make payments to its members. This has not affected the contributions the Bank makes to the scheme, which has been closed to new members for over 20 years.

OVERALL PROFIT

	2012 $M	2011 $M
Income:		
Net interest income	**280**	302
Foreign exchange gains (losses)	**(38)**	(144)
Gains (losses) from changes in the market value of financial instruments	**(73)**	31
Other investment income	**2**	2
Net investment income	**171**	191
Other operating income	**8**	8
Total income	**179**	199
Total operating expenses	**61**	55
Net profit (losses)	**118**	144



The Bank reported a lower net profit in 2012 due to lower net interest income.

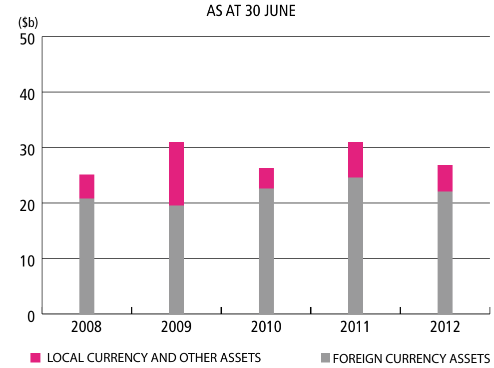
The Bank, like other central banks, has a balance sheet structure and resulting financial performance that reflects its statutory functions and decisions about how these functions are carried out. Central banks with an unhedged foreign exchange position have volatile earnings. In addition to the unhedged foreign exchange position, financial performance reflects changes in the interest rate environment, both globally and in the domestic market.

Therefore, as previously signalled, the Bank's reported profit is expected to vary considerably from year to year.

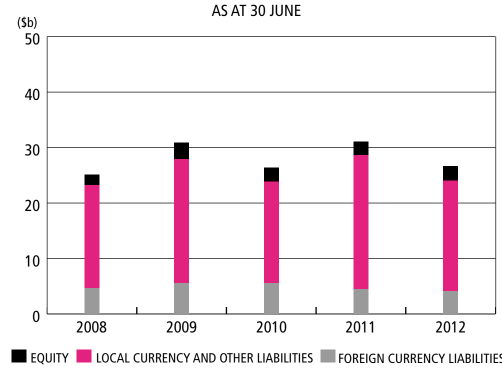
BALANCE SHEET: FINANCIAL POSITION AS AT 30 JUNE

	2012 $M	2011 $M
Assets:		
Foreign currency financial	**21,971**	24,647
Local currency financial	**4,695**	6,360
Other assets	**78**	83
Total assets	**26,744**	31,090
Liabilities and equity:		
Foreign currency financial	**4,129**	4,481
Local currency financial	**15,381**	19,627
Currency in circulation	**4,375**	4,173
Other liabilities	**257**	300
Equity	**2,602**	2,509
Total liabilities and equity	**26,744**	31,090

LOCAL AND FOREIGN CURRENCY ASSETS
AS AT 30 JUNE



LOCAL AND FOREIGN CURRENCY LIABILITIES AND EQUITY
AS AT 30 JUNE



At 30 June 2012, total assets were $26.7 billion (2011: $31.1 billion).

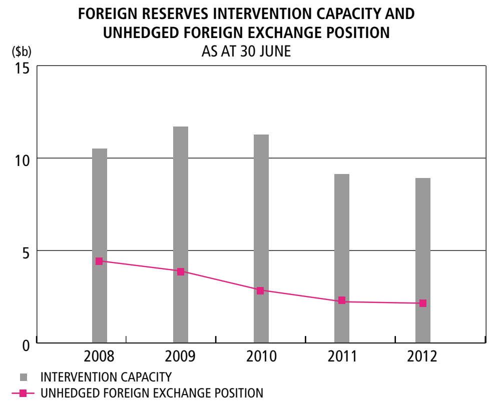
The size and composition of the Bank's balance sheet is primarily determined by the public's demand for notes and coin, the level of deposits placed with the Bank by the New Zealand government, the amount of cash held at the Bank to facilitate daily interbank payments, and the amount of foreign reserves the Bank holds to maintain its foreign reserves intervention capacity and the means of funding these reserves.

The reduction in assets in 2012 was attributable to a decrease in deposits placed with the Bank by the New Zealand government. At 30 June 2011, the government had much higher deposits with the Bank as part of the government's preparations to repay an issue of New Zealand government securities which matured in November 2011. The level of the government's deposits has only a minor impact on the Bank's net investment income.

The Bank holds foreign currency assets that are both liquid and of high credit quality, comprising mainly government and near-government-rated securities. While there have been downgrades of sovereign ratings by credit rating agencies during the year, the credit quality of the Bank's foreign currency assets remains high.

UNHEDGED FOREIGN EXCHANGE POSITION

	2012 $M	2011 $M
Unhedged foreign exchange position	**2,147**	2,227

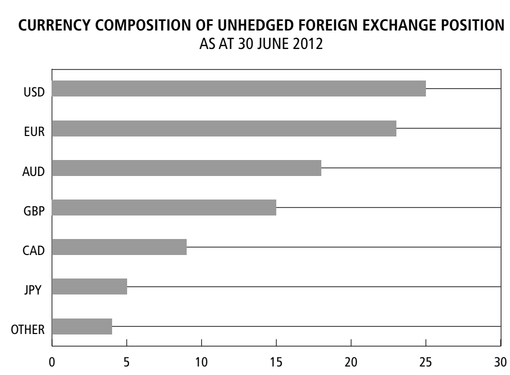


The foreign reserves intervention capacity is the measure of the Bank's ability to quickly sell foreign currency and buy New Zealand dollars, should market conditions warrant such an action.

An unhedged foreign exchange position means that the Bank's foreign assets and liabilities are not exactly matched or 'hedged', but allows the Bank to sell foreign currency outright without having to later purchase or borrow foreign currency. Movements in foreign currency exchange rates may therefore result in valuation losses or gains.

During the past year, the foreign reserves intervention capacity declined slightly to $8.9 billion. The Bank continued to hold an unhedged position slightly above its long-term benchmark of SDR[21] 1 billion (equivalent to approximately NZD 2.16 billion at 30 June 2012).

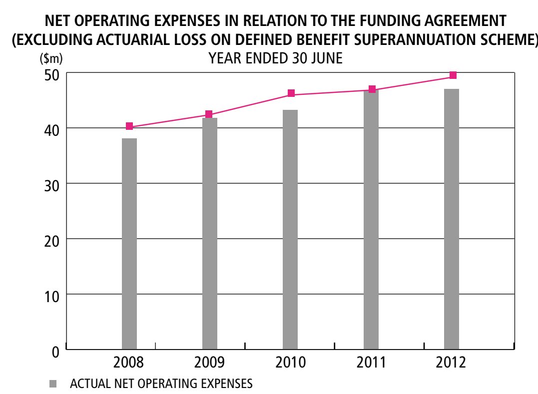
The chart shows the composition of foreign currencies included in the unhedged foreign exchange position.



21. Special Drawing Rights - see Glossary page 37.

SPENDING REMAINS INSIDE THE FIVE-YEAR FUNDING AGREEMENT

	2012 $M	2011 $M
Net operating expenses in relation to the Funding Agreement		
Staff expenses	**28.4**	27.3
Net currency-issue expenses	**5.2**	6.7
Asset management expenses	**6.4**	7.3
Other operating expenses	**15.0**	13.3
Total operating expenses excluding actuarial loss on defined benefit superannuation scheme	**55.0**	54.6
Income from operations	**8.0**	7.8
Actual net operating expenses	**47.0**	46.8
Net operating expenses specified in the Funding Agreement	**50.2**	47.8
Funding Agreement under-expenditure	**3.2**	1.0



Net operating expenses (excluding actuarial gains and losses) were below the level provided for in the Funding Agreement for the 2012 year.

Aggregate spending for the two years to June 2012 is $4.2 million less than the amount provided in the Funding Agreement for the period.

RESERVE BANK BUSINESS PRIORITIES 2012–13

PRIORITY	EXPLANATION	DEPARTMENT
1. Ensure monetary and financial stability policies are appropriate in light of recent structural changes in the economic and financial environment.	The global financial crisis, sovereign debt crisis and Canterbury earthquakes have complicated the macro-economic environment, challenging long-standing frameworks for monetary and financial policies. This new environment raises questions about potential output growth, 'neutral' real interest rates, the level of the exchange rate, long-run unemployment levels, the growth of credit, and private sector leverage. The Bank will explore this new environment and ensure that monetary and macro-prudential policies are fit for purpose.	ECONOMICS
2. All relevant banks to have pre-positioned IT and operating systems to enable Open Bank Resolution (OBR).	OBR is a bank failure management tool that enables authorities to keep a failing bank open. All locally incorporated banks with balance sheets in excess of $1 billion are required to be able to implement OBR.	PRUDENTIAL SUPERVISION
3. Implementation of the Basel III capital adequacy requirements for banks.	The Bank has already completed an initial consultation on high-level aspects of Basel III and, in 2012, will be consulting on further key elements, including the definition of 'capital' and the conservation and countercyclical buffers. Our intention is to implement Basel III calibrated to New Zealand conditions.	PRUDENTIAL SUPERVISION FINANCIAL MARKETS
4. Determination of the detailed specifications for the new series of banknotes.	An important objective for the Bank is to maintain confidence in the national currency, including by minimising the potential for counterfeiting. The rapid innovation and ready availability of new copying and printing technologies makes it timely to upgrade and modernise our banknotes.	CURRENCY
5. Implementation of a new operating model for risk management and assurance.	Significant developments in the global environment and notable changes in the Bank's role introduce both new and heightened risks that require a refreshed approach to internal assurance and risk management processes. The new operating model for risk management and assurance will be introduced progressively through 2012–13.	RISK ASSESSMENT & ASSURANCE BANK-WIDE

BUSINESS PRIORITIES OVER TIME

THEME	2007–2008	2008–2009	2009–2010
MONETARY POLICY	Macroeconomic policy framework: Assess how to maintain price stability while avoiding unnecessary damage to the external sector.		Support effective monetary policy for inflation targeting in a world of volatile financial and economic conditions.
ECONOMIC MODELLING	Model redevelopment: Upgrade the current policy and forecasting model.	Economic model construction and implementation: Introduce a state-of-the-art model into the policy and forecasting process.	
STATISTICS		Financial Sector Information System (FSIS) development: Design and build an integrated computer application.	Implement our Financial Sector Information System (FSIS), significantly improving the management of statistics and enabling new prudential data collections.
BANK LIQUIDITY		Prudential liquidity policy: Develop and implement a prudential liquidity policy for registered banks.	Ensure the banking system has sufficient liquidity to meet its ongoing funding needs.
FOREIGN RESERVES MANAGEMENT			
MACRO-PRUDENTIAL POLICY			
BANK REGULATION	Basel II implementation: Develop and implement policy on bank capital requirements under Basel II.		Ensure that the registered banks maintain adequate capital, through close monitoring of asset quality and prompt supervisory responses.
NON-BANK DEPOSIT TAKERS	Financial sector regulatory arrangements: Help develop and implement new non-bank regulatory arrangements.	Extended prudential regulatory regime: Implement new regulatory arrangements for non-bank deposit takers and develop a prudential regime for the insurance sector.	Introduce a prudential regime for the insurance sector, and implement new regulatory arrangements for non-bank deposit takers.
INSURANCE			
CURRENCY			
HUMAN RESOURCE DEVELOPMENT	Management: Enable managers to continually develop leadership and management competencies.	Support management in further developing their values-based leadership competencies.	Engage and develop staff to meet the challenges of a volatile financial and economic environment.
BUSINESS CONTINUITY			Improve business continuity and disaster-recovery capability through the establishment of a business support office in Auckland.
RISK MANAGEMENT & ASSURANCE			

2010–2011	2011–2012	2012–2013
Begin unwinding special financial system support and monetary policy stimulus. [*See also Macro-prudential Policy*.]	Assess the impact of the Canterbury earthquakes and the implications for the Bank's monetary policy.	Ensure monetary and financial stability policies are appropriate in light of recent structural changes in the economic and financial environment.
	Implement a new asset allocation and performance benchmarking framework for foreign reserves.	
Investigate the potential for macro-prudential policy tools for New Zealand. *[See also Monetary Policy.]*	Develop an implementation framework for macro-prudential policy tools in New Zealand and consider the inter-relationship with monetary policy.	*[See Monetary Policy Priority.]*
Identify any appropriate changes to the bank supervision regime, including those based on international regulatory reforms.	Develop a plan for the implementation of Basel III prudential requirements for banks, suitably adapted for New Zealand conditions.	• All relevant banks to have pre-positioned IT and operating systems to enable Open Bank Resolution (OBR). • Implementation of the Basel III capital adequacy requirements for banks.
Advance the implementation of the new non-bank deposit taker regime.		
Develop and implement the new prudential regime for Insurance.	Ensure that insurers are on the path to obtaining a full licence by September 2013, meeting at least the provisional licensing requirements by March 2012.	
	Undertake initial planning and consultation for a new (Series 7) issue of banknotes.	Determination of the detailed specifications for the new series of banknotes.
Engage, develop and support staff to meet the challenges of the Bank's evolving responsibilities.	Develop cross-functional capabilities among our staff to support the Bank's wider range of responsibilities.	
Improve business continuity and disaster-recovery capability through the establishment of a business support centre in Auckland.		
		Implementation of a new operating model for risk management and assurance

INVESTING
IN OUR
FUTURE

HIGH-SPEED BANKNOTE SORTER

The Bank's high-speed note-sorting machine is used to process bank notes received from commercial banks. Some 27.2 million used banknotes with a value of $587.7 million were machine-processed in 2011–2012, checked for their value, authenticity and fitness for circulation.

The machine's advanced detectors improve the Bank's ability to detect counterfeits, and to identify unfit notes and remove them from circulation. They also allow the Bank to recover and re-issue more fit notes rather than destroying them, thus making significant financial savings. Unfit notes are automatically destroyed, while fit notes are strapped into bundles for re-issue.

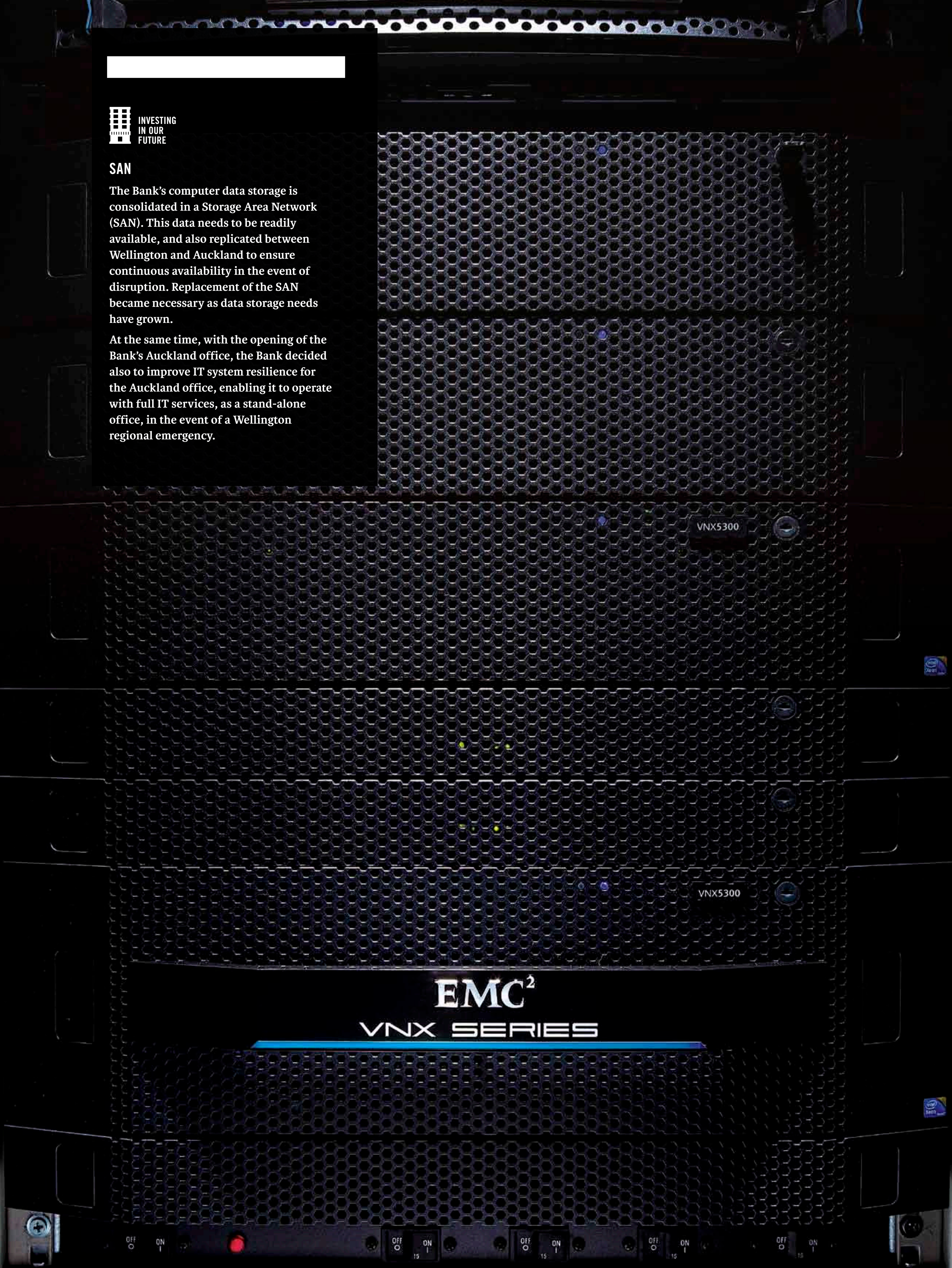

90,000
25 notes per second
90,000 notes per hour,
with multi-level,
multi-denomination
in a single pass

INVESTING
IN OUR
FUTURE

SAN

The Bank's computer data storage is consolidated in a Storage Area Network (SAN). This data needs to be readily available, and also replicated between Wellington and Auckland to ensure continuous availability in the event of disruption. Replacement of the SAN became necessary as data storage needs have grown.

At the same time, with the opening of the Bank's Auckland office, the Bank decided also to improve IT system resilience for the Auckland office, enabling it to operate with full IT services, as a stand-alone office, in the event of a Wellington regional emergency.



