B.33

Statement of Financial Risk Management

Tauākī Whakahaere Mōrea Ahumoni

10 July 2022

Reserve Bank of New Zealand
Te Pūtea Matua

Introduction

In accordance with sections 250 and 251 of the Reserve Bank of New Zealand Act 2021 (the Act), the Reserve Bank of New Zealand – Te Pūtea Matua (the RBNZ) is required to prepare and keep up to date a Statement of Financial Risk Management (SFRM).

The purpose of this SFRM is to:

a) report on matters relating to the RBNZ Board's duty to ensure that the RBNZ operates in a financially responsible manner (section 47 of the Act);

b) report on the RBNZ's management of financial risks;

c) ensure the accountability of the RBNZ for its management of those risks;

d) provide for principles for determining the RBNZ's annual dividend; and

e) facilitate the role of the monitor.

This is the first SFRM published under the Act and in accordance with the transition arrangements to the Act, which takes effect from 1 July 2022, this SFRM does not include the following backward-looking requirements:

- Information about how the Board has complied with the duty (to ensure that the RBNZ operates in a financially responsible manner) during the most recently completed financial year (section 251 (2) (a) (ii)).
- Information about how the RBNZ has complied with any direction given under section 208 of the Act (Power of Minister to direct Bank relating to minimum level of capital and financial risk management) during the most recently completed financial year (section 251 (2) (c)).
- Identification of significant financial risks to which the RBNZ was exposed at any time during the most recently completed financial year (including the impacts of those risks on the RBNZ's statement of financial position for that financial year) (section 251 (2) (d) (i))[1].

1 This information will be included in the Reserve Bank's financial statements for the year ended 30 June 2022, included in the Reserve Bank's Annual Report for that year.

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Overview of financial responsibility

1. Under section 209 of the Act, the Minister of Finance and the RBNZ agree a five-year funding agreement. The funding agreement is an accountability measure that sets out how much the RBNZ commits to spend to maintain its capability to deliver on its purpose and achieve positive outcomes over time. The agreement specifies how much of the RBNZ's revenue may be applied to meeting the RBNZ's operating and capital expenditure (separately specified) for carrying out its functions and exercising its powers.
2. Under section 47 of the Act, the RBNZ must operate in a financially responsible manner and manage its assets and liabilities prudently, ensuring that its total expenditure complies with the funding agreement for the respective five-year period. The RBNZ receives no direct funding for operating expenditure through the Parliamentary appropriation process.
3. The RBNZ's current funding agreement period runs from 1 July 2020 to 30 June 2025. The RBNZ targets securing future funding prior to the maturity of any funding agreement.
4. The RBNZ targets a minimum level of capital that is sufficient to cover a prudent range of potential financial risks in carrying out its functions and exercising its powers (as outlined in section 16 of this SFRM). The Minister of Finance reviews the RBNZ's assessment of target capital when considering the RBNZ's annual dividend principles and recommendation. Under section 208 of the Act, the Minister may direct the RBNZ in relation to the minimum level of capital it must hold and its financial risk management.
5. Under section 213 of the Act, after the end of each financial year the RBNZ is required to recommend to the Minister the amount of dividend to be paid to the Crown, determined in accordance with the dividend principles set out below.