MANAGEMENT STATEMENT

RESERVE BANK OF NEW ZEALAND

21 August 2012

MANAGEMENT STATEMENT

Pursuant to section 165 of the Reserve Bank of New Zealand Act 1989, we hereby certify that:

1. We have been responsible for the preparation of the annual financial statements and for the judgements used in them.
2. We have been responsible for establishing and maintaining a system of internal controls designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting.
3. In our opinion, the annual financial statements for the year ended 30 June 2012 fairly reflect the financial position and operations of the Bank.

Alan Bollard

Governor

Deputy Governor

AUDIT REPORT

Independent Auditors' report

To the readers of the Reserve Bank of New Zealand and Group's Financial Statements for the year ended 30 June 2012

The Auditor-General is the auditor of the Reserve Bank of New Zealand and Group (the 'Bank'). The Auditor-General has appointed me, Chris Barber, using the staff and resources of PricewaterhouseCoopers, to carry out the audit of the financial statements of the Bank on her behalf.

We have audited the financial statements of the Bank on pages 54 to 97 that comprise the statement of financial position as at 30 June 2012, the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows for the year ended on that date and the notes to the financial statements that include accounting policies and other explanatory information.

Opinion

In our opinion the financial statements of the Bank on pages 54 to 97:

- comply with generally accepted accounting practice in New Zealand; and
- fairly reflect the Bank's:
  - financial position as at 30 June 2012; and
  - financial performance and cash flows for the year ended on that date.

Our audit was completed on 21 August 2012. This is the date at which our opinion is expressed.

The basis of our opinion is explained below. In addition, we outline the responsibilities of the Governor and our responsibilities, and explain our independence.

Basis of opinion

We carried out our audit in accordance with the Auditor-General's Auditing Standards, which incorporate the International Standards on Auditing (New Zealand). Those standards require that we comply with ethical requirements and plan and carry out our audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

Material misstatements are differences or omissions of amounts and disclosures that would affect a reader's overall understanding of the financial statements. If we had found material misstatements that were not corrected, we would have referred to them in our opinion.

An audit involves carrying out procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including our assessment of risks of material misstatement of the financial statements whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the preparation of the Bank's financial statements that fairly reflect the matters to which they relate. We consider internal control in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.

Independent Auditors' report

An audit also involves evaluating:
- the appropriateness of accounting policies used and whether they have been consistently applied;
- the reasonableness of the significant accounting estimates and judgements made by the Governor;
- the adequacy of all disclosures in the financial statements; and
- the overall presentation of the financial statements.

We did not examine every transaction, nor do we guarantee complete accuracy of the financial statements. We have obtained all the information and explanations we have required and we believe we have obtained sufficient and appropriate audit evidence to provide a basis for our audit opinion.

Responsibilities of the Governor
The Governor is responsible for preparing financial statements that:
- comply with generally accepted accounting practice in New Zealand; and
- fairly reflect the Bank's financial position, financial performance and cash flows.

The Governor is also responsible for such internal control as he determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

The Governor's responsibilities arise from the Reserve Bank of New Zealand Act 1989.

Responsibilities of the Auditor
We are responsible for expressing an independent opinion on the financial statements and reporting that opinion to you based on our audit. Our responsibility arises from section 15 of the Public Audit Act 2001 and section 166 of the Reserve Bank of New Zealand Act 1989.

Independence
When carrying out the audit we followed the independence requirements of the Auditor-General, which incorporate the independence requirements of the New Zealand Institute of Chartered Accountants.

In addition to the audit we have carried out assignments in the areas of systems audits and advice on the operation and assessment of payment systems which are compatible with those independence requirements. Other than the audit and these assignments, we have no relationship with or interests in the Bank.

Chris Barber
Chris Barber
On behalf of the Auditor-General
Wellington, New Zealand

PricewaterhouseCoopers
PricewaterhouseCoopers

Matters relating to the electronic presentation of the audited financial statements
This audit report relates to the financial statements of the Reserve Bank of New Zealand (the 'Bank') and Group for the year ended 30 June 2012 included on the Bank's website. The Governor is responsible for the maintenance and integrity of the Bank's website. We have not been engaged to report on the integrity of the Bank's website. We accept no responsibility for any changes that may have occurred to the financial statements since they were initially presented on the website.

The audit report refers only to the financial statements named above. It does not provide an opinion on any other information which may have been hyperlinked to or from the financial statements. If readers of this report are concerned with the inherent risks arising from electronic data communication they should refer to the published hard copy of the audited financial statements as well as the related audit report dated 21 August 2012 to confirm the information included in the audited financial statements presented on this website.

Legislation in New Zealand governing the preparation and dissemination of financial information may differ from legislation in other jurisdictions.

GUIDE TO THE MAIN FUNCTIONS OF THE RESERVE BANK

The Reserve Bank's role is defined by the Reserve Bank of New Zealand Act 1989 (the "Reserve Bank Act").

For the year ended 30 June 2012, the Bank classified its outputs according to its main functions in the ways described below.[22]

MONETARY POLICY FORMULATION:

Developing monetary policy to achieve and maintain price stability in line with the Policy Targets Agreement.

DOMESTIC MARKET OPERATIONS:

Transacting with, monitoring and liaising with financial markets to manage aggregate liquidity in the New Zealand banking system. These actions are for the purpose of implementing monetary policy, facilitating payments and monitoring financial stability.

PRUDENTIAL SUPERVISION:

Registering and supervising banks, licensing and supervising insurers, regulating non-bank deposit takers, overseeing payment systems, and undertaking policy development in all of these areas. These actions are for the purpose of promoting a sound and efficient New Zealand financial system by limiting damage to the financial system that could arise from bank, non-bank deposit taker or insurer failure(s) or other financial system distress. Supervising banks, non-bank deposit takers and life insurers for compliance with their anti-money laundering obligations.

MACRO-FINANCIAL STABILITY:

Analysing and managing financial system risks to promote a sound and efficient system that supports the functioning of the economy.

CURRENCY OPERATIONS:

Maintaining the supply and integrity of legal tender currency to facilitate cash transactions in the community.

FOREIGN RESERVES MANAGEMENT:

Managing the Bank's foreign reserves held to support monetary policy objectives and the maintenance of orderly markets. This includes execution of foreign currency intervention activities.

SETTLEMENT SERVICES:

Providing New Zealand dollar settlement accounts to financial institutions and the New Zealand government and providing securities settlement and depository services, mainly to financial institutions.

22. The Bank's classification of its main functions was revised from 1 July 2011. The principal changes included establishing a Macro–Financial Stability function, amalgamating the Settlement Services and Registry and Depository Services functions and renaming the Financial System Surveillance and Policy function, which is now known as the Prudential Supervision function.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

As at 30 June	Note	2012 $M	2011 $M
ASSETS			
Foreign Currency Financial Assets			
Cash Balances		**2,785**	1,959
Securities Purchased under Agreements to Resell		**4,566**	3,803
Marketable Securities	3	**12,780**	16,574
Derivative Financial Assets	4	**1,700**	2,080
Other Foreign Currency Financial Assets	5	**140**	231
Total Foreign Currency Financial Assets		**21,971**	24,647
Local Currency Financial Assets			
Securities Purchased under Agreements to Resell		**1,501**	2,591
New Zealand Government Securities		**3,193**	3,768
Other Local Currency Financial Assets		**1**	1
Total Local Currency Financial Assets		**4,695**	6,360
Total Financial Assets		**26,666**	31,007
Other Assets	6	**78**	83
Total Assets		**26,744**	31,090
LIABILITIES			
Foreign Currency Financial Liabilities			
Short-term Foreign Currency Financial Liabilities	9	**1,069**	1,092
Securities Sold under Agreements to Repurchase		**606**	475
Derivative Financial Liabilities	4	**306**	466
Term Liabilities		**2,148**	2,448
Total Foreign Currency Financial Liabilities		**4,129**	4,481
Local Currency Financial Liabilities			
Deposits	10	**15,262**	19,627
Securities Sold under Agreements to Repurchase		**119**	-
Currency in Circulation		**4,375**	4,173
Other Local Currency Financial Liabilities	11	**85**	84
Total Local Currency Financial Liabilities		**19,841**	23,884
Total Financial Liabilities		**23,970**	28,365
Other Liabilities	12	**172**	216
Total Liabilities		**24,142**	28,581
EQUITY	14	**2,602**	2,509
Total Liabilities and Equity		**26,744**	31,090

The above statement is to be read in conjunction with the notes set out on pages 59 to 97.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Note	Capital $M	Available for Sale Reserve $M	Property, Currency and Artwork Collections Revaluation Reserve $M	Retained Earnings $M	Total $M
Equity as at 1 July 2010		1,600	216	47	711	2,574
Net Profit for the Year		-	-	-	144	144
Total Income and Expense Taken to Equity during the Year		-	1	-	-	1
Dividend Payable to the New Zealand Government		-	-	-	(210)	(210)
Equity as at 30 June 2011		1,600	217	47	645	2,509
Net Profit for the Year		**-**	**-**	**-**	**118**	**118**
Total Income and Expense Taken to Equity during the Year		**-**	**136**	**(1)**	**-**	**135**
Dividend Payable to the New Zealand Government	13	**-**	**-**	**-**	**(160)**	**(160)**
Equity as at 30 June 2012	14	**1,600**	**353**	**46**	**603**	**2,602**

The above statement is to be read in conjunction with the notes set out on pages 59 to 97.

CONSOLIDATED INCOME STATEMENT

For the year ended 30 June	Note	2012 $M	2011 $M
Interest Income		**655**	670
Interest Expense		**375**	368
Net Interest Income		**280**	302
Net Gains/(Losses) from Fair Value Changes		**(73)**	31
Net Losses from Foreign Exchange Rate Changes		**(38)**	(144)
Dividend Income		**2**	2
Total Net Investment Income	24	**171**	191
Other Income		**8**	8
Total Operating Income		**179**	199
Total Operating Expenses	26	**61**	55
Net Profit for the Year		**118**	144

The above statement is to be read in conjunction with the notes set out on pages 59 to 97.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30 June	Note	2012 $M	2011 $M
Net Profit for the Year from the Consolidated Income Statement		**118**	144
Items Recognised Directly in the Consolidated Statement of Comprehensive Income			
Movement in Available-for-sale Revaluation Reserve Taken to Equity	14	**136**	1
Movement in Property Revaluation Reserve Taken to Equity	14	**(1)**	-
Total Income and Expense Taken to Equity during the Year		**135**	1
Total Comprehensive Income for the Year		**253**	145

The above statement is to be read in conjunction with the notes set out on pages 59 to 97.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the year ended 30 June	Note	2012 $M	2011 $M
CASH FLOWS FROM OPERATING ACTIVITIES			
Sources from Income			
Interest Received:			
Foreign Currency:			
Derivatives		**(34)**	(12)
Other		**64**	49
Local Currency:			
Derivatives		**415**	383
Available-for-sale Securities		**195**	204
Other		**32**	16
Dividend		**4**	5
Fees, Commission and Other Income Received		**8**	8
Total Sources of Cash Flows from Income		**684**	653
Disbursements for Expenses			
Interest Paid:			
Foreign Currency		**6**	-
Local Currency		**367**	367
Payments to Suppliers and Employees		**48**	45
Total Disbursements of Cash Flows from Expenses		**421**	412
Operating Cash Flows from Income and Expenses		**263**	241
Operating Cash Flows from Changes in Operating Asset Balances			
Net (Increase)/Decrease in Foreign Currency Operating Assets		**3,211**	(3,102)
Net (Increase)/Decrease in Local Currency Operating Assets		**1,090**	(2,390)
Total Operating Cash Flows from Changes in Asset Balances		**4,301**	(5,492)
Operating Cash Flows from Changes in Operating Liability Balances			
Net (Increase)/Decrease in Other Foreign Currency Operating Liabilities		**(103)**	(210)
Net (Increase)/Decrease in Local Currency Operating Liabilities		**4,249**	(5,696)
Total Operating Cash Flows from Changes in Liability Balances		**4,146**	(5,906)
Operating Cash Flows from Changes in Asset and Liability Balances		**155**	414
Net Cash Flows from Operating Activities	27	**418**	655
CASH FLOWS FROM INVESTING ACTIVITIES			
Sources			
Maturity of Available-for-sale Securities		**919**	-
Total Sources of Cash Flows from Investing Activities		**919**	-
Disbursements			
Purchases of Available-for-sale Securities		**217**	295
Purchase of Property, Plant and Equipment and Intangible Assets		**4**	6
Total Disbursements of Cash Flows from Investing Activities		**221**	301
Net Cash Flows from Investing Activities		**698**	(301)

CONSOLIDATED STATEMENT OF CASH FLOWS (CONTINUED)

For the year ended 30 June	Note	2012 $M	2011 $M
CASH FLOWS FROM FINANCING ACTIVITIES			
Sources			
Net Issue of Circulating Currency		**203**	234
Total Sources of Cash Flows from Financing Activities		**203**	234
Disbursements			
Repayment of Foreign Currency Term Liabilities		**321**	-
Dividend Payments to the New Zealand Government		**210**	290
Total Disbursements of Cash Flows from Financing Activities		**531**	290
Net Cash Flows from Financing Activities		**(328)**	(56)
NET CASH FLOWS		**788**	298
Plus Foreign Exchange Rate Effect on Cash Balances at the Beginning of the Year		**38**	(299)
NET CASH FLOWS FROM ALL ACTIVITIES		**826**	(1)
Cash Balances at the Beginning of the Year		**1,959**	1,960
Cash Balances at the End of the Year		**2,785**	1,959

The above statement is to be read in conjunction with the notes set out on pages 59 to 97.

NOTES TO BE READ AS PART OF THE CONSOLIDATED FINANCIAL STATEMENTS

1. STATEMENT OF ACCOUNTING POLICIES

(A) REPORTING ENTITY AND STATUTORY BASE

These are the consolidated financial statements of the Reserve Bank of New Zealand, a body corporate under the Reserve Bank of New Zealand Act 1989 (the "Reserve Bank Act"). These consolidated financial statements apply to the financial year ended 30 June 2012. They are prepared in accordance with part VI of the Reserve Bank Act and comply with Generally Accepted Accounting Practice in New Zealand.

In these financial statements, the Reserve Bank of New Zealand is also referred to as the "Reserve Bank" or the "Bank". The Bank's parent entity is the government of New Zealand.

The Governor and Deputy Governor of the Reserve Bank authorised these financial statements for issue on 21 August 2012.

(B) COMPLIANCE WITH NEW ZEALAND EQUIVALENTS TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

Under NZ IAS 1 *Presentation of Financial Statements,* the Bank is classified as a Public Benefit Entity (PBE). A PBE is a reporting entity whose primary objective is to provide goods and services for community or social benefit and where any equity has been provided with a view to supporting that primary objective rather than for a financial return to equity holders. PBEs are required to comply with requirements under New Zealand Equivalents to International Financial Reporting Standards (NZ IFRS), which differ from corresponding provisions of the equivalent International Financial Reporting Standards (IFRS). For the reasons set out below, while the Bank asserts full compliance with Generally Accepted Accounting Practice in New Zealand and NZ IFRS, it is unable to make an unreserved statement of compliance with IFRS.

The following accounting practice adopted in accordance with the Bank's PBE status has prevented the Bank from asserting full compliance with IFRS.

NZ IAS 2 *Inventories* requires that inventories of currency that are held for distribution be measured at cost. Where that inventory is acquired at no cost, or for nominal consideration, it should be measured at current replacement cost. The corresponding IFRS provision in IAS 2 requires that inventories be measured at the lower of cost and net realisable value.

Inventories of currency on hand include currency repatriated to the Bank at no cost. In accordance with NZ IAS 2, this portion of inventory is measured at the current replacement cost of that inventory at the time of repatriation. At 30 June 2012, the carrying value of inventory was $2.6 million more than that which would have been reported had IAS 2 been applied (2011: $1.9 million more).

(C) BASIS OF PREPARATION OF FINANCIAL STATEMENTS

Measurement Base

These financial statements have been prepared using the general principles of historical cost accounting, modified by fair value accounting for available-for-sale financial assets, all derivative contracts, financial assets and liabilities that are held at fair value through profit or loss, land and buildings, and currency and artwork collections.

Changes in Accounting Policies

There have been no changes in accounting policies and all accounting policies have been applied consistently by the Bank for all the financial years presented (unless otherwise stated).

Standards and Interpretations Applied with Effect from 1 July 2011

The Bank has applied the following new or updated accounting standards with effect from 1 July 2011:

- *Amendments to New Zealand Equivalents to International Financial Standards to Harmonise with International Financial Reporting Standards and Australian Accounting Standards ("Harmonisation Amendments")*
- *FRS 44 New Zealand Additional Disclosures*
- *Amendments to NZ IFRS 7 Disclosures – Transfers of Financial Assets*

Application of the Harmonisation Amendments, Amendments to NZ IFRS 7, and FRS 44 has not impacted the accounting policies that are applied by the Bank. These accounting standards have not impacted measurement of the Bank's reported net profit, financial position and cash flows, although they have had a minor impact on disclosures included in the Bank's financial statements.

Standards and Interpretations Issued but not yet Effective and not Early Adopted

The following standard has been issued and is expected to be relevant to the Bank:

NZ IFRS 9 *Financial Instruments* replaces part of NZ IAS 39 *Financial Instruments: Recognition and Measurement* and will be mandatory for the Bank's financial statements for the year beginning 1 July 2015 (if the Bank is still applying IFRS). It establishes two primary measurement categories for financial assets: amortised cost and fair value, with classification depending on an entity's business model and the contractual cash flow characteristics of the financial asset. Under NZ IFRS 9, liabilities may continue to be valued at amortised cost or at fair value if accounting using fair value either reflects the way the liability is managed or eliminates an accounting mismatch. Where liabilities are accounted for at fair value, changes in fair value relating to changes in the Bank's own credit risk are presented in other comprehensive income and are not included in reported net profit. The Bank is in the process of evaluating the potential effect of this standard.

Proposed Changes to Accounting Standards Applicable to Public Benefit Entities

The External Reporting Board (XRB) has announced that it intends to adopt a multi-standards framework for financial reporting. The XRB's intention is that, from 1 July 2014, Public Sector Public Benefit Entities will generally be required to apply new accounting standards based on International Public Sector Accounting Standards (IPSAS), while For-Profit Entities will continue to apply accounting standards that are based on International Financial Reporting Standards (IFRS). The Bank and other Crown-owned financial institutions are working with the XRB to determine whether the Bank will be required to apply IPSAS, or whether it may continue to apply IFRS.

In light of its decision to adopt a multi-standards approach, the XRB has determined that new IFRS-based accounting standards, or changes to existing IFRS-based accounting standards with a mandatory effective date of 1 January 2012 or later, may be applied by profit-oriented entities only. For example, Public Benefit Entities are prohibited from applying NZ IFRS 13 *Fair Value Measurement,* which was promulgated in 2011 and which has a mandatory application date for annual periods beginning on or after 1 January 2013.

Basis of Consolidation

These consolidated financial statements are prepared using the acquisition method. All material inter-company balances and transactions are eliminated. Parent financial statements are not produced because the difference between the parent and group is not material.

Trust and Custodial Activities

Assets held for third parties under custodial arrangements and income arising thereon is excluded from these financial statements, as they are not assets or income of the Bank (see Note 34).

Segment Reporting

The Bank's operations comprise a single operating segment for the purposes of NZ IFRS 8 *Operating Segments.* The Bank has significant foreign currency financial liabilities and foreign currency financial assets as part of its Foreign Reserves Management and Domestic Market Operations activities. While the Bank is required by the Reserve Bank Act to report revenue and expenses by reference to the functions carried out by the Bank, these activities do not constitute separate operating segments for the purposes of NZ IFRS 8.

Functional and Presentation Currency

The Bank's financial statements are presented in New Zealand dollars, the Bank's functional and presentation currency. Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

Foreign Currency Conversions

Transactions denominated in foreign currency are translated to New Zealand dollars using exchange rates applied on the trade date of the transaction.

Foreign currency assets and liabilities are translated to New Zealand dollars at the relevant market bid or offer foreign exchange rate as at balance date.

Foreign exchange gains and losses resulting from settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currency are recognised in the Income Statement. Where a gain or loss on a non-monetary item is recognised directly in equity, such as equity investments classified as financial assets that are available for sale, the related exchange gain or loss is also recognised in equity.

(D) FINANCIAL ASSETS

Classification of Financial Assets

The Bank classifies its financial assets into the following categories: financial assets at fair value through profit or loss, loans and receivables, and available-for-sale financial assets. Bank management determines the classification of its financial assets at initial recognition.

Financial Assets at Fair Value through Profit or Loss

This category has two sub-categories: financial assets designated as fair value through profit or loss at inception and those that are held for trading.

The bulk of the Bank's assets and liabilities are designated as fair value through profit or loss, as compliance with the Bank's investment mandates and performance of the Bank's Foreign Reserves Management and Domestic Market Operations functions are assessed daily on the basis of the fair value of assets and related liabilities funding those assets.

This designation may only be made if the financial asset either contains an embedded derivative or will be managed on a fair value basis in accordance with a documented risk management strategy, or if designating it (and any financial liability) at fair value will reduce an accounting mismatch.

The Bank has active management portfolios, which are classified as held for trading. A financial asset is classified as held for trading if acquired or incurred principally for selling it in the near term; if it is part of a portfolio of identical financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking; if it is a derivative that is not a designated hedging instrument; or if it is so designated on acquisition by management.

Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides goods or services directly to a debtor with no intention of trading the receivable.

Available-for-sale Financial Assets

Available-for-sale financial securities are those non-derivative financial assets that are designated as available for sale or that are not classified as financial assets at fair value through profit or loss, or loans and receivables.

Available-for-sale financial assets include the Bank's holdings of New Zealand government bonds and its shareholding in the Bank for International Settlements. These assets are intended to be held either to maturity or for an indefinite period of time, and in the case of New Zealand government bonds, these may be sold in the course of the Bank's operations. As part of its liquidity management operations, the Bank purchases New Zealand government securities generally up to six months before these securities mature. Government securities purchased for liquidity management operations are classified as financial assets at fair value through profit or loss.

Recognition and Measurement of Financial Assets

Purchases and sales of financial assets are recognised on trade date, the date on which the Bank commits to purchase or sell the asset. Financial assets are recognised initially at fair value. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all the risks and rewards of ownership.

Loans and receivables are carried at amortised cost less impairment losses.

Available-for-sale financial assets and financial assets through profit or loss are subsequently carried at fair value.

The fair values of quoted investments in active markets are based on current bid prices. In other cases, the Bank establishes fair value by using appropriate valuation techniques.

Realised and unrealised gains and losses arising from changes in the fair value of financial assets at fair value through profit or loss are included in the Income Statement in the year in which they arise. These realised and unrealised gains and losses exclude interest and dividends.

Gains and losses arising from changes in the fair value of available-for-sale financial assets are recognised directly in equity until the financial asset is derecognised or impaired, at which time the cumulative gain or loss previously recognised in equity is recognised in the Income Statement.

Interest income on all assets is calculated using the effective interest method and is recognised in the Income Statement. The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument. The calculation includes all fees paid or received between parties, transaction costs and all other premiums or discounts.

Dividends on available-for-sale equity instruments are recognised in the Income Statement when the right to receive payment is established.

Derivative Financial Instruments

Derivatives are initially recognised in the Statement of Financial Position at fair value on the date on which a derivative contract is entered into and are subsequently remeasured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, or valuation techniques, as appropriate. The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e., the fair value of the consideration given or received).

Derivative transactions, such as foreign currency swaps, and the payment and receipt of different currencies are stated in the Statement of Financial Position at the net of the fair value of receipts less the fair value of payments, both expressed in New Zealand dollars. The net fair value of each derivative contract is determined individually and carried as an asset if the net fair value is positive and as a liability if that value is negative.

The majority of the Bank's assets and liabilities are carried at fair value and managed on a fair value basis. Therefore, the Bank has not applied the hedge accounting rules of *NZ IAS 39 Financial Instruments: Recognition and Measurement.*

Gains and losses on all derivatives are recognised in the Income Statement.

Securities Purchased under Agreements to Resell

Where the Bank purchases securities under agreements to resell (reverse-repurchase agreements), the Bank records as an asset the consideration receivable from the agreement to resell the security.

The consideration receivable under the agreement to resell is recorded at fair value. Movements in the fair value of reverse-repurchase agreements are reported in the Income Statement.

Securities Lending Programme

The Bank operates a securities lending programme. Where securities are lent, the Bank receives collateral in the form of cash or other securities and the securities continue to be recorded as assets in the Bank's Statement of Financial Position.

The Bank's agent administers the securities lending programme and monitors the securities lending and related collateral against requirements agreed with the Bank.

The Bank records an asset being the market value of the securities lent and a liability for the same amount in respect of the collateral to be returned by the Bank at the conclusion of the loan.

The Bank records income from securities lending as it accrues. Changes in the value of the asset are reflected by a change in the corresponding liability.

Impairment of Financial Assets

For financial assets that are not classified as fair value through profit or loss, the Bank assesses as at each balance date whether there is objective evidence that a financial asset or group of financial assets is impaired. Objective evidence of impairment would include observable data that comes to the attention of the Bank, such as significant financial difficulty of the issuer or counterparty, the disappearance of an active market for the financial asset because of financial difficulties, or a market downgrade in credit rating of the financial asset.

(E) OTHER ASSETS

Inventories

Inventories of currency on hand are recognised in the Statement of Financial Position at cost. Costs include the cost of bringing inventories to their present location and condition.

For the portion of inventories of currency on hand that relates to currency repatriated to the Bank, this cost is measured at the current replacement cost of producing the currency at the time of repatriation, and is recorded by crediting currency issue expense and increasing the value of inventory recognised in the Statement of Financial Position.

When currency is issued, the value of inventory is reduced and an expense is recorded for currency issuance costs. Currency issuance cost is determined on a first-in, first-out (FIFO) basis.

Property, Plant and Equipment

Land and Buildings

Land and buildings owned by the Bank are classified as Property, Plant and Equipment.

Land is recorded at fair value. Buildings are recorded at depreciated fair value. Surpluses of book value over historical cost for this class of asset are recorded in the Property Revaluation Reserve. Where the book value of this class of asset falls below historical cost, previous revaluations are reversed and any remaining balance is charged as an expense in the financial year it occurs. Buildings are depreciated on a straight-line basis over 40 years.

The Bank obtains an independent valuation of land and buildings every three years. In the years between independent valuations, an annual assessment is made of whether or not there is likely to have been a material change in value. An independent valuation is obtained where a material change has occurred.

Currency and Artwork Collections and Archives

Items held in the Bank's currency and artwork collections and archives that have a material commercial value are independently assessed to determine estimated fair values. Surpluses of book value over historical cost for this class of asset are recorded in the Currency and Artwork Collections and Archives Revaluation Reserve. Nominal values have been placed on items with no material commercial value. Collections are not depreciated. Additions are held at cost until subsequent revaluations.

Other Property, Plant and Equipment

Other property, plant and equipment is carried at cost less depreciation and impairment losses. The following assets held by the Bank are depreciated on a straight-line basis over the following terms:

Computer Hardware	3-5 years
Plant and Equipment	5-10 years
Property Improvements	8 years
Miscellaneous	expected useful life

Intangible Assets

Intangible assets comprise acquired and internally developed computer software. Intangible assets are stated at cost less accumulated amortisation and impairment losses. Costs include all direct expenses incurred to acquire and bring to use the specific software.

Costs incurred in bringing to use enhancements to an existing software programme are capitalised only if the enhancement will produce additional future economic benefits exceeding costs over more than one year.

Capitalised software development costs are amortised on a straight-line basis over the estimated useful life of the software (three to 10 years). Costs associated with maintaining computer software are recognised as expenses when incurred.

Leases

Leases of plant and equipment where the Bank has substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalised at the lease's inception at the lower of the fair value of the leased property and the present value of the minimum lease payments. The corresponding rental obligations, net of finance charges, are included in Other Liabilities. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate of return on the finance balance outstanding. Plant and equipment acquired under finance leases is depreciated over the shorter of the asset's useful life and the lease term.

Leases in which a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Minimum payments made under operating leases (net of any incentives received from the lessor) are charged to the Income Statement on a straight-line basis over the period of the lease.

Impairment of Non-financial Assets

Non-financial assets are reviewed for indicators of impairment annually. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash generating units).

(F) FINANCIAL LIABILITIES

Recognition of Financial Liabilities

Financial liabilities are recognised initially at fair value. Except for liabilities classified as financial liabilities at fair value through profit or loss, financial liabilities are subsequently stated at amortised cost.

Financial liabilities are derecognised only when the obligation is discharged, cancelled or expired.

Financial liabilities are recorded on trade date, the date on which the Bank commits to borrow or repay the relevant funds.

Financial Liabilities at Fair Value through Profit or Loss

This category has two sub-categories: financial liabilities held for trading and those designated as fair value through profit or loss at inception. Financial liabilities that are classified as financial liabilities through profit or loss are included in those sub-categories on the same basis as financial assets at fair value through profit or loss (see page 60).

Securities Sold under Agreements to Repurchase

Where the Bank sells securities under agreements to repurchase (repurchase agreements), the security continues to be included as an asset in the Bank's Statement of Financial Position.

The consideration payable under the agreement to repurchase is recorded at fair value. Movements in the fair value of repurchase agreements are reported in the Income Statement.

Short Sales of Marketable Securities

A short sale is a sale of a security that the Bank does not own. Securities that are sold short are recorded at fair value through profit or loss using quoted market offer prices.

Any gains or losses are recognised in the Income Statement.

Currency in Circulation

Currency issued by the Bank represents a claim on the Bank in favour of the holder. The liability for currency in circulation is recorded at face value in the Statement of Financial Position.

Demonetised Currency

The Bank has a liability for the face value of demonetised currency still in circulation. For currency demonetised before 1 July 2004, this is recognised as a contingent liability except for a provision retained in the Statement of Financial Position to cover expected future redemptions. For currency demonetised from 1 July 2004, the Bank records a liability equal to the face value of that currency still in circulation.

Collectors' Currency

The Bank has a liability for the face value of collectors' currency. The face value of collectors' currency issued before 1 July 2004 is recognised as a contingent liability. For collectors' currency issued from 1 July 2004, the Bank records a liability equal to the face value of that currency.

Offsetting of Financial Assets and Financial Liabilities

Financial assets and liabilities are offset and the net amount reported in the Statement of Financial Position when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the asset and settle the liability simultaneously.

(G) OTHER LIABILITIES

Employee Entitlements

Wages and Salaries, Annual and Sick Leave

Liabilities for wages and salaries, including non-monetary benefits and annual leave, are recognised in Other Liabilities in respect of employees' services and are measured at the amounts expected to be paid when liabilities are settled.

Retirement Gratuity

Retirement gratuities and post-retirement benefits are recognised in Other Liabilities in respect of employees' services and are measured at the present value of future payments expected to be made in respect of services provided by employees up to balance date. This is calculated by an independent actuary using a discounted cash flow model. Expected future payments are discounted to their net present value using market yields at the reporting date on government bonds with terms that match as closely as possible the estimated timing of future cash flows.

Changes in the value of the liability for retirement gratuities and post-retirement benefits are included in the Income Statement in staff expenses in Operating Expenses.

Superannuation Obligations

Obligations for contributions to defined benefit superannuation schemes are recognised as an expense in the Income Statement as incurred.

A liability is recognised in the Statement of Financial Position where the present value of defined benefit obligations exceeds the fair value of the scheme's assets (as adjusted for unrecognised past-service costs).

An asset is recognised in the Statement of Financial Position where the present value of defined benefit obligations is less than the fair value of the scheme's assets (as adjusted for unrecognised past-service costs). Any net asset recognised in the Statement of Financial Position is limited to the estimated present value of reductions in future employer contributions to the defined benefit scheme.

The present value of the defined benefit obligation is determined by discounting the estimated future cash flows using interest rates of New Zealand government bonds that have terms to maturity approximating the terms of the related superannuation liability. The calculation is performed annually by an independent qualified actuary using the projected unit credit method.

Staff expenses within Operating Expenses in the Income Statement includes the current-service cost, past-service cost, an interest cost and an expected return for the defined benefit superannuation scheme. The actuarial gain or loss on the defined benefit superannuation scheme is included as a separate item within Operating Expenses.

(H) INCOME AND EXPENSES

Fee Income

Fee income earned from provision of services is recognised as revenue on an accruals basis as the service is provided.

Income and Expenses Allocated to Functions

The Reserve Bank Act requires the Bank to account for revenue and expenses by reference to the functions the Bank performs. Each function receives income and incurs expenses relating directly to the assets and liabilities used exclusively by that function. Earnings from the investment of the Bank's equity are allocated to each function based on the estimated amount of equity required for each function.

Income and expense flows are attached to the notional funding for each function. The Bank operates notional balance sheets to calculate the notional income and expenditure for each of the Bank's functions as though each function operates autonomously. The Bank also has systems in place to allocate operating costs to functions. Operating costs are allocated as closely as possible to reflect their consumption. Direct operating costs are assigned directly to functions. Indirect operating costs are allocated to functions based on predetermined cost drivers and related activity or usage information. These structures enable each function to report more accurately the financial outcome of the services provided.

Income Tax

Section CW38 of the Income Tax Act 2007 exempts the Bank from income tax. Accordingly, no provisions are raised for current or deferred income taxes.

(I) CASH FLOWS

For the purposes of the Statement of Cash Flows, cash and cash equivalents include balances with other central banks and amounts available at call with other institutions.

Certain cash flows have been netted in order to provide more meaningful disclosure. Netting of cash flows occurs where cash receipts and payments on behalf of customers reflect the activities of the customer rather than the Bank, or where cash receipts or payments are for items in which turnover is quick, amounts are large, and maturities are short.

(J) SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Fair Value of Financial Instruments

Financial instruments classified as held for trading or designated at fair value through profit or loss and financial assets classified as available for sale are recognised in the financial statements at fair value. All derivatives are measured and recognised at fair value.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Financial instruments are priced either with reference to a quoted market price for that instrument or by using a valuation model. Where the fair value is calculated using financial market pricing models, the methodology used is to calculate the expected cash flows under the terms of each specific contract and then discount these values back to the present value. These models use as their basis independently sourced market parameters including, for example, interest rate yield curves and currency rates. Most market parameters are either observable directly or are implied from instrument prices.

Judgement is applied also in assessing the extent of impairment of financial and other assets.

Superannuation and Post-retirement Obligation

The Bank has obligations under the defined benefit superannuation plan and for certain post-retirement obligations as described on page 63 above. The carrying amount of these obligations is based upon actuarial valuations, which in turn are dependent upon a series of assumptions. Key valuation assumptions include price inflation, earnings growth, employee retirement dates, and investment returns. Valuations are performed on the basis that the scheme will not be wound up.

Valuation of Land and Buildings

Every three years, the fair value of the Bank's land and buildings is assessed by an independent registered property valuer. Estimated fair value is arrived at by the valuer, based on a number of assumptions, principally with respect to market rates of rental and market capitalisation rates.

2. NATURE AND EXTENT OF ACTIVITIES

The Reserve Bank's role as a central bank determines the nature and extent of its activities with respect to financial instruments. This role is defined by the Reserve Bank Act.

(A) LOCAL CURRENCY ACTIVITIES

The Bank provides exchange settlement account facilities to financial institutions and to the New Zealand government. The Bank manages the aggregate level of liquidity held by financial institutions in their exchange settlement accounts.

The financial instruments used to inject funds into the banking system include local currency reverse-repurchase transactions, outright purchases of New Zealand government securities shortly before maturity and foreign currency swaps. The Bank uses securities from holdings of New Zealand government securities in repurchase transactions and issues Reserve Bank bills to withdraw funds from the banking system for liquidity management purposes.

Balances in exchange settlement accounts are repayable on demand and the Bank pays interest on overnight balances. From time to time, the Bank may also hold small trading positions in New Zealand government securities or registered bank securities as part of market test activities.

The Bank issues notes and coins to registered banks in order to meet the currency needs of the public. When currency is issued to a registered bank, that bank's settlement account is debited with the face value of currency issued.

The Bank also operates the NZClear System. This includes carrying out securities registry and paying agent responsibilities.

(B) FOREIGN CURRENCY ACTIVITIES

The Bank's foreign currency activities arise mainly from:

- holding foreign currency assets for crisis management purposes;
- the investment of proceeds of foreign currency swaps entered into for managing the aggregate level of liquidity of the New Zealand banking system; and
- the purchase or sale of foreign currency in order to meet monetary policy objectives.

Foreign reserve assets held for crisis management purposes are funded by a combination of foreign currency loans from the Treasury, which are made on arm's length terms, and New Zealand dollar-denominated liabilities, including currency in circulation and deposits placed with the Bank by financial institutions. Foreign currency swaps are used to convert New Zealand dollar funding into foreign currency and to manage a significant portion of foreign currency risk. A proportion of foreign currency assets held for crisis management purposes are maintained without hedging their foreign currency risk. The hedged/unhedged position will vary over time as the Bank determines appropriate.