Dividend principles

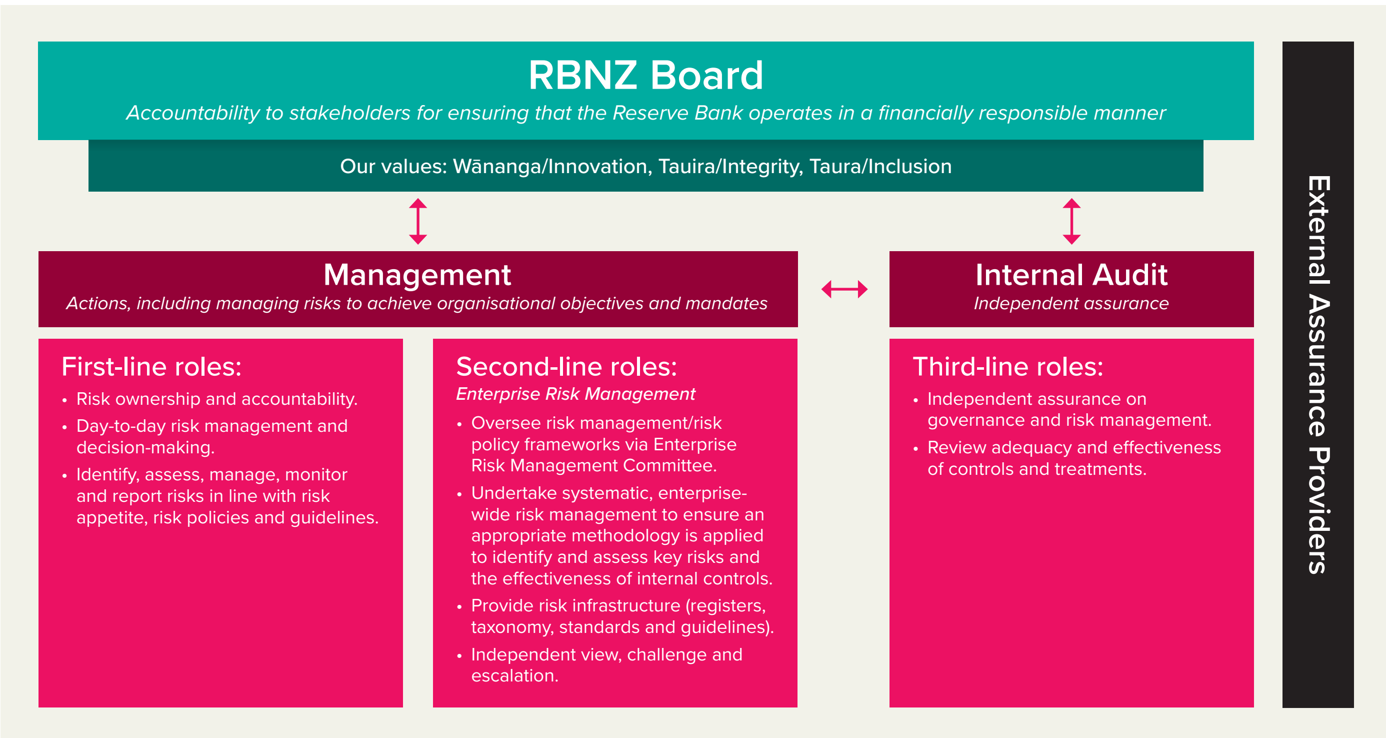
The RBNZ should maintain sufficient equity for the financial risks associated with performing its functions. Equity in excess of that required to cover those risks will be distributed to the Crown.

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

6. The Minister receives a recommendation from the RBNZ and determines the amount the RBNZ must pay to the Crown as an annual dividend.

Overview of financial risk management

7. The majority of the RBNZ's financial risks arise from its mandated responsibilities to manage liquidity in the financial system, implement monetary policy, facilitate the smooth functioning of the payment and settlement systems and manage foreign reserve assets. These activities involve foreign currency, interest rate, credit and liquidity risks.
8. In accordance with the decision-making framework set by the Board, the RBNZ's Assets and Liabilities Committee approves the operational and investment framework for financial market operations. The framework sets out objectives, governance arrangements and operational controls.
9. The RBNZ is also exposed to operational financial risks that, in the absence of internal controls, may arise through inadequate or failed internal processes, people and systems, and from external events.
10. The Board sets the RBNZ's tolerance for risks through its risk-appetite statement and delegates to management the implementation of a framework of controls to ensure that the RBNZ does not take risks beyond its tolerance levels. The RBNZ's risk-appetite statement acknowledges that the RBNZ has a low risk appetite for operating outside policy parameters, but a higher appetite for taking financial risks with our balance sheet to achieve policy objectives.
11. In accordance with the risk-appetite statement set by the Board, the RBNZ's Enterprise Risk Management Committee oversees the RBNZ's enterprise risk management framework to ensure that risks are identified, assessed and managed in line with risk appetites. The Chief Risk Officer is responsible for systematic, enterprise-wide risk management at the RBNZ, ensuring an appropriate methodology is applied to identify and assess key risks.
12. The RBNZ's approach to enterprise risk management is outlined below:



Significant financial risks

13. The significant financial risks to which the RBNZ is currently exposed and how the RBNZ manages these risks are outlined in the table below:

Financial Risk	Nature of Bank's Exposure	How Managed by the RBNZ
Foreign currency risk *is the risk that the fair value of a financial instrument will fluctuate due to a change in foreign exchange rates.*	The RBNZ holds significant foreign-currency assets, of which a portion is purposely unhedged to enable timely intervention in the market should it be required.	• Hedging where possible. The RBNZ does not fully mitigate its foreign currency risk (due to the need to maintain an unhedged position) and uses the following to reduce risk where possible: • Passive benchmarking. • Foreign currency position limits. • Target currency portfolio, composition weights and deviations. • Value at Risk monitoring and stress testing. • Management reporting.
Interest rate risk *is the risk that the fair value of a financial instrument will fluctuate due to changes in interest rates.*	The RBNZ's foreign currency assets are funded in part by NZ dollar liabilities. The RBNZ is exposed to the risk of changes in New Zealand interest rates relative to interest rates overseas. The RBNZ is also exposed to mismatches in maturity and interest rate resets between assets and liabilities. The cessation of LIBOR as a global benchmark interest rate in 2023.	Interest rate risk is managed by: • hedging where appropriate; • interest rate limits (e.g. duration mismatches); • limit monitoring and reporting; • Value at Risk (VaR) monitoring and stress testing; and • indemnity from the Crown (for interest rate risks arising from the Large Scale Asset Purchase Programme). The RBNZ has a strategy to ensure it manages the transition from LIBOR to other risk-free rates effectively.

Financial Risk	Nature of Bank's Exposure	How Managed by the RBNZ
Credit risk *is the potential for financial loss arising from an issuer or counterparty defaulting on its obligations.*	The RBNZ engages with foreign and domestic counterparties and holds a large balance of foreign currency securities.	Credit risk is managed by: • selecting of securities issuers and transaction counterparties, and monitoring credit ratings; • holding highly rated securities; • requirements to hold highly rated collateral; • over-collateralisation (e.g. over-collateralisation for non-tradeable, single-name securities); • management reporting and risk monitoring; and • standardised and robust legal documentation.
Liquidity risk *is the risk that the RBNZ will not have the resources required at a particular time to meet its obligation to settle its financial liabilities. Liquidity risk also includes the risk associated with the RBNZ, in extraordinary circumstances, having to sell a financial asset quickly at less than its fair value.*	The RBNZ holds a portfolio of high-quality foreign currency securities to ensure it has the capability to transact in markets for policy objectives. The RBNZ injects and withdraws liquidity into/from the New Zealand banking system. To do this, the RBNZ holds a portfolio of New Zealand government bonds. The RBNZ operates New Zealand's Real Time Gross Settlement System and principal securities settlement system (NZClear).	Liquidity risk is managed by: • ensuring securities held for transactional purposes are able to be sold in an orderly fashion, within agreed timeframes; • ensuring New Zealand market interest rates are consistent with monetary policy settings; • facilitating the smooth and efficient operation of the New Zealand inter-bank payment system; and • creating New Zealand dollar liquidity through market operations.

Financial Risk	Nature of Bank's Exposure	How Managed by the RBNZ
Operational risk *is the risk of loss from inadequate or failed internal processes, people and systems, or from external events.*	The RBNZ operates and maintains an IT, HR, financial and risk management infrastructure to provide the operational capability necessary to achieve its strategic and policy objectives.	The RBNZ manages operational risk under its enterprise risk management framework, ensuring that: • risks are identified; • risk Tolerance is set and managers are accountable for managing risks within levels of risk tolerance; • resourcing is adequate; • the design and operation of internal controls e.g. segregation of duties, pre-trade approval, post-trade confirmation and account reconciliations, are appropriate; • internal reporting and monitoring supports effective oversight and governance; and • there is a legal liability exclusion for NZClear operations.