The Bank routinely injects New Zealand dollars into the New Zealand banking system as part of its liquidity management operations. The injection of New Zealand dollars entails the Bank entering into foreign currency swap transactions for a finite term. The foreign currency received from a swap is invested in foreign currency-denominated securities for a term coinciding with the term of the swap. Proceeds received on maturity of the foreign currency investment are used by the Bank to repay the foreign currency at the end of the term of the foreign currency swap transaction.

Foreign currency purchased or sold when the Bank intervenes in the foreign exchange market to meet monetary policy objectives would usually entail the Bank borrowing or lending New Zealand currency to finance the foreign currency transaction.

Financial instruments held within foreign currency portfolios consist mainly of sovereign securities, securities held under reverse-repurchase transactions, or balances held with other central banks, commercial banks, or highly-rated supranational institutions. Liquidity and credit risk are key criteria in determining the type of instruments held.

The Bank manages the foreign currency exposure arising from certain operating and capital expenditure commitments denominated in foreign currency. The Bank will purchase foreign currency cover for those foreign currency-denominated commitments that will fall due over the following financial year.

For further information on the risk management policies relating to financial instruments, see Notes 16 to 23.

(C) FOREIGN EXCHANGE DEALING

Section 16 of the Reserve Bank Act provides the Bank with the power to deal in foreign currency for the purpose of carrying out its functions and powers. All dealings in foreign currency assets and liabilities occur under that section, except for transactions that occur at the direction of the Minister of Finance.

Sections 17 and 18 of the Reserve Bank Act provide for the Minister of Finance to direct the Bank to deal in foreign exchange, or for the Minister of Finance to fix the foreign exchange rates for foreign exchange dealing by the Bank. Section 21 of the Reserve Bank Act requires the Bank to either pay any foreign currency exchange gains to the Crown, or to be reimbursed for any foreign exchange losses, as a result of dealing in foreign exchange under sections 17 or 18 of the Reserve Bank Act. For the year ended 30 June 2012, there have been no directions from the Minister under section 17 or 18 and there have been no payments to or from the Crown under section 21 of the Reserve Bank Act (2011: nil).

Under section 24 of the Reserve Bank Act, the Minister, in consultation with the Bank, determines the level or range of foreign reserve assets that must be maintained by the Bank.

(D) DERIVATIVE FINANCIAL INSTRUMENTS

The Bank's involvement in derivative financial instruments includes primarily foreign currency swaps, bond and interest rate futures, interest rate swaps and forward foreign exchange contracts.

Foreign currency swaps are used to manage transactions for foreign exchange for both Domestic Market Operations and Foreign Reserves Management. The arrangements are described in more detail above in (B) Foreign Currency Activities.

Bond and interest rate futures and interest rate swaps are used to enhance expected returns on foreign currency assets and, from time to time, to manage interest rate and foreign exchange risks.

(E) TITLE TO ASSETS

As part of its foreign currency operations, the Bank enters into security repurchase transactions. These foreign currency securities sold by the Bank under repurchase agreements are recorded as an asset within Marketable Securities in the Bank's Statement of Financial Position. These foreign currency-denominated transactions are also recognised as a liability within Securities Sold under Agreements to Repurchase in the Bank's Statement of Financial Position.

The Bank enters into security repurchase transactions as part of its liquidity management operations and market testing activities. These local currency-denominated securities sold by the Bank under repurchase agreements are recorded as an asset in New Zealand Government Securities in the Bank's Statement of Financial Position.

The Bank also purchases securities under reverse-repurchase agreements in both its foreign currency and local currency operations. These transactions are recognised as Securities Purchased under Agreements to Resell in the Bank's Statement of Financial Position.

The Bank can be required to deliver collateral under swap arrangements. Any collateral delivered by the Bank remains in the Statement of Financial Position.

Note 3 gives details of the collateral taken or provided as at balance date.

3. ANALYSIS OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Foreign Currency Marketable Securities

Foreign Currency Marketable Securities of $12,780 million (2011: $16,574 million) comprise fixed interest securities issued by foreign governments, foreign near-government entities and supranational organisations. Further details, such as the credit rating and the country in which the issuer is resident, are provided in note 18 in respect of all financial assets including Foreign Currency Marketable Securities.

Analysis of Financial Assets and Liabilities by Measurement Basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the Statement of Financial Position by class and by category as defined by NZ IAS 39. There have been no transfers between classes of financial instruments.

	Fair Value through Profit or Loss						
As at 30 June 2012	Total $M	Designated Upon Initial Recog-nition $M	Derivatives Deemed Held for Trading $M	Held for Trading $M	Available-for-sale Financial Assets $M	Loans and Receiv-ables $M	Financial Assets and Liabilities at Amortised Cost $M
ASSETS							
Foreign Currency Financial Assets							
Cash Balances	2,785	2,782	-	3	-	-	-
Securities Purchased under Agreements to Resell	4,566	4,566	-	-	-	-	-
Marketable Securities	12,780	12,780	-	-	-	-	-
Derivative Financial Assets	1,700	-	1,700	-	-	-	-
Other Foreign Currency Financial Assets	140	-	-	-	139	1	-
Total Foreign Currency Financial Assets	21,971	20,128	1,700	3	139	1	-
Local Currency Financial Assets							
Securities Purchased under Agreements to Resell	1,501	1,501	-	-	-	-	-
New Zealand Government Securities	3,193	-	-	-	3,193	-	-
Other Local Currency Financial Assets	1	-	-	-	-	1	-
Total Local Currency Financial Assets	4,695	1,501	-	-	3,193	1	-
Total Financial Assets	26,666	21,629	1,700	3	3,332	2	-
LIABILITIES							
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	1,069	1,064	-	-	-	-	5
Securities Sold under Agreements to Repurchase	606	606	-	-	-	-	-
Derivative Financial Liabilities	306	-	306	-	-	-	-
Term Liabilities	2,148	2,148	-	-	-	-	-
Total Foreign Currency Financial Liabilities	4,129	3,818	306	-	-	-	5
Local Currency Financial Liabilities							
Deposits	15,262	15,262	-	-	-	-	-
Securities Sold under Agreements to Repurchase	119	119	-	-	-	-	-
Currency in Circulation	4,375	-	-	-	-	-	4,375
Other Local Currency Financial Liabilities	85	-	-	-	-	-	85
Total Local Currency Financial Liabilities	19,841	15,381	-	-	-	-	4,460
Total Financial Liabilities	23,970	19,199	306	-	-	-	4,465

As at 30 June 2011	Total $M	Fair Value through Profit or Loss: Designated Upon Initial Recog-nition $M	Fair Value through Profit or Loss: Derivatives Deemed Held for Trading $M	Fair Value through Profit or Loss: Held for Trading $M	Available-for-sale Financial Assets $M	Loans and Receiv-ables $M	Financial Assets and Liabilities at Amortised Cost $M
ASSETS							
Foreign Currency Financial Assets							
Cash Balances	1,959	1,959	-	-	-	-	-
Securities Purchased under Agreements to Resell	3,803	3,803	-	-	-	-	-
Marketable Securities	16,574	16,574	-	-	-	-	-
Derivative Financial Assets	2,080	-	2,080	-	-	-	-
Other Foreign Currency Financial Assets	231	-	-	-	134	97	-
Total Foreign Currency Financial Assets	24,647	22,336	2,080	-	134	97	-
Local Currency Financial Assets							
Securities Purchased under Agreements to Resell	2,591	2,591	-	-	-	-	-
New Zealand Government Securities	3,768	-	-	-	3,768	-	-
Other Local Currency Financial Assets	1	-	-	-	-	1	-
Total Local Currency Financial Assets	6,360	2,591	-	-	3,768	1	-
Total Financial Assets	31,007	24,927	2,080	-	3,902	98	-
LIABILITIES							
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	1,092	1,092	-	-	-	-	-
Securities Sold under Agreements to Repurchase	475	475	-	-	-	-	-
Derivative Financial Liabilities	466	-	466	-	-	-	-
Term Liabilities	2,448	2,448	-	-	-	-	-
Total Foreign Currency Financial Liabilities	4,481	4,015	466	-	-	-	-
Local Currency Financial Liabilities							
Deposits	19,627	19,627	-	-	-	-	-
Currency in Circulation	4,173	-	-	-	-	-	4,173
Other Local Currency Financial Liabilities	84	-	-	-	-	-	84
Total Local Currency Financial Liabilities	23,884	19,627	-	-	-	-	4,257
Total Financial Liabilities	28,365	23,642	466	-	-	-	4,257

FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

All financial assets and liabilities are recorded at fair value based on either quoted market prices or prices derived from market yield curves, as described in the Bank's accounting policies, except as detailed below. Refer to page 68 for details of the classification by valuation hierarchy of financial assets and financial liabilities carried at fair value.

(a) Unsettled Transactions

The reported value of unsettled sales and purchases is considered to approximate their fair value due to the very short period between balance date and the settlement date.

(b) Short-term Deposits

The carrying value of short-term deposits is considered to approximate their fair value, as they are payable on demand.

(c) Currency in Circulation

Currency in Circulation is reported at its face value, as currency in circulation is payable on demand. NZ IAS 39 requires that the fair value cannot be less than the face value.

DETERMINATION OF FAIR VALUE OF FINANCIAL INSTRUMENTS CARRIED AT FAIR VALUE

Each financial instrument carried at fair value is categorised within the hierarchy based on the lowest-level input that is significant to the fair value measurement of the whole instrument.

Fair values are determined according to the following hierarchy:

(a) Quoted Market Price

Financial instruments with quoted prices for identical instruments in active markets (level 1).

(b) Valuation Technique Using Observable Inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets, and financial instruments valued using models where all significant inputs are observable (level 2).

The determination of what constitutes 'observable' requires significant judgement by the Bank. The Bank considers observable data to be that market data that is available readily, distributed or updated regularly, reliable and verifiable, not proprietary, and provided by independent sources that are involved actively in the relevant market. Judgement is required to be exercised also in determining appropriate margins to representative forward prices and interest rate yield curves in order to model more accurately the market price of the specific instrument that is being valued.

Where necessary, valuation models include estimated future cash flows and discount rates that are calculated using forward prices and interest rate yield curves. Forward prices and interest rate yield curves are sourced from the relevant published market observable exchange rates and interest rates applicable to the remaining life of the instrument at the valuation date. Also, where necessary, margin adjustments are made to representative prices and interest rate yield curves in order to allow for features of the instrument that would be taken into account in valuing a financial instrument, where those features are not included or priced into representative forward prices and interest rate yield curves.

(c) Valuation Technique with Significant Non-observable Inputs

Financial instruments valued using models where one or more significant inputs are not observable (level 3).

CHANGE IN VALUATION CATEGORY FOR SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL AND SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

All securities purchased under agreements to resell and securities sold under agreements to repurchase are now classified as using level 2 (using observable inputs) rather than level 1 (quoted market price). Whilst the market quotes prices for securities purchased under agreements to resell and securities sold under agreements to repurchase for high-quality securities, there is no secondary market for existing agreements to repurchase or resell. Using level 2 classification for securities purchased under agreements to resell and securities sold under agreements to repurchase is consistent with market practice. In the Bank's 2011 financial statements, foreign currency securities purchased under agreements to resell with a market value of $3,803 million and local currency securities sold under agreements to repurchase with a market value of $475 million were classified as level 1. In the comparative figures within the 2012 financial statements, these financial instruments are classified as level 2.

The following table analyses the basis for the valuation of financial assets and financial liabilities measured at fair value:

As at 30 June 2012	Total $M	Valuation Techniques: Quoted Market Price $M	Using Observable Inputs $M	With Significant Non-observable Inputs $M
ASSETS				
Foreign Currency Financial Assets				
Cash Balances	**2,785**	2,783	2	-
Securities Purchased under Agreements to Resell	**4,566**	-	4,566	-
Marketable Securities	**12,780**	5,464	7,316	-
Derivative Financial Assets	**1,700**	-	1,700	-
Other Foreign Currency Financial Assets	**139**	-	-	139
Total Foreign Currency Financial Assets Carried at Fair Value	**21,970**	**8,247**	**13,584**	**139**
Local Currency Financial Assets				
Securities Purchased under Agreements to Resell	**1,501**	-	1,501	-
New Zealand Government Securities	**3,193**	3,193	-	-
Total Local Currency Financial Assets Carried at Fair Value	**4,694**	**3,193**	**1,501**	**-**
Total Financial Assets Carried at Fair Value	**26,664**	**11,440**	**15,085**	**139**
LIABILITIES				
Foreign Currency Financial Liabilities				
Short-term Foreign Currency Financial Liabilities	**1,064**	-	1,064	-
Securities Sold under Agreements to Repurchase	**606**	-	606	-
Derivative Financial Liabilities	**306**	-	306	-
Term Liabilities	**2,148**	-	2,148	-
Total Foreign Currency Financial Liabilities Carried at Fair Value	**4,124**	**-**	**4,124**	**-**
Local Currency Financial Liabilities				
Deposits	**15,262**	15,262	-	-
Securities Sold under Agreements to Repurchase	**119**	-	119	-
Total Local Currency Financial Liabilities Carried at Fair Value	**15,381**	**15,262**	**119**	**-**
Total Financial Liabilities Carried at Fair Value	**19,505**	**15,262**	**4,243**	**-**

As at 30 June 2011	Total $M	Valuation Techniques: Quoted Market Price $M	Valuation Techniques: Using Observable Inputs $M	Valuation Techniques: With Significant Non-observable Inputs $M
ASSETS				
Foreign Currency Financial Assets				
Cash Balances	1,959	1,958	1	-
Securities Purchased under Agreements to Resell	3,803	-	3,803	-
Marketable Securities	16,574	3,264	13,310	-
Derivative Financial Assets	2,080	-	2,080	-
Other Foreign Currency Financial Assets	134	-	-	134
Total Foreign Currency Financial Assets Carried at Fair Value	24,550	5,222	19,194	134
Local Currency Financial Assets				
Securities Purchased under Agreements to Resell	2,591	-	2,591	-
New Zealand Government Securities	3,768	3,768	-	-
Total Local Currency Financial Assets Carried at Fair Value	6,359	3,768	2,591	-
Total Financial Assets Carried at Fair Value	30,909	8,990	21,785	134
LIABILITIES				
Foreign Currency Financial Liabilities				
Short-term Foreign Currency Financial Liabilities	1,092	-	1,092	-
Securities Sold under Agreements to Repurchase	475	-	475	-
Derivative Financial Liabilities	466	-	466	-
Term Liabilities	2,448	-	2,448	-
Total Foreign Currency Financial Liabilities Carried at Fair Value	4,481	-	4,481	-
Local Currency Financial Liabilities				
Deposits	19,627	19,627	-	-
Total Local Currency Financial Liabilities Carried at Fair Value	19,627	19,627	-	-
Total Financial Liabilities Carried at Fair Value	24,108	19,627	4,481	-

ADDITIONAL INFORMATION FOR FINANCIAL INSTRUMENTS CARRIED AT FAIR VALUE WHERE THE VALUATION INCORPORATES NON-OBSERVABLE MARKET DATA

Financial instruments carried at fair value where the valuation incorporates non-observable market data comprise the Bank's shares in the Bank for International Settlements (BIS). The Bank's investment in shares issued by the BIS is valued at fair value, which is determined as being 70 percent of the Bank's interest in the BIS's net asset value. This is the valuation basis confirmed by the International Court at The Hague in 2002 for the acquisition of shares from former private shareholders of the BIS. While the Bank considers that the 30 percent discount against the BIS's net asset value continues to be the appropriate basis for valuation, the valuation inputs are not considered to be observable and, therefore, it has classified the shares as level 3: Valuation Technique with Significant Non-observable Inputs.

The following table details movements in the level 3 assets. There have been no transfers between level 1 and level 2 assets except that all Securities Purchases under Agreements to Resell are classified as level 2 assets.

	2012 $M	2011 $M
Opening Balance	**134**	140
New Purchases and Sales	**-**	-
Transfers into the Category	**-**	-
Transfers out of the Category	**-**	-
Fair Value Gain Recognised in the Consolidated Statement of Comprehensive Income Recorded in:		
Movement in Available-for-sale Revaluation Reserve taken to Equity	**5**	(6)
Closing Balance	**139**	134

COLLATERAL PLEDGED

The carrying amount of securities pledged as collateral for liabilities comprising Securities Sold under Agreements to Repurchase was $119 million (2011: $nil) and the fair value of collateral pledged was $117 million (2011: $nil). Cash collateral of $nil was provided (2011: $nil).

COLLATERAL RECEIVED

Residential Mortgage-backed Securities, Asset-backed Securities and Asset-backed Commercial Paper

The Bank has entered into reverse-repurchase agreements in respect of New Zealand dollar-denominated residential mortgage-backed securities, asset-backed securities and asset-backed commercial paper. At 30 June 2012, the principal amount subject to reverse-repurchase agreements for residential mortgage-backed securities was $nil (2011: $50 million), and asset-backed securities was $nil (2011: nil). Depending on the type of collateral received, the principal value of securities received as collateral for those repurchase agreements must be at least 105 percent (2011: 105 percent) in the case of residential mortgage-backed securities and at least 119 percent (2011: 119 percent) in the case of asset-backed securities and asset-backed commercial paper of the cash to be paid to the Bank when the securities are repurchased. The Bank does not sell or repledge that collateral unless the counterparty is in default of its obligations.

Marketable Securities

The Bank has entered into reverse-repurchase agreements in respect of New Zealand dollar-denominated marketable securities. The principal amount subject to reverse-repurchase agreements for New Zealand dollar-denominated marketable securities was $1,501 million (2011: $2,540 million) and the fair value of collateral received was $1,527 million (2011: $2,613 million). The Bank may sell or repledge that collateral even if the counterparty is not in default of its obligations.

The Bank has entered into reverse-repurchase agreements in respect of foreign currency-denominated marketable securities. The principal amount subject to reverse-repurchase agreements for foreign currency-denominated marketable securities was $3,962 million (2011: $3,326 million). The fair value of collateral received was $4,043 million (2011: $3,385 million). The Bank may sell or repledge that collateral even if the counterparty is not in default of its obligations.

Other Collateral Received

In addition, cash collateral received is $1,064 million (2011: $1,092 million). Cash collateral received is recorded in the Statement of Financial Position in Short-term Deposits within Short-term Foreign Currency Financial Liabilities.

Under the Bank's securities lending programme, the Bank has lent securities with a fair value of $606 million (2011: $475 million). The Bank has accepted securities with a fair value of $619 million (2011: $485 million) as collateral for the securities lent under this programme.

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse-repurchase agreements.

ADDITIONAL INFORMATION FOR FINANCIAL LIABILITIES

The carrying amount as at balance date of financial liabilities designated at fair value through profit or loss, excluding derivatives, was $23 million less (2011: $27 million less) than the contractual amount at maturity.

Interest rates that are used as observable inputs in determining the fair value of financial liabilities will inherently include a component for credit risk. However, given the Bank's status as a sovereign issuer, it is difficult to isolate and accurately measure the change in interest rates and the resulting change in fair value of financial liabilities directly attributable to credit risk.

With respect to the credit ratings assigned to debt issued by the New Zealand government, in September 2011 Standard and Poor's cut its long-term foreign currency rating on New Zealand to AA from AA+ and its long-term local currency rating on New Zealand to AA+ from AAA.

Even with the change in formal credit rating, it is not practicable to accurately isolate the impact of changes in the fair values of the Bank's liabilities that are due to changes in the Bank's own credit risk.

Collateral has been pledged for all Securities Sold under Agreements to Repurchase. All other liabilities of the Bank are unsecured and rank equally in the event that the Bank ceases to trade.

4. DERIVATIVE FINANCIAL INSTRUMENTS

	Book Value 2012 $M	Notional Principal 2012 $M	Book Value 2011 $M	Notional Principal 2011 $M
Bond/Rate Futures				
Bond/Rate Futures Assets	**-**	**4**	-	-
Bond/Rate Futures Liabilities	**-**	**-**	-	28
Net Bond/Rate Futures Position	**-**	**4**	-	28
As at 30 June 2012, the Bank had 20 open Interest Rate Futures contracts (2011: 134).				
Cross Currency Basis Swaps				
Cross Currency Basis Swaps Assets	**1,476**	**10,632**	1,648	9,004
Cross Currency Basis Swaps Liabilities	**(263)**	**2,224**	(446)	3,096
Net Foreign Currency Swaps Position	**1,213**	**12,856**	1,202	12,100
Foreign Exchange Swaps				
Foreign Exchange Swaps Assets	**224**	**5,604**	432	11,816
Foreign Exchange Swaps Liabilities	**(43)**	**3,232**	(20)	1,010
Net Foreign Exchange Contracts Position	**181**	**8,836**	412	12,826
Total Derivative Financial Assets	**1,700**	**16,240**	2,080	20,820
Total Derivative Financial Liabilities	**(306)**	**5,456**	(466)	4,134
Net Derivative Financial Instruments Recognised in the Statement of Financial Position	**1,394**	**21,696**	1,614	24,954

5. OTHER FOREIGN CURRENCY FINANCIAL ASSETS

	2012 $M	2011 $M
Shareholding in the Bank for International Settlements	**139**	134
Dividend Receivable	**-**	2
Receivable for Unsettled Sales of Securities	**1**	95
	140	231

As at 30 June 2012, the Bank owned 3,211 shares (2011: 3,211 shares) issued by the Bank for International Settlements (BIS). This represents approximately 0.6 percent of all shares on issue. The shares have a par value of SDR 5,000 each and are paid up to SDR 1,250 each. The Bank's investment in shares issued by the BIS is valued at fair value, which is determined as being 70 percent of the Bank's interest in the BIS's net asset value. This is the valuation basis confirmed by the International Court at The Hague for the acquisition of shares from former private shareholders of the BIS.

6. OTHER ASSETS

	Note	2012 $M	2011 $M
Property, Plant and Equipment	7	**56**	57
Intangible Assets	8	**6**	6
Inventory		**16**	20
		78	83

7. PROPERTY, PLANT AND EQUIPMENT

	Total $M	Land and Buildings $M	Property Improve-ments $M	Computer Hardware $M	Plant and Equipment $M	Currency and Artworks Collections and Archives $M
As at 30 June 2011						
Cost (includes revaluations)	71	48	6	7	5	5
Accumulated Depreciation	14	2	3	6	3	-
Net Book Value	57	46	3	1	2	5
For the Year Ended 30 June 2012						
Net Book Value at the Beginning of the Year	**57**	**46**	**3**	**1**	**2**	**5**
Additions	**3**	**-**	**1**	**1**	**1**	**-**
Revaluation	**(4)**	**(4)**	**-**	**-**	**-**	**-**
Accumulated Depreciation Written Back	**3**	**3**	**-**	**-**	**-**	**-**
Less Depreciation	**3**	**1**	**-**	**1**	**1**	**-**
Net Book Value at the End of the Year	**56**	**44**	**4**	**1**	**2**	**5**
As at 30 June 2012						
Cost (includes revaluations)	**70**	**44**	**7**	**8**	**6**	**5**
Accumulated Depreciation	**14**	**-**	**3**	**7**	**4**	**-**
Net Book Value	**56**	**44**	**4**	**1**	**2**	**5**

The Bank obtains an independent valuation of land and buildings every three years. The most recent valuation of land and buildings, dated 30 June 2012, was prepared by Jones Lang LaSalle Limited, an independent registered valuer. The valuation was prepared by discounting rental and nominal rental flows at current market capitalisation rates. The valuation report included details of recent sales of broadly comparable premises. The capitalisation rate applied in valuing property was a weighted average of 8.5 percent. The aggregate market value of land and buildings was $44 million. The original cost was $10 million.

8. INTANGIBLE ASSETS

	Computer Software $M
As at 30 June 2011	
Cost	20
Accumulated Amortisation	14
Net Book Value	6
For the Year Ended 30 June 2012	
Net Book Value at the Beginning of the Year	**6**
Additions	**1**
Less Amortisation	**1**
Net Book Value at the End of the Year	**6**
As at 30 June 2012	
Cost	**21**
Accumulated Amortisation	**15**
Net Book Value	**6**

9. SHORT-TERM FOREIGN CURRENCY FINANCIAL LIABILITIES

	2012 $M	2011 $M
Payable for Unsettled Purchases of Securities	**5**	-
Short-term Deposits	**1,064**	1,092
	1,069	1,092

10. DEPOSITS

	2012 $M	2011 $M
New Zealand Government Deposits	**9,095**	13,099
Settlement Bank Deposits	**6,134**	6,470
Central Bank Deposits	**26**	51
International Monetary Fund Deposits	**7**	7
	15,262	19,627

11. OTHER LOCAL CURRENCY FINANCIAL LIABILITIES

	2012 $M	2011 $M
Accounts Payable	**3**	2
Demonetised Currency	**82**	82
	85	84

12. OTHER LIABILITIES

	Note	2012 $M	2011 $M
Dividend Payable to the New Zealand Government	13	**160**	210
Accrued Salaries and Holiday Pay		**1**	2
Accrued Retirement Gratuities		**3**	3
Superannuation Liability	29	**8**	1
		172	216

No provision is made for non-vesting sick leave, as the pattern of sick leave taken indicates that no additional liability will arise for non-vesting sick leave.

13. PAYMENTS TO THE NEW ZEALAND GOVERNMENT

The Bank has recommended that a statutory dividend of $160 million be paid for the 2011-12 financial year. The Minister has given a direction that a dividend of $160 million (2011: $210 million) be paid. The dividend will be paid in September 2012.

In making dividend determinations, the Minister must have regard to the recommendations of the Bank, the views of the Board of Directors of the Bank and any other relevant matters.

The Bank's *Statement of Intent* includes a statement of the principles in accordance with which the Bank must determine the amount it recommends to the Minister as an annual dividend. Those principles are:

- The Bank should maintain sufficient equity for the financial risks of performing its functions. Equity in excess of that required to cover those risks will be distributed to the Crown.
- In general, unrealised gains should be retained by the Bank until they are realised in New Zealand dollars. However, the Bank may recommend the distribution of unrealised gains where the Bank believes that the probability of the gain being realised is high.

14. EQUITY

The Bank's Equity as at balance date, together with the movements for the financial year, comprised:

	Note	2012 $M	2011 $M
Capital			
Balance at the Beginning of the Year		**1,600**	1,600
Total Capital		**1,600**	1,600
Retained Earnings			
Balance at the Beginning of the Year		**645**	711
Net Profit for the Year		**118**	144
Dividend Payable to the New Zealand Government	13	**(160)**	(210)
Total Retained Earnings		**603**	645
Available-for-sale Revaluation Reserve			
Balance at the Beginning of the Year		**217**	216
Fair Value Movements during the Year		**136**	1
Total Available-for-sale Revaluation Reserve		**353**	217
Property Revaluation Reserve			
Balance at the Beginning of the Year		**42**	42
Fair Value Movements during the Year	7	**(1)**	-
Total Property Revaluation Reserve		**41**	42
Currency and Artwork Collections and Archives Revaluation Reserve			
Balance at the Beginning of the Year		**5**	5
Total Currency and Artwork Collections and Archives Revaluation Reserve		**5**	5
Total Equity		**2,602**	2,509

Retained Earnings comprises:

	2012 $M	2011 $M
Realised Gains not yet Distributed	**749**	682
Changes in the Market Value of Financial Instruments not yet Realised	**(29)**	43
Foreign Exchange Losses not yet Realised in New Zealand Dollars	**(117)**	(80)
Total Retained Earnings	**603**	645

MANAGEMENT OF THE BANK'S CAPITAL

The Bank's capital management framework focuses on the Bank's total equity reported in its financial statements.

The main drivers of reported equity are reported financial results and the Bank's dividend. The dividend is determined annually by the Minister of Finance under the provisions of the Reserve Bank Act and the principles referred to in Note 13.

The Bank's primary capital management objective is to have sufficient capital to carry out effectively its statutory responsibilities. In determining whether the Bank has sufficient capital for those purposes, it assesses the extent of financial risks and the resulting potential for losses arising from its operations. The Bank assesses the appropriate ranges for capital by considering financial risks across the Statement of Financial Position, including the use of statistical models at varying levels of confidence, and supplements that analysis with judgement, where appropriate.

15. CONCENTRATIONS OF FUNDING

The Bank's significant end-of-year concentrations of funding were as follows:

	Total 2012 $M	New Zealand Government $M	New Zealand Public $M	New Zealand Financial Institutions $M	Overseas Financial Institutions $M	Other $M
Financial Liabilities						
Term Liabilities	**2,148**	**2,148**	**-**	**-**	**-**	**-**
Securities Sold under Agreements to Repurchase	**725**	**-**	**-**	**-**	**725**	**-**
Deposits	**15,262**	**9,095**	**-**	**4,531**	**1,636**	**-**
Currency in Circulation	**4,375**	**-**	**4,375**	**-**	**-**	**-**
Other Liabilities	**1,460**	**-**	**82**	**505**	**870**	**3**
Total Financial Liabilities	**23,970**	**11,243**	**4,457**	**5,036**	**3,231**	**3**

	Total 2011 $M	New Zealand Government $M	New Zealand Public $M	New Zealand Financial Institutions $M	Overseas Financial Institutions $M	Other $M
Financial Liabilities						
Term Liabilities	2,448	2,448	-	-	-	-
Securities Sold under Agreements to Repurchase	475	-	-	-	475	-
Deposits	19,627	13,099	-	4,128	2,400	-
Currency in Circulation	4,173	-	4,173	-	-	-
Other Liabilities	1,642	-	82	683	875	2
Total Financial Liabilities	28,365	15,547	4,255	4,811	3,750	2

All figures are stated at carrying values in the Statement of Financial Position.

16. RISK MANAGEMENT

The Reserve Bank is involved in policy-oriented activities. Therefore, elements of the Bank's risk management framework might differ from the risk management frameworks for most other financial institutions. The main financial risks to which the Bank is exposed include credit risk, foreign currency risk, and interest rate risk on both foreign and local currency assets. In the management of foreign reserves, minimising liquidity risk is a major consideration in order to maintain an effective foreign exchange intervention capability. Policies for managing credit, interest rate, foreign currency, and liquidity risks are outlined in Notes 18 to 22. Like most other central banks, the nature of the Bank's operations creates exposure to a range of operational and reputational risks.

The Bank seeks to ensure that strong and effective risk management and control systems are in place for identifying, assessing, monitoring, and managing risk exposures. An Asset and Liability Committee (ALCO), comprising the governors and senior management, is responsible for advising the Governor on the management and monitoring of the Bank's strategy, risks and performance of all balance sheet-related activities. This review includes the appropriateness of risk-return trade-offs underlying the Bank's strategy. Specialist staff conduct the Bank's local currency, foreign currency reserves management, and foreign exchange-dealing operations in accordance with a clearly defined risk management framework, including delegated authorities and limits set by the Governor. The risk management framework is subject to regular review by ALCO. The overall risk management framework is designed to promote the sound and prudent management of the Bank's risks.

The majority of the Bank's financial risks arise from the Foreign Reserves Management and Domestic Market Operations units of the Bank's Financial Markets department. Within this department, a Risk Unit is responsible for maintaining the Bank's financial risk management framework. A separate department of the Bank (Financial Services Group) operates independent risk reporting systems that monitor and report compliance with various risk limits and policies.

The Risk Assessment and Assurance department (which includes an internal audit unit) reports on internal audit and related issues to the governors. A risk-based framework, which evaluates key business risks and internal controls, is used to determine the extent and frequency of internal audits conducted. All Bank departments are subject to periodic internal audit review. The Head of Risk Assessment and Assurance and the Manager, Internal Audit have direct and independent access to the Audit Committee of the Board of Directors, comprising three of the Bank's non-executive directors. Summary information on the outcomes of internal audits is reported to the Audit Committee.

The Bank is subject to an annual external audit by the Auditor-General under the Public Audit Act 2001. Auditing arrangements are overseen by the Audit Committee of the Board of Directors, which meets regularly to monitor the financial reporting and audit functions within the Bank. The committee reviews the internal audit function and has direct access to the external auditor. The committee reports to the Board of Directors on its activities. The Board of Directors monitors the Bank's management of risk as part of its role of keeping the Bank's performance and use of resources under constant review.

The Bank self-insures all property, plant and equipment, including the Bank's Wellington building.

17. OPERATIONAL RISK

Operational risk is the risk of loss in both financial and non-financial terms resulting from human error and the failure of internal processes and systems.

Managing operational risk in the Bank is seen as an integral part of day-to-day operations and management, which includes explicit consideration of both the opportunities and the risks of all business activities. Operational risk management includes Bank-wide corporate policies that describe the standard of conduct required of staff, a number of mandated requirements (e.g., a project management template), and specific internal control systems designed around the particular characteristics of various Bank activities.

Compliance with corporate policies and departmental internal control systems is supported by:

- an induction programme for new employees to create awareness of policy and system requirements;
- a quarterly management affirmation by each Head of Department that corporate policies and departmental internal control systems have been complied with;
- a proactive problem management process whereby problems and incidents are reported and analysed for potential risk management improvements;
- periodic review of each department's risks and internal controls; and
- an active internal audit function.

The above policies and procedures for managing operational risk are reinforced by the requirements of section 165 of the Reserve Bank Act. The Reserve Bank Act requires that the financial statements of the Bank include a statement signed by the Governor and Deputy Chief Executive accepting responsibility for, among other things, the establishment and maintenance of a system of effective internal control within the Bank.

18. CREDIT RISK

Credit risk is the potential for loss arising from the failure of a debtor or counterparty to meet their contractual obligations.

Within the Bank, credit risk arises principally through the investment of funds and related derivative contracts for the Foreign Reserves Management and Domestic Market Operations functions.

Credit risks arising from the various Bank activities are aggregated for limit and monitoring purposes.

(A) FOREIGN RESERVES MANAGEMENT CREDIT RISK MANAGEMENT

Credit risk for Foreign Reserves Management is monitored and managed daily. Exposures are controlled through comprehensive individual counterparty and issuer credit limits. Individual credit limits are set on the basis of the rating of the counterparty or issuer. Additionally, sovereign and supranational issuers are assigned a higher limit than similarly rated corporates. Individual credit exposures are also aggregated and managed against cumulative limits, such as country exposure limits. The credit risk framework recognises differences in short-term (settlement risk) and longer-term credit risk.

In measuring compliance with credit limits, actual exposures are calculated on a credit-equivalent basis. In particular, where exposures to counterparties are collateralised by cash or by securities issued by sovereign states, the measure of actual credit exposure is reduced to reflect the collateral held. Credit exposures arising from securities purchased under agreements to resell (reverse-repurchase agreements) are classified according to the issuer of the security for credit exposure concentration purposes.

The Bank does not constrain credit exposure to certain sovereign issuers (e.g. the US). Exposures to these sovereign issuers are managed through other limits and controls (such as currency composition limits).

As part of the arrangements for using financial instruments, credit risk is mitigated by receiving collateral. Collateral is likely to take the form of cash or government securities. The value of collateral held is required to be within a prescribed range of the value of the exposure to the counterparty. Valuations are updated daily and, as a result, additional collateral may be called for or excess collateral returned to the counterparty.

(B) DOMESTIC MARKET OPERATIONS CREDIT RISK MANAGEMENT

The Domestic Market Operations function gives rise to credit risk primarily by transacting foreign currency swaps and reverse-repurchase transactions. The Bank accepts a wide range of pre-approved securities for reverse-repurchase transactions. Acceptable securities include government securities, securities issued by registered banks, highly-rated entities including supranational organisations, local authorities, residential mortgage-backed securities, asset-backed securities, asset-backed commercial paper and state-owned enterprises. Where funds are advanced by reverse-repurchase agreements, the amount advanced is subject to specified discounts depending upon the type of security so as to ensure that the value of security held exceeds the amount advanced. The value of security held is monitored daily and calls are made for additional collateral from, or excess collateral is returned to, the counterparty as required.

Exposures to the New Zealand government are not included in this credit framework.

(C) CONCENTRATIONS OF CREDIT EXPOSURE

The following table presents the Bank's financial assets based on end-of-year concentrations of credit exposure, classified by the country in which the issuer is resident. For this table, where collateral is held for reverse-repurchase agreements, the exposure measured is that to the issuer of the collateral, as opposed to the counterparty to the reverse-repurchase agreement.

Country in which Issuer is Resident:	**Total 2012 $M**	**Sovereign 2012 $M**	**Financial Institutions 2012 $M**	Total 2011 $M	Sovereign 2011 $M	Financial Institutions 2011 $M
United States	**9,664**	**9,283**	**381**	5,722	5,414	308
New Zealand	**5,289**	**4,648**	**641**	7,192	5,977	1,215
France	**2,613**	**1,416**	**1,197**	3,176	384	2,792
Germany	**1,621**	**285**	**1,336**	4,923	2,089	2,834
Netherlands	**1,401**	**167**	**1,234**	2,603	210	2,393
Australia	**1,327**	**18**	**1,309**	1,842	20	1,822
Japan	**1,262**	**1,262**	**-**	862	862	-
Supranational	**1,104**	**-**	**1,104**	2,909	-	2,909
Sweden	**752**	**-**	**752**	639	-	639
Denmark	**485**	**-**	**485**	-	-	-
Austria	**378**	**-**	**378**	576	-	576
United Kingdom	**301**	**244**	**57**	212	22	190
Canada	**163**	**125**	**38**	37	20	17
Asian Bond Funds	**149**	**-**	**149**	137	-	137
Other Non-European	**115**	**-**	**115**	61	-	61
Switzerland	**42**	**-**	**42**	116	-	116
Total Financial Assets	**26,666**	**17,448**	**9,218**	31,007	14,998	16,009

The following table presents the Bank's financial assets based on end-of-year concentrations of credit exposure, classified by the country in which the counterparty is resident.[23] For this table, any collateral held is not included in determining exposures.