14. For the 2021/22 financial year, the RBNZ's financial statements provide information on the significant financial risks to which the RBNZ was exposed at any time during the financial year and the impacts of these risks on the RBNZ's statement of financial position as at 30 June 2022.

Additional medium-term Financial Risks

15. Over the medium term, the RBNZ expects to continue to be exposed to the above financial risks. In addition to responding to these risks, the RBNZ expects to review and agree to a revised target capital level with the Minister and give effect to the new Foreign Reserves Co-ordination Framework.

Target capital level

16. The RBNZ is not subject to any formal capital requirements, unless it is subject to a section 208 direction from the Minister as outlined in paragraph 21. The RBNZ determines a minimum TCL that is sufficient to cover a prudent range of potential risks and to ensure it has sufficient capital to perform its functions. In rare and exceptional circumstances it is possible the RBNZ's capital will be insufficient to cover fully its financial risks.
17. The RBNZ reviews the TCL each year. The review considers historical experience and severe but plausible hypothetical scenarios to estimate the TCL. The review applies a combination of Value at Risk modelling and stress testing to estimate how much capital is needed to cover market and credit risks in its traded and non-traded portfolios, over a one-year time horizon.
18. The TCL is assessed by the RBNZ's Asset and Liability Committee and Executive Leadership Team and approved by the Board. The Minister reviews the RBNZ's assessment of target capital when considering the RBNZ's annual dividend recommendation.
19. The RBNZ could face a capital shortfall if its capital levels were to fall below the TCL. A shortfall could occur due to risks occurring beyond those considered reasonable for determining the TCL. For example, losses due to a severe financial crisis or arising from the need to undertake extraordinary actions not covered by the capital framework e.g. unconventional monetary policy or lender of last resort.
20. The RBNZ can continue to operate with low or negative capital (technical insolvency) due to its ability to create legal tender. However, low capital levels could weaken our ability to achieve our statutory objectives (e.g. by damaging credibility), hence the RBNZ sets a TCL within which it seeks to operate.
21. Under section 208 of the Act, the Minister may direct the RBNZ to comply with a specified minimum TCL and/or financial risk framework. Should the Minister make a section 208 direction, the RBNZ would make changes to its risk management framework that are necessary for it to comply with the direction.

Operating in a financially responsible manner

22. Under section 47 of the Act, the RBNZ must operate in a financially responsible manner and manage its assets and liabilities prudently. In particular the Board must take all reasonable steps to ensure that:

- the RBNZ's total expenditure complies with the funding agreement for that five-year period; and
- the RBNZ complies with a direction given by the Minister under section 208.

Working within the funding agreement, the Board ensures the RBNZ operates in a financially responsible manner by:

a) ensuring the RBNZ's strategies, annual plans and budgets are aligned with the funding agreement;

b) receiving regular reports and undertaking due inquiry with Management on balance-sheet management and outcomes against plans and budgets;

c) management is held accountable for delivering outcomes relating to the RBNZ's functions, objectives set by the Board and any expectations or directions set by the Minister;

d) ensuring the RBNZ's resources are applied so that it can adequately carry out its functions, strategies and operations over time;

e) putting in place, overseeing and regularly reviewing the RBNZ's decision-making framework;

f) ensuring management is accountable for managing risks within levels of risk tolerance and any expectations the Minister may set out for the RBNZ's risk management, including any directions under section 208;

g) keeping the RBNZ's risk appetite under regular review;

h) engaging regularly with and receiving reports from external and internal auditors and ensuring and supporting their independence through the Board's Audit Committee;

i) ensuring the Board receives sufficient information to approve and progress reviews and assurance reports (as required) for major projects in accordance with the RBNZ's decision-making framework;

j) ensuring management has in place policies that are designed to optimise value for money in spending and procurement; and

k) ensuring the RBNZ complies with any direction received from the Minister under section 208 of the Act.

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