Country in which Counterparty is Resident:	**Total 2012 $M**	**Sovereign 2012 $M**	**Financial Institutions 2012 $M**	Total 2011 $M	Sovereign 2011 $M	Financial Institutions 2011 $M
United States	**5,386**	**4,719**	**667**	3,564	3,010	554
New Zealand	**4,509**	**3,193**	**1,316**	5,469	3,768	1,701
United Kingdom	**4,060**	**244**	**3,816**	3,213	22	3,191
France	**2,933**	**1,416**	**1,517**	3,731	384	3,347
Germany	**2,002**	**285**	**1,717**	3,942	690	3,252
Australia	**1,802**	**18**	**1,784**	3,180	20	3,160
Netherlands	**1,401**	**167**	**1,234**	2,603	210	2,393
Japan	**1,265**	**1,261**	**4**	862	862	-
Supranational	**1,059**	**-**	**1,059**	2,877	-	2,877
Sweden	**752**	**-**	**752**	639	-	639
Denmark	**485**	**-**	**485**	-	-	-
Austria	**378**	**-**	**378**	576	-	576
Switzerland	**207**	**-**	**207**	116	-	116
Canada	**163**	**125**	**38**	37	20	17
Asian Bond Funds	**149**	**-**	**149**	137	-	137
Other Non-European	**115**	**-**	**115**	61	-	61
Total Financial Assets	**26,666**	**11,428**	**15,238**	31,007	8,986	22,021

The carrying value of financial assets is the Bank's maximum exposure to credit risk as at balance date. The Bank's maximum credit risk exposure in relation to financial derivatives is the cost of re-establishing the derivative contracts in the market in the event of the failure of the counterparty to fulfil its obligations. This cost is the fair value of the financial derivative assets as reported in Note 4.

23. The differences between amounts disclosed by issuer and by counterparty relate to Securities Purchased under Agreements to Resell.

(D) CREDIT EXPOSURE BY CREDIT RATING

The following table presents the Bank's financial assets based on Standard & Poor's credit rating of the issuer. AAA is the highest-quality rating possible and indicates the entity has an extremely strong capacity to pay interest and principal. AA is a high-grade rating, indicating a very strong capacity, and A is an upper-medium grade, indicating a strong capacity to pay interest and principal. BBB is the lowest investment-grade rating, indicating a medium capacity to pay interest and principal. Ratings lower than AAA can be modified by + or - signs to indicate relative standing within the major categories. N/R indicates the entity has not been rated by Standard & Poor's.

For this table, where collateral is held for reverse-repurchase agreements, the credit rating is that for the collateral and not the credit rating for the counterparty to the reverse-repurchase agreement.

Country in which Issuer is Resident:	**Total 2012 $M**	**AAA 2012 $M**	**AA+/- 2012 $M**	**A+/- 2012 $M**	**Various 2012 $M**	**N/R 2012 $M**
United States	**9,664**	**-**	**9,297**	**366**	**-**	**1**
New Zealand	**5,289**	**-**	**5,288**	**-**	**-**	**1**
France	**2,613**	**-**	**2,553**	**60**	**-**	**-**
Germany	**1,621**	**1,621**	**-**	**-**	**-**	**-**
Netherlands	**1,401**	**1,387**	**14**	**-**	**-**	**-**
Australia	**1,327**	**657**	**670**	**-**	**-**	**-**
Japan	**1,262**	**-**	**1,262**	**-**	**-**	**-**
Supranational[24]	**1,104**	**287**	**-**	**-**	**-**	**817**
Sweden	**752**	**752**	**-**	**-**	**-**	**-**
Denmark	**485**	**485**	**-**	**-**	**-**	**-**
Austria	**378**	**-**	**378**	**-**	**-**	**-**
United Kingdom	**301**	**245**	**-**	**56**	**-**	**-**
Canada	**163**	**125**	**38**	**-**	**-**	**-**
Asian Bond Funds	**149**	**-**	**-**	**-**	**149**	**-**
Other Non-European	**115**	**-**	**115**	**-**	**-**	**-**
Switzerland	**42**	**-**	**-**	**42**	**-**	**-**
Total Financial Assets	**26,666**	**5,559**	**19,615**	**524**	**149**	**819**

Country in which Issuer is Resident:	Total 2011 $M	AAA 2011 $M	AA+/- 2011 $M	A+/- 2011 $M	Various 2011 $M	N/R 2011 $M
New Zealand	7,192	6,028	1,164	-	-	-
United States	5,722	5,414	242	66	-	-
Germany	4,923	4,910	-	13	-	-
France	3,176	2,935	135	106	-	-
Supranational[24]	2,909	1,696	-	-	-	1,213
Netherlands	2,603	2,603	-	-	-	-
Australia	1,842	1,318	524	-	-	-
Japan	862	-	862	-	-	-
Sweden	639	639	-	-	-	-
Austria	576	576	-	-	-	-
United Kingdom	212	22	26	164	-	-
Asian Bond Funds	137	-	-	-	137	-
Switzerland	116	-	-	116	-	-
Other Non-European	61	-	61	-	-	-
Canada	37	20	17	-	-	-
Total Financial Assets	31,007	26,161	3,031	465	137	1,213

Collateral taken in reverse-repurchase agreements involving residential mortgage-backed securities with a carrying value of nil (2011: $50 million) is included in the table above as local currency financial assets that are AAA-rated securities. The issuers of these securities are special-purpose entities that are assigned credit ratings by rating agencies in their own right, and these ratings may differ from the credit ratings of the reverse-repurchase agreement counterparties.

Between the 2011 and 2012 years, there has been a significant movement in the value of assets with an AAA credit rating to an AA+/- credit rating. This is due principally to credit rating downgrades announced during the 2011/12 year for the United States, France and New Zealand governments.

24. Exposures to Supranational that do not have a credit rating are exposures to the Bank for International Settlements.

(E) CREDIT EXPOSURE BY COUNTERPARTY AS A PERCENTAGE OF BANK'S EQUITY

The following table shows the number of individual counterparties, or groups of closely-related counterparties, where the Bank's credit exposures equalled or exceeded 10 percent of the Bank's equity as at the end of the year. These exposures are measured without taking into account collateral held by the Bank for credit exposures to individual counterparties. Credit exposures are measured taking into account any enforceable rights of set-off.

Percentage of Equity	End-of-year 2012	End-of-year 2011
10% to 19.9%	**10**	9
20% to 29.9%	**2**	5
30% to 39.9%	**4**	3
40% to 49.9%	**2**	5
50% to 59.9%	**1**	2
60% to 69.9%	**-**	1
110% to 119.9%	**-**	1
120% to 129.9%	**1**	1
140% to 149.9%	**1**	-
150% to 159.9%	**-**	1
180% to 189.9%	**1**	-

19. MARKET RISK

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. In respect of the Bank, market risk comprises interest rate risk and foreign currency risk.

The Bank uses a range of position size, duration and stop-loss limits, together with Value at Risk (VaR) methodology for measurement and mitigation of market risk. Actual limits and measures differ according to whether the relevant portfolio is established for trading purposes or for policy-related purposes (such as foreign reserves management, foreign exchange intervention or domestic market operations).

INTEREST RATE RISK - EFFECTIVE DURATION LIMITS

For policy-related portfolios (i.e., portfolios that are not trading portfolios), the Bank controls interest rate risk with effective duration limits.

FOREIGN CURRENCY RISK - POSITION LIMITS

Limits are established for the aggregate net foreign currency position that may be taken, together with limits for the net exposure to individual foreign currency positions.

VAR LEVELS AND LIMITS

VaR estimates the potential daily loss from movements in market variables (security prices, interest rate changes and foreign currencies movements) in normal market conditions. The Bank uses a VaR model based on equally weighted data for the previous year (250 trading days), a one-day time horizon, and a 99 percent confidence interval. This means the Bank would expect to incur losses greater than those predicted by VaR estimates once every 100 trading days, or about 2.5 times a year. VaR does not capture market risk losses arising from the extreme price volatility associated with financial market crises.

VaR limits are utilised for the management of market risk arising from the Bank's trading portfolios, and for market risk arising in respect of the investment of foreign currency swaps proceeds received as part of the Domestic Market Operations function. Trading portfolios, in which the Bank actively manages positions, generate a relatively small part of the Bank's aggregate exposure to market risk.

Market risk in respect of other non-trading portfolios, including positions held for crisis management and currency intervention, is managed through open position and duration-based limits augmented with monitoring of actual against expected VaR.

	Trading Portfolios		Non-trading Portfolios		Trading and Non-trading Foreign Reserves Management Portfolios Combined			
	Total Market Risk		Total Market Risk		Foreign Currency Risk	Interest Rate Risk	Total Market Risk	
VaR	2012 $000	2011 $000	2012 $000	2011 $000	2012 $000	2012 $000	2012 $000	2011 $000
Limit	**2,000**	2,000	**n/a**	n/a	**n/a**	**n/a**	**n/a**	n/a
As at 30 June	**574**	38	**31,175**	29,916	**28,432**	**10,410**	**31,572**	29,898
Peak over the Year	**700**	327	**36,932**	46,875	**32,747**	**12,804**	**37,011**	47,094
Low over the Year	**28**	31	**28,537**	29,916	**24,846**	**10,107**	**28,553**	29,842
Average over the Year	**197**	94	**33,460**	39,861	**29,570**	**11,218**	**33,564**	39,581

STOP-LOSS LIMITS

Stop-loss limits are set to control losses that may arise in trading portfolios. When market risk losses exceed the stop-loss limit, trading positions are closed down. The Governor must approve the re-establishment of trading positions.

SENSITIVITY TO INTEREST RATE RISK AND FOREIGN CURRENCY RISK

The sensitivity of the Bank's financial assets and liabilities to assumed across-the-board changes in interest rates and the exchange rate is shown below.

	Total Gain/(Loss) Impacting Comprehen-sive Income 2012 $000	**Gain/(Loss) Reported in the Income Statement 2012 $000**	**Gain/(Loss) Reported Directly in Equity 2012 $000**	Total Gain/(Loss) Impacting Comprehen-sive Income 2011 $000	Gain/(Loss) Reported in the Income Statement 2011 $000	Gain/(Loss) Reported Directly in Equity 2011 $000
Impact of:						
A rise of 10% in the value of the New Zealand dollar	**(195,214)**	**(182,546)**	**(12,668)**	(202,469)	(190,232)	(12,237)
A fall of 10% in the value of the New Zealand dollar	**238,595**	**223,111**	**15,484**	247,462	232,506	14,956
A rise of one percentage point in the local currency yield curve	**(135,057)**	**(15,459)**	**(119,598)**	(142,769)	(26,218)	(116,551)
A fall of one percentage point in the local currency yield curve	**143,962**	**16,255**	**127,707**	150,059	26,230	123,829
A rise of one percentage point in the yield curve for all foreign currencies	**(3,900)**	**(3,900)**	**-**	(5,107)	(5,107)	-
A fall of one percentage point in the yield curve for all foreign currencies	**3,517**	**3,517**	**-**	2,826	2,826	-

The Bank's exposures to foreign currency risk and interest rate risk can change materially over time, depending on the Bank's policy objectives and economic conditions.

20. INTEREST RATE RISK

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes to market interest rates.

FOREIGN RESERVES MANAGEMENT INTEREST RATE RISK MANAGEMENT

The Bank holds an open foreign currency position, effectively financing a portion of its foreign currency assets using New Zealand dollar funding. This exposes the Bank to the risk of changes in the relative interest rates between New Zealand and overseas currencies. Interest rate risk also arises as a result of mismatches between the maturity or interest rate resets of assets and liabilities, where the assets and liabilities are denominated in the same currency. The Bank manages this interest rate risk through effective duration mismatch limits between assets and the corresponding liabilities.

DOMESTIC MARKET OPERATIONS INTEREST RATE RISK MANAGEMENT

The Bank's exposure to interest rate risk that arises from transacting foreign currency swaps in domestic market operations is constrained by an effective duration limit, which ensures that interest rate exposures are of a short-term nature. The exposure to interest rate risk arising from reverse-repurchase transactions in various liquidity facilities is managed by restricting the tenor of those transactions and by issuing Reserve Bank bills.

The average duration of the Bank's holding of New Zealand government securities in its investment portfolio (which excludes outright purchases of government securities for liquidity management purposes) as at 30 June 2012 was 3.9 years (2011: 3.2 years). Interest rate risk on New Zealand government securities is not dynamically managed and it is intended that these securities be held to maturity.

Assets and liabilities will mature or reprice within the following periods:

	Total 2012 $M	Non-interest Sensitive $M	Overnight $M	3 Months or Less $M	Between 3 and 12 Months $M	Between 1 and 2 Years $M	Between 2 and 5 Years $M	Over 5 Years $M
Assets								
Marketable Securities	12,780	-	-	11,928	703	-	52	97
Securities Purchased under Agreements to Resell	6,067	-	-	6,067	-	-	-	-
New Zealand Government Securities	3,193	-	-	-	824	-	685	1,684
Other Financial Assets	4,626	142	2,782	1,702	-	-	-	-
Other Assets	78	78	-	-	-	-	-	-
Total Assets	26,744	220	2,782	19,697	1,527	-	737	1,781
Liabilities								
Term Liabilities	2,148	-	-	2,148	-	-	-	-
Securities Sold under Agreements to Repurchase	725	-	-	725	-	-	-	-
Deposits	15,262	-	15,262	-	-	-	-	-
Currency in Circulation	4,375	4,375	-	-	-	-	-	-
Other Financial Liabilities	1,460	90	1,068	302	-	-	-	-
Other Liabilities	172	172	-	-	-	-	-	-
Equity	2,602	2,602	-	-	-	-	-	-
Total Liabilities and Equity	26,744	7,239	16,330	3,175	-	-	-	-
	-	(7,019)	(13,548)	16,522	1,527	-	737	1,781
Futures Contracts	4	-	-	-	-	3	-	1
Total Interest Rate Sensitivity Gap	4	(7,019)	(13,548)	16,522	1,527	3	737	1,782
Interest Rate Sensitivity Gap by Currency:[25]								
New Zealand dollar	(2,147)	(7,153)	(15,263)	17,076	824	-	685	1,684
United States dollar	549	56	1,475	(1,662)	624	3	52	1
Euro	490	48	168	195	79	-	-	-
Japanese yen	109	15	15	79	-	-	-	-
British pound	318	15	37	266	-	-	-	-
Australian dollar	393	1	18	374	-	-	-	-
Canadian dollar	198	(1)	2	197	-	-	-	-
Other	94	-	-	(3)	-	-	-	97
	4	(7,019)	(13,548)	16,522	1,527	3	737	1,782

25. The interest rate sensitivity gap by currency differs from the open foreign currency position by the notional principal on open futures contracts.

Assets and liabilities will mature or reprice within the following periods:

	Total 2011 $M	Non-interest Sensitive $M	Overnight $M	3 Months or Less $M	Between 3 and 12 Months $M	Between 1 and 2 Years $M	Between 2 and 5 Years $M	Over 5 Years $M
Assets								
Marketable Securities	16,574	-	-	14,392	2,045	-	137	-
Securities Purchased under Agreements to Resell	6,394	-	-	6,394	-	-	-	-
New Zealand Government Securities	3,768	-	-	-	936	845	670	1,317
Other Financial Assets	4,271	232	1,958	2,036	45	-	-	-
Other Assets	83	83	-	-	-	-	-	-
Total Assets	31,090	315	1,958	22,822	3,026	845	807	1,317
Liabilities								
Term Liabilities	2,448	-	-	2,448	-	-	-	-
Securities Sold under Agreements to Repurchase	475	-	-	475	-	-	-	-
Deposits	19,627	-	19,627	-	-	-	-	-
Currency in Circulation	4,173	4,173	-	-	-	-	-	-
Other Financial Liabilities	1,642	84	997	561	-	-	-	-
Other Liabilities	216	216	-	-	-	-	-	-
Equity	2,509	2,509	-	-	-	-	-	-
Total Liabilities and Equity	31,090	6,982	20,624	3,484	-	-	-	-
	-	(6,667)	(18,666)	19,338	3,026	845	807	1,317
Futures contracts	28	-	-	-	-	24	-	4
Total Interest Rate Sensitivity Gap	28	(6,667)	(18,666)	19,338	3,026	869	807	1,321
Interest Rate Sensitivity Gap by Currency:[26]								
New Zealand dollar	(2,227)	(6,898)	(19,627)	19,232	2,234	845	670	1,317
United States dollar	586	156	677	(674)	356	21	47	3
Euro	518	48	211	(177)	436	-	-	-
Japanese yen	117	16	11	90	-	-	-	-
British pound	236	17	22	193	-	3	-	1
Australian dollar	409	(5)	20	394	-	-	-	-
Canadian dollar	298	(1)	20	280	-	-	(1)	-
Other	91	-	-	-	-	-	91	-
	28	(6,667)	(18,666)	19,338	3,026	869	807	1,321

26. The interest rate sensitivity gap by currency differs from the open foreign currency position by the notional principal on open futures contracts.

21. FOREIGN CURRENCY RISK

Foreign currency risk is the risk of loss arising from changes in exchange rates.

Foreign exchange risk arises from:

- maintenance of a portion of foreign currency reserves on an unhedged basis for crisis management purposes;
- currency intervention to meet monetary policy objectives; and
- active management undertaken in trading portfolios.

The Bank intends to hold some of its reserves on an unhedged basis through most of the exchange rate cycle. The Bank has a policy of maintaining a passive 'benchmark' open foreign exchange position of SDR 1 billion ($NZ1.9 billion), but can vary the actual open position, and thus the amount of unhedged reserves, around that benchmark level, depending on the behaviour of the exchange rate and foreign exchange markets. This variation might be significant.

For non-trading portfolios, foreign currency risk is managed by way of open position limits, target open-currency composition weights and deviation bands. Additionally, the Bank monitors actual and expected VaR outcomes for these portfolios.

Stop-loss and VaR limits are also used to assist in managing the Bank's trading portfolios, which account for a minor proportion of the Bank's total open foreign exchange position.

As at 30 June 2012, the Bank's net exposure to major currencies, in New Zealand dollar terms, was:

	2012 $M	2011 $M
Australian dollar	**393**	409
British pound	**318**	232
Canadian dollar	**198**	298
Euro	**490**	518
Japanese yen	**109**	117
Swiss francs	**(3)**	-
United States dollar	**545**	562
Various currencies (Asian Bond Fund 2)	**97**	91
Total Net Open Foreign Exchange Position	**2,147**	2,227

At 30 June 2012, the net open foreign exchange position was SDR 1,130 million (2011: SDR 1,153 million). The quantum of the open position varies over time to the level the Bank determines is warranted by its policy objectives and economic conditions. The largest net open foreign exchange position (measured in SDR terms) during the 12 months ended 30 June 2012 was SDR 1,157 million ($NZ 2,133 million) (2011: SDR 1,393 million ($NZ 2,951 million)). The smallest net open foreign exchange position (measured in SDR terms) during the 12 months ended 30 June 2012 was SDR 1,110 million ($NZ 2,327 million) (2011: SDR 1,143 million ($NZ 2,256 million)).

22. LIQUIDITY RISK

Liquidity risk is the risk that the Bank will encounter difficulty in meeting financial obligations associated with financial liabilities that are settled by delivering cash or another financial asset. Liquidity risk also includes the risk that the Bank may have to sell a financial asset quickly at less than its fair value.

The objectives of the Bank's liquidity policy are to:

- ensure all financial obligations are met when due;
- ensure foreign reserves assets held for currency intervention purposes are able to be liquidated in an orderly fashion, within agreed timeframes; and
- ensure the Bank manages the aggregate level of New Zealand dollar liquidity in the New Zealand banking system, so as to, in turn, ensure that interest rates in inter-bank markets are consistent with monetary policy settings, and to facilitate the smooth operation of the inter-bank payment system.

(A) FOREIGN CURRENCY ACTIVITIES

Liquidity is a key criterion in determining the composition of the Bank's foreign currency assets. This reflects the potential requirement to liquidate foreign reserves for intervention purposes, should the need arise. Accordingly, there is an array of interacting controls aimed at ensuring quick access to funds. These controls include a required composition of portfolios based on the liquidity characteristics of securities, with defined minimum levels, duration, and limits on the minimum and maximum proportion of reserves that may be held in any one currency. Day-to-day foreign currency liquidity is managed through forecasting cash inflows and outflows.

At 30 June 2012, foreign currency assets valued at $18,736 million were classified as being able to be settled within two business days of being liquidated (30 June 2011: $21,445 million).

The Bank also manages refinancing risk on foreign reserves funded from borrowing by applying limits on the amount of borrowing maturing in any 12-month period.

(B) LOCAL CURRENCY ACTIVITIES

The Bank's management of its own New Zealand dollar liquidity risk is a function of the Bank's management of the daily aggregate liquidity that is available within the New Zealand banking system.

The Bank manages its own New Zealand dollar cash flows by advancing funds to, and withdrawing funds from, the New Zealand banking system. This is achieved through a range of financial transactions, including entering into foreign exchange swap and basis swap transactions, and repurchase and reverse-repurchase agreements, and by issuing Reserve Bank bills. As New Zealand's central bank, the Bank is able to create New Zealand dollar liquidity through its daily market operations. Therefore, the Bank is not required to maintain a certain level of liquid assets in order to meet its New Zealand dollar obligations.

23. CASH FLOWS BY REMAINING CONTRACTUAL MATURITIES

The following table sets out the maturity profile of the Bank's financial assets and liabilities. The table discloses the contractual principal receivable or due at the maturity date, together with interest receivable or payable for the period to the maturity date based on interest rates and foreign exchange rates prevailing as at balance date. Financial liabilities payable on demand includes currency in circulation. However, historical experience has shown such balances provide a stable source of long-term funding for the Bank.

Deposits, which are on-demand liabilities, are managed taking into account the Bank's ability to create New Zealand dollar liquidity through its daily market operations. In all other respects, the Bank manages liquidity on a contractual maturity basis, which is consistent with the expected maturities of financial instruments.

The balances in this table do not equate with the balances in the Consolidated Statement of Financial Position, as the table incorporates all cash flows on an undiscounted basis.

Contractual maturities exclude the following assets, which have no fixed maturity dates: Asian Bond Fund 1, Asian Bond Fund 2, and shares in the Bank for International Settlements. The aggregate carrying value of these assets at 30 June 2012 was $288 million (2011: $272 million).

	Total 2012 $M	On Demand $M	3 Months or Less $M	3 to 12 Months $M	1 to 2 Years $M	2 to 5 Years $M	Over 5 Years $M
Foreign Currency Financial							
Assets							
Cash Balances	2,785	2,785	-	-	-	-	-
Securities Purchased under Agreements to Resell	4,569	-	4,569	-	-	-	-
Marketable Securities	12,643	-	11,940	703	-	-	-
Other Foreign Currency Financial Assets	1	-	1	-	-	-	-
	19,998	2,785	16,510	703	-	-	-
Foreign Currency Financial							
Liabilities							
Short-term Foreign Currency Financial Liabilities	1,069	1,069	-	-	-	-	-
Securities Sold under Agreements to Repurchase	606	-	606	-	-	-	-
Term Liabilities	2,155	-	-	344	144	747	920
	3,830	1,069	606	344	144	747	920
Foreign Currency Derivatives							
Contractual Inflows	4,764	-	1,831	1,259	1,040	559	75
Contractual Outflows	(19,381)	-	(9,170)	(3,200)	(1,894)	(3,366)	(1,751)
	(14,617)	-	(7,339)	(1,941)	(854)	(2,807)	(1,676)
Foreign Currency Net Gap in Contractual Maturities	1,551	1,716	8,565	(1,582)	(998)	(3,554)	(2,596)
Local Currency Financial Assets							
Securities Purchased under Agreements to Resell	1,501	-	1,501	-	-	-	-
New Zealand Government Securities	3,610	-	8	952	120	903	1,627
Other Local Currency Financial Assets	1	-	1	-	-	-	-
	5,112	-	1,510	952	120	903	1,627
Local Currency Financial Liabilities							
Deposits	15,262	15,262	-	-	-	-	-
Securities Sold under Agreements to Repurchase	119	-	119	-	-	-	-
Currency in Circulation	4,375	4,375	-	-	-	-	-
Other Local Currency Financial Liabilities	85	82	3	-	-	-	-
	19,841	19,719	122	-	-	-	-
Local Currency Derivatives							
Contractual Inflows	17,900	-	7,758	2,511	1,544	3,863	2,224
Contractual Outflows	(1,024)	-	(106)	(97)	(193)	(519)	(109)
	16,876	-	7,652	2,414	1,351	3,344	2,115
Local Currency Net Gap in Contractual Maturities	2,147	(19,719)	9,040	3,366	1,471	4,247	3,742
Total Net Gap in Contractual Maturities	3,698	(18,003)	17,605	1,784	473	693	1,146

	Total 2011 $M	On Demand $M	3 Months or Less $M	3 to 12 Months $M	1 to 2 Years $M	2 to 5 Years $M	Over 5 Years $M
Foreign Currency Financial							
Assets							
Cash Balances	1,959	1,959	-	-	-	-	-
Securities Purchased under Agreements to Resell	3,803	-	3,803	-	-	-	-
Marketable Securities	16,444	-	14,396	2,048	-	-	-
Other Foreign Currency Financial Assets	97	-	97	-	-	-	-
	22,303	1,959	18,296	2,048	-	-	-
Foreign Currency Financial							
Liabilities							
Short-term Foreign Currency Financial Liabilities	1,092	1,092	-	-	-	-	-
Securities Sold under Agreements to Repurchase	475	-	475	-	-	-	-
Term Liabilities	2,648	-	1	330	357	977	983
	4,215	1,092	476	330	357	977	983
Foreign Currency Derivatives							
Contractual Inflows	5,237	-	1,957	1,286	1,062	607	325
Contractual Outflows	(22,138)	-	(11,275)	(3,433)	(2,661)	(2,689)	(2,080)
	(16,901)	-	(9,318)	(2,147)	(1,599)	(2,082)	(1,755)
Foreign Currency Net Gap in Contractual Maturities	1,187	867	8,502	(429)	(1,956)	(3,059)	(2,738)
Local Currency Financial Assets							
Securities Purchased under Agreements to Resell	2,592	-	2,592	-	-	-	-
New Zealand Government Securities	4,395	-	52	1,054	949	907	1,433
Other Local Currency Financial Assets	1	-	1	-	-	-	-
	6,988	-	2,645	1,054	949	907	1,433
Local Currency Financial Liabilities							
Deposits	19,627	19,627	-	-	-	-	-
Currency in Circulation	4,173	4,173	-	-	-	-	-
Other Local Currency Financial Liabilities	84	82	2	-	-	-	-
	23,884	23,882	2	-	-	-	-
Local Currency Derivatives							
Contractual Inflows	21,360	-	9,867	3,226	2,204	3,297	2,766
Contractual Outflows	(1,971)	-	(112)	(885)	(112)	(358)	(504)
	19,389	-	9,755	2,341	2,092	2,939	2,262
Local Currency Net Gap in Contractual Maturities	2,493	(23,882)	12,398	3,395	3,041	3,846	3,695
Total Net Gap in Contractual Maturities	3,680	(23,015)	20,900	2,966	1,085	787	957

24. NET INVESTMENT INCOME

Net Investment Income includes:

	Total 2012 $M	Foreign Currency $M	Local Currency $M	Total 2011 $M	Foreign Currency $M	Local Currency $M
Interest Income						
Cash Balances	**5**	**5**	**-**	4	4	-
Securities Purchased Under Agreements to Resell	**27**	**8**	**19**	21	5	16
Marketable Securities	**43**	**43**	**-**	45	45	-
Derivative Financial Instruments	**377**	**(35)**	**412**	386	(13)	399
New Zealand Government Securities	**203**	**-**	**203**	214	-	214
Total Interest Income	**655**	**21**	**634**	670	41	629
Interest Expense						
Securities Sold Under Agreements to Repurchase	**3**	**-**	**3**	4	-	4
Term Liabilities	**4**	**4**	**-**	-	-	-
New Zealand Government Deposits	**186**	**-**	**186**	158	-	158
Settlement Bank Deposits	**180**	**-**	**180**	206	-	206
Other	**2**	**1**	**1**	-	-	-
Total Interest Expense	**375**	**5**	**370**	368	-	368
Net Interest Income	**280**	**16**	**264**	302	41	261
Net Gains/(Losses) from Fair Value Changes	**(73)**	**(77)**	**4**	31	31	-
Net Losses from Foreign Exchange Rate Changes	**(38)**	**(38)**	**-**	(144)	(144)	-
Dividend Income	**2**	**2**	**-**	2	2	-
Total Net Investment Income/(Loss)	**171**	**(97)**	**268**	191	(70)	261

Interest income from the New Zealand government (including entities controlled by the New Zealand government) comprised 31 percent (2011: 32 percent) of total interest received.

COMPONENTS OF NET INVESTMENT INCOME FROM FINANCIAL INSTRUMENTS

Net Investment Income includes net income/(expense) arising from:

	2012 $M	2011 $M
Financial Assets and Financial Liabilities Classified as Fair Value through Profit or Loss upon Initial Recognition	**(398)**	(409)
Derivative Instruments Deemed to be Classified as Held for Trading	**377**	386
Financial Assets and Financial Liabilities Classified as Held for Trading	**-**	(2)
Interest and Dividend Income from Available-for-sale Financial Assets	**192**	216
Total Net Investment Income/(Loss)	**171**	191

	2012 $M	2011 $M
Market Value Gains and Foreign Exchange Gains on Financial Assets Classified as Available-for-sale reported in the Income Statement	**-**	-
Interest Expense on Financial Liabilities Measured at Amortised Cost	**-**	-
Market Value Changes and Foreign Exchange Rate Changes on Financial Liabilities Measured at Amortised Cost reported in the Income Statement	**-**	-

25. INCOME AND EXPENDITURE BY FUNCTION

The following table sets out operating income and operating expenditure for each of the Bank's main functions.

For the year ended 30 June	Operating Income 2012 $M	Attribution of Earnings on Investments Funded by Equity 2012 $M	Operating Expenses 2012 $M	Net Profit/ (Loss) 2012 $M
FUNCTIONS				
Monetary Policy Formulation	**-**	**-**	**12**	**(12)**
Domestic Market Operations	**11**	**24**	**6**	**29**
Prudential Supervision	**-**	**-**	**14**	**(14)**
Macro-Financial Stability	**-**	**-**	**4**	**(4)**
Currency Operations	**190**	**1**	**12**	**179**
Foreign Reserves Management	**(123)**	**68**	**8**	**(63)**
Settlement Services	**8**	**-**	**5**	**3**
Total for Bank before Earnings on Investments Funded by Equity	**86**	**93**	**61**	**118**
Earnings not Allocated to Functions:				
Earnings on Investments Funded by Equity	**93**	**(93)**	**-**	**-**
Total for Bank	**179**	**-**	**61**	**118**
Income Retained under the Funding Agreement			**8**	
Net Operating Expenses			**53**	

For the year ended 30 June	Operating Income 2011 $M	Attribution of Earnings on Investments Funded by Equity 2011 $M	Operating Expenses 2011 $M	Net Profit/(Loss) 2011 $M
FUNCTIONS				
Monetary Policy Formulation	-	-	10	(10)
Domestic Market Operations	22	15	6	31
Financial System Surveillance and Policy	-	-	13	(13)
Currency Operations	194	-	13	181
Foreign Reserves Management	(134)	94	7	(47)
Settlement Services	4	-	2	2
Registry and Depository Services	4	-	3	1
Other Outputs	-	-	1	(1)
Total for Bank before Earnings on Investments Funded by Equity	90	109	55	144
Earnings not Allocated to Functions:				
Earnings on Investments Funded by Equity	109	(109)	-	-
Total for Bank	199	-	55	144
Income Retained under the Funding Agreement			8	
Net Operating Expenses			47	

Operating income for each function includes allocations of notional interest income and expenditure on New Zealand dollar funding provided by (or provided to) the function through internal lending and borrowing. Notional interest rates take into account the estimated term of the funding and the associated external interest earned or incurred. Earnings from the investment of equity are allocated to individual functions based on the estimated level of equity required for that function. The total operating expenses for each function include internal transfers between functions.

26. OPERATING EXPENSES

	Note	2012 $M	2011 $M
Staff Expenses		**28**	27
Net Currency-issued Expenses		**5**	7
Asset Management Expenses		**7**	7
Other Operating Expenses		**15**	14
Total Operating Expenses excluding Actuarial (Gain)/Loss on Defined Benefit Superannuation Scheme		**55**	55
Actuarial Loss on Defined Benefit Superannuation Scheme	29	**6**	-
Total Operating Expenses		**61**	55

	2012 $000	2011 $000
Operating Expenses includes:		
Depreciation of Property, Plant and Equipment	**3,154**	3,173
Amortisation of Intangible Assets	**1,286**	1,905
Impairment Charges for Property, Plant and Equipment	**-**	-
Impairment Charges for Intangible Assets	**-**	-
Bad Debt Expenses	**-**	-
Rental and Lease Expenses	**348**	502
Auditor's Remuneration:		
Statutory Audit	**235**	227
Payment Systems Audits	**122**	63
Advisory Services	**24**	8

The Statutory Audit expense comprises the fee for the audit of the annual financial statements of the Bank.

The Payment Systems Audits expense comprises fees paid for the contractual audits of the NZClear depository system and the Exchange Settlement Account System.

The Advisory Services expense comprises fees for advice on financial reporting and the operation and assessment of payment systems. These advisory services were approved in accordance with the Bank's External Auditor Independence Policy, which requires that prior to engaging the external auditor for any of these services, the advice of the Chair of the Audit Committee must be sought and approval must be given by the Governor.

KEY MANAGEMENT PERSONNEL

Key management personnel comprise the Governor, Deputy Governor and Assistant Governors. Because non-executive Board members are not responsible for decision-making by the Bank, and their statutory role is to monitor the performance of the Bank, they are not considered to be key management personnel as defined in NZ IAS 24 *Related Party Disclosures*. For the year ended 30 June, aggregate compensation paid to key management personnel comprised:

	2012 $000	2011 $000
Salaries, Superannuation Contributions and Other Short-term Benefits	**1,710**	1,668
Total Key Management Personnel Compensation	**1,710**	1,668

This table includes all compensation paid to key management personnel.

27. RECONCILIATION OF NET CASH FLOWS FROM OPERATING ACTIVITIES WITH NET PROFIT/(LOSS) FOR THE YEAR

	2012 $M	2011 $M
Net Profit/(Loss) for the Year	**118**	144
Add/(Subtract) Items included in Net Profit/(Loss) relating to cash flows from changes in Operating Assets and Operating Liability Balances, Investing and Financing Activities:		
Foreign Exchange (Gains)/Losses[27]	**38**	144
Market Value Changes	**73**	(31)
Add/(Subtract) Non-cash Items:		
Depreciation and Amortisation	**4**	5
Amortisation of Premium/Discount on Financial Instruments	**12**	(22)
Net Movement in Repatriated Currency Income and Expense	**(1)**	1
	126	97
Movements in Other Working Capital Items		
Decrease/(Increase) in Current Assets:		
Movement in Accounts Receivable	**2**	3
Movement in Inventories	**4**	5
Movement in Interest Receivable	**6**	(9)
	12	(1)
Increase/(Decrease) in Current Liabilities:		
Movement in Miscellaneous Liabilities	**5**	-
Movement in Interest Payable	**2**	1
	7	1
Net Movements in Other Working Capital Items	**19**	-
Operating Cash Flows from Income and Expenses	**263**	241
Cash Flows from Changes in Operating Assets and Operating Liability Balances	**155**	414
	155	414
Net Cash Flows from Operating Activities	**418**	655

27. Foreign Exchange (Gains)/Losses includes the Foreign Exchange Rate Effect on Cash Balances at the Beginning of the Year in the Consolidated Statement of Cash Flows on pages 57 and 58.

28. STATEMENT OF COMMITMENTS

(A) PROVISION OF FUNDING TO THE NEW ZEALAND FINANCIAL SYSTEM

As New Zealand's central bank, the Bank is able to create New Zealand dollar liquidity through its liquidity management operations, which include the daily open market operations. The Bank's open market operations include providing New Zealand dollar liquidity facilities to eligible borrowers on terms stipulated by the Bank, including the provision of approved collateral.

(B) RECIPROCAL FUNDING ARRANGEMENTS WITH FOREIGN CENTRAL BANKS

On 18 April 2011, the People's Bank of China (PBOC) and the Bank established a reciprocal currency arrangement (swap line) to support the settlement of trade transactions between New Zealand and Chinese businesses in circumstances where it might otherwise be difficult to settle obligations in Chinese renminbi (RMB). The swap facility provides for the PBOC and the Bank to enter into foreign exchange swap transactions that have a total value at any point in time of up to RMB 25 billion (NZD 5 billion), with the terms of the foreign exchange swaps to be agreed at the time the swaps are entered into. The swap line is for a term of three years, which may be extended if both parties agree. No drawings have been made under this arrangement in the year ended 30 June 2012 (2011: nil).

The Bank also has a reciprocal arrangement with the Hong Kong Monetary Authority, which allows either party to enter into repurchase agreements with the other to raise up to USD250 million, secured by US government securities. The existing arrangement expires on 31 March 2013, but may be extended by mutual agreement. No drawings have been made under this arrangement in the year ended 30 June 2012 (2011: nil).

(C) COMMITMENTS TO THE NEW ZEALAND GOVERNMENT

In January 2010, the Bank agreed to make available to the New Zealand government up to SDR 624.34 million from foreign reserves on an arm's length basis, if the International Monetary Fund (IMF) makes a call on the New Zealand government in respect of the government's commitment under the IMF's "New Arrangements to Borrow" facility and it is determined that this is the most efficient means of effecting settlement of the government's commitment. The Bank has increased its holdings of foreign reserves by SDR 200 million to partially reflect this contingent call on foreign reserves. In the event that the government is required to make payment to the IMF under this facility and the Bank provides the funds to the government, the Bank's foreign reserves intervention capacity will be reduced until such time as the government repays the Bank. During the year ended 30 June 2012, no funds had been made available to the government under this arrangement (year ended 30 June 2011: nil).

Further, the Bank is in discussions with the Treasury regarding similar settlement arrangements in respect of an additional USD $1 billion standby loan facility commitment to the IMF agreed to by the government in June 2012. When this proposed commitment is made, it will be a contingent call on foreign reserves. The Bank intends to increase its holdings of foreign reserves by a proportion of the commitment once the commitment is made.

(D) OPERATING LEASE COMMITMENTS

The Bank leases office equipment and premises under operating leases. The payments are determined at the beginning of the lease agreements and remain constant during the term of the lease.

	2012 $000	2011 $000
Office Equipment and Premises Operating Leases		
Due within One Year	**149**	304
Due between One and Two Years	**115**	146
Due between Two and Five Years	**287**	343
Total Office Equipment Premises Operating Lease Commitments	**551**	793

(E) CAPITAL EXPENDITURE AND INVENTORY COMMITMENTS

	2012 $000	2011 $000
Capital Expenditure and Inventory		
Property, Plant and Equipment:		
Due within One Year	**900**	523
Intangible Assets:		
Due within One Year	**-**	225
Inventories:		
Due within One Year	**765**	2,802
Total Capital Expenditure and Inventory Commitments	**1,665**	3,550

(F) LEASE PAYMENTS RECEIVABLE

The Bank owns its head office in Wellington and leases six and one-half of the 14 floors to tenants under operating leases. Under the current non-cancellable lease agreements, the total minimum lease payments receivable are as follows:

	2012 $000	2011 $000
Tenancy Lease Payments Receivable		
Receivable within One Year	**1,175**	1,459
Receivable between One and Five Years	**974**	2,341
Total Tenancy Lease Payments Receivable	**2,149**	3,800

29. SUPERANNUATION COMMITMENTS

The Bank has a superannuation fund for staff. The superannuation fund includes both a defined contribution scheme and a defined benefit scheme. Contributions, as specified in the rules of the respective schemes, are made by the Bank as required. Statutory actuarial valuations of the schemes are undertaken every three years, with the last statutory valuation being undertaken as at 31 March 2012. Each year, the actuary provides an assessment of the value of the assets and liabilities of the superannuation fund, with the last valuation performed as at 31 March 2012. There have been no material changes to the fund's financial position between 31 March 2012 and 30 June 2012. Contributions to the defined benefit scheme are at a rate, reviewed annually, sufficient to keep the scheme solvent, based on actuarial assessments. The defined benefit scheme was closed to new members in 1991.

DEFINED BENEFIT SCHEME

The following information is provided in respect of the defined benefit scheme.

As at 31 March	2012 $000	2011 $000
Superannuation Asset/Superannuation Liability Recognised in the Statement of Financial Position		
Present Value of Wholly Unfunded Obligations	**-**	-
Present Value of Wholly or Partly Funded Obligations	**43,242**	37,716
Fair Value of Plan Assets	**35,645**	36,369
Present Value of Net Obligations	**7,597**	1,347
Actuarial Gains Not Recognised in the Statement of Financial Position	**-**	-
Net Liability Recognised in the Statement of Financial Position	**7,597**	1,347
The net asset (if any) recognised at the end of the year is limited to the estimated present value of reductions in future employer contributions to the defined benefit plan. The value of net assets of the defined benefit superannuation scheme not recognised as an asset of the Bank was nil (2011: nil).		
Movements in the Defined Benefit Obligation		
Current-service Cost	**112**	162
Interest Cost	**1,499**	1,586
Contributions by Plan Participants	**42**	51
Actuarial Losses on Defined Benefit Obligations	**6,477**	434
Benefits Paid	**(2,604)**	(4,129)
Movement for the Year	**5,526**	(1,896)
Present Value of Defined Benefit Obligations at the Start of the Year	**37,716**	39,612
Present Value of Defined Benefit Obligations at the End of the Year	**43,242**	37,716

	2012 $000	2011 $000
Movements in the Fair Value of Plan Assets		
Expected Return on Plan Assets	**1,578**	1,646
Actuarial Gains on Plan Assets	**136**	11
Contributions by Employer	**124**	138
Contributions by Plan Participants	**42**	51
Benefits Paid	**(2,604)**	(4,129)
Movement for the Year	**(724)**	(2,283)
Fair Value of Plan Assets at the Start of the Year	**36,369**	38,652
Fair Value of Plan Assets at the End of the Year	**35,645**	36,369

	2012 % of Plan Assets	2011 % of Plan Assets
Composition of Plan Assets by Type of Financial Instrument		
Cash and Short-term Securities	**19.8**	17.1
Domestic Fixed-interest Securities	**49.2**	51.4
Foreign Fixed-interest Securities	**0.0**	0.0
Domestic Equity Securities	**19.3**	19.9
Foreign Equity Securities	**11.7**	11.8
Other Assets	**0.0**	(0.2)

EXPENSE RECOGNISED IN THE INCOME STATEMENT

The amounts recognised in the Income Statement as operating expenses for the financial year in respect of the defined benefit superannuation scheme are as follows:

For the year ended 30 June	2012 $000	2011 $000
Past-service Cost	**-**	-
Current-service Cost	**112**	162
Interest Cost	**1,499**	1,586
Expected Return on Plan Assets	**(1,578)**	(1,646)
Defined Benefit Scheme Expense Recognised in Staff Expenses	**33**	102
Actuarial Losses on Plan Assets and Defined Benefit Obligations	**6,341**	423
Addition to/(Decrease in) Actuarial Gains Not Recognised in the Statement of Financial Position	**-**	-
Net Actuarial Loss Recognised in Operating Expenses	**6,341**	423
Total Defined Benefit Expense Recognised in Operating Expenses	**6,374**	525

The estimated employer contribution to be paid to the defined benefit scheme for the year ending 30 June 2013 is $180,000.

The primary actuarial assumptions used in the above calculations, expressed as weighted averages, are as follows:

	2012 %	2011 %
Discount Rate at the Beginning of the Year	**2.92**	4.10
Expected Rate of Return on Plan Assets at the Beginning of the Year	**4.50**	4.50
Future Salary Increases	**3.50**	3.50
Other Material Actuarial Assumptions - Pension Increases	**2.50**	2.50

HISTORICAL DETAILS

The following table provides amounts for the defined benefit superannuation scheme for the current and previous four periods:

For the year ended 30 June	**2012 $000**	2011 $000	2010 $000	2009 $000	2008 $000
Present Value of Defined Benefit Obligations	**43,242**	37,716	39,612	39,383	39,117
Fair Value of Plan Assets	**35,645**	36,369	38,652	36,620	40,576
Present Value of Net Obligations	**(7,597)**	(1,347)	(960)	(2,763)	1,459
Actuarial Gains Not Recognised in the Statement of Financial Position	**-**	-	-	-	283
Superannuation Asset/(Liability)	**(7,597)**	(1,347)	(960)	(2,763)	1,176
Experience Adjustments					
Gain/(Loss) on Plan Liabilities due to Experience	**(995)**	53	(835)	279	(1,717)
Gain/(Loss) on Plan Assets due to Experience	**136**	11	2,721	(3,205)	(2,704)

DEFINED CONTRIBUTION SCHEME

The Bank recognised as an expense the following contributions to defined contribution superannuation schemes:

	2012 $000	2011 $000
Bank's Defined Contribution Scheme	**86**	94
Other Defined Contribution Schemes	**933**	954
	1,019	1,048

30. SUBSIDIARY COMPANIES

The Bank has a wholly-owned New Zealand incorporated subsidiary, New Zealand Central Securities Depository Limited (NZCSD).

NZCSD is a non-trading company, incorporated solely for the purpose of acting as a custodian trustee. It holds assets on behalf of the participants in the NZClear System, as described in Note 34.

31. RELATED PARTIES

In the normal course of its operations, the Bank enters into transactions with related parties. Related parties include the Crown, various government departments, and Crown entities. Unless stated otherwise, all transactions with related parties take place at arm's length.

Transactions entered into include:

- banking services;
- agency transactions (at no charge);
- foreign exchange transactions;
- funding from the Treasury as part of the Foreign Reserves Management operations; and
- purchases of New Zealand government securities.

Material transactions with entities controlled by the Crown and balances with entities controlled by the Crown were:

Year ended 30 June	**2012 $M**	2011 $M
Receipts from and Payments to Entities Controlled by the New Zealand Government		
Receipts of Income from Entities Controlled by the New Zealand Government		
Interest Income	**203**	216
Rental Income	**1**	2
Receipts of a Capital Nature from Entities Controlled by the New Zealand Government		
Receipt of Proceeds on Maturity of New Zealand Government Securities - Available for Sale	**919**	-
Receipt of Proceeds on Maturity of New Zealand Government Securities - Fair Value through Profit or Loss	**2,962**	-
Payments of Expenses to Entities Controlled by the New Zealand Government		
Interest Expense	**193**	161
Payments of Capital to Entities Controlled by the New Zealand Government		
Net Decrease/(Increase) in Deposits	**3,982**	(6,066)
Repayment of Term Liabilities	**322**	-
Payment for Purchase of New Zealand Government Securities	**217**	295

As at 30 June	2012 $M	2011 $M
Balances with Entities Controlled by the New Zealand Government		
Assets that Comprise Claims on Entities Controlled by the New Zealand Government		
New Zealand Government Securities	**3,193**	3,768
Securities Purchased under Agreements to Resell	**25**	247
Liabilities that Comprise Claims by Entities Controlled by the New Zealand Government		
Deposits	**9,311**	13,292
Term Liabilities	**2,148**	2,448

In addition, during the year, as part of the Bank's domestic market operations, the Bank entered into securities reverse-repurchase agreements with Crown-owned entities on standard commercial terms. Except as noted above, all amounts advanced under these agreements have been repaid. The table above also includes interest income received by the Bank from this activity.

32. CONTINGENT LIABILITIES

(a) In terms of a Trust Deed dated 16 May 1980, the Reserve Bank has a contingent liability to maintain the actuarial soundness of the Reserve Bank of New Zealand Staff Superannuation and Provident Fund (the Fund).

The Actuary carried out a review of the financial position of the Fund as at 31 March 2012.

The Fund's Trust Deed provides for the Defined Benefit division of the Fund to be wound up in the event that the Bank is wound up or by resolution of the Bank's directors. In the event that the Fund is wound up, the Fund is required to purchase annuities having values equal to the actuarial value of benefits payable by the Fund. The Actuary reported that, based on current estimates of the cost of annuities, in the event the Defined Benefit division of the Fund is wound up, the purchase cost of annuities would exceed the value of Defined Benefit assets of the Fund. On winding up, the Bank is required by the Trust Deed to make good any shortfall. The Bank considers that the likelihood of the Fund being wound up is remote.

(b) Five former employees of the Bank who either are, or at one time were, members of the Bank's Defined Benefit superannuation scheme commenced proceedings against the Bank. In February 2012, the Employment Court rejected the plaintiffs' claim and found in favour of the Bank. The Court of Appeal has granted the plaintiffs leave to appeal the decision of the Employment Court. Based on the legal advice received, the likelihood of the appeal being successful is considered to be remote and no provision has been made for any loss that may arise after balance date in respect of this matter. Provision has been made in the financial statements at 30 June 2012 for the estimated legal costs associated with the appeal.

(c) The Bank has a contingent liability for currency in circulation that has been demonetised but not returned to the Bank, but only to the extent that the Bank has not recognised an actual liability. The total face value of demonetised currency as at 30 June 2012 was $104.6 million (2011: $104.8 million). Of the total face value of demonetised currency, $81.6 million (2011: $81.8 million) is recognised as a liability in the Consolidated Statement of Financial Position.

(d) The Bank has a liability for the face value of collectors' currency. However, it is most unlikely that significant amounts of collectors' currency will be returned for redemption at face value. The face value of collectors' currency issued before 1 July 2004 and that is not recognised as a liability is $9.8 million (2011: $9.8 million).

(e) As at 30 June 2012, the Bank had a contingent liability of $22.87 million (SDR 12.04 million) (2011: $23.26 million (SDR 12.04 million)) in respect of uncalled and unpaid capital attached to its shareholding in the Bank for International Settlements.

33. INCOME TAX

Section CW38 of the Income Tax Act 2007 exempts the Bank from income tax. The Bank incurs and meets liabilities for goods and services tax, fringe benefit tax and other withholding tax.

34. CUSTODIAL ACTIVITIES

The Bank operates the NZClear System (formerly the Austraclear New Zealand System), which is a securities clearing and settlement system. It holds assets, on behalf of the participants, in the name of New Zealand Central Securities Depository Limited (NZCSD), which it has appointed as custodian trustee in terms of the Trustee Act 1956.

NZCSD is a wholly owned New Zealand-incorporated subsidiary of the Bank, which, in terms of a Deed of Appointment between the Bank and NZCSD, is incorporated solely for the purpose of acting as a custodian trustee. The Bank undertakes to accept liability for all costs and debts of NZCSD as a means of reinforcing that role. NZCSD is a non-trading company, but has legal ownership of securities beneficially owned by members of the NZClear System. With the exception of the local currency securities owned by the Bank and held through NZCSD, the Bank has no beneficial interest in the securities that NZCSD holds, or any management obligations apart from safekeeping or acting as paying agent in certain circumstances.

The total value of securities held by NZCSD as at 30 June 2012 was $160.9 billion (2011: $148.9 billion).

Under the NZClear System Rules, the Bank's and NZCSD's liability to any member of NZClear, arising out of, or in connection with, the system, is limited to direct losses, up to an aggregate of $5 million for any one event.

35. SIGNIFICANT POST-BALANCE DATE EVENTS

There have been no significant post-balance date events.

FIVE-YEAR HISTORICAL FINANCIAL INFORMATION

FIVE-YEAR FINANCIAL POSITION

As at 30 June	NZ IFRS Audited 2008 $M	NZ IFRS Audited 2009 $M	NZ IFRS Audited 2010 $M	NZ IFRS Audited 2011 $M	**NZ IFRS Audited 2012 $M**
Assets					
Foreign Currency Financial	20,754	19,460	22,612	24,647	**21,971**
Local Currency Financial	4,307	11,369	3,658	6,360	**4,695**
Other Assets	101	93	87	83	**78**
Total Assets	25,162	30,922	26,357	31,090	**26,744**
Liabilities and Equity					
Foreign Currency Financial	4,605	5,539	5,533	4,481	**4,129**
Local Currency Financial	18,458	21,777	17,953	23,884	**19,841**
Other Liabilities	173	639	297	216	**172**
Equity	1,926	2,967	2,574	2,509	**2,602**
Total Liabilities and Equity	25,162	30,922	26,357	31,090	**26,744**

FIVE-YEAR FINANCIAL PERFORMANCE

For the year ended 30 June	NZ IFRS Audited 2008 $M	NZ IFRS Audited 2009 $M	NZ IFRS Audited 2010 $M	NZ IFRS Audited 2011 $M	**NZ IFRS Audited 2012 $M**
Operating Income					
Net Investment Income	573	952	(69)	191	**171**
Other Income	8	8	8	8	**8**
Total Operating Income	581	960	(61)	199	**179**
Operating Expenses					
Staff Expenses	22	24	26	27	**28**
Currency-issued Expenses	4	6	4	7	**5**
Asset Management Expenses	7	7	8	7	**7**
Other Operating Expenses	13	13	14	14	**15**
Total Operating Expenses excluding Actuarial Loss on Defined Benefit Superannuation Scheme	46	50	52	55	**55**
Actuarial Loss/(Gain) on Defined Benefit Superannuation Scheme	-	4	(2)	-	**6**
Total Operating Expenses	46	54	50	55	**61**
Net Profit/(Loss) for the Year	535	906	(111)	144	**118**
Five-year Outcomes under the Funding Agreement					
Actual Net Expenses under the Funding Agreement[28]	38.1	45.7	41.2	46.8	**47.0**
Net Expenditure Specified under the Funding Agreement	41.0	43.3	46.9	47.8	**50.2**
Funding Agreement Under-expenditure/(Over-expenditure)	2.9	(2.4)	5.7	1.0	**3.2**

FIVE-YEAR DIVIDENDS PAID TO THE NEW ZEALAND GOVERNMENT

For the year ended 30 June	NZ IFRS Audited 2008 $M	NZ IFRS Audited 2009 $M	NZ IFRS Audited 2010 $M	NZ IFRS Audited 2011 $M	**NZ IFRS Audited 2012 $M**
Dividends Paid to the New Zealand Government	168	630	335	210	**160**

The dividend paid in 2010 includes a voluntary dividend to the Crown of $45 million that was paid in April 2010.

28. The five-year Funding Agreement that commenced 1 July 2010 excludes actuarial gains and losses from net operating expenses that are subject to the Funding Agreement. Prior to that date, actuarial gains and losses were included in net operating expenses subject to the Funding Agreement.

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