RESERVE
BANK
O F N E W Z E A L A N D
T E P Ū T E A M A T U A

Reserve Bank of New Zealand
Statement of Intent

For the period 1 July 2014 to 30 June 2017

Contents

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Foreword

The New Zealand economy is performing well, with output, employment and investment growing strongly and business and consumer confidence at high levels. This strong performance looks set to continue, with real GDP expected to grow by around 3.5 percent this year.

The Bank has played a major role in catalysing the current economic expansion. Six years of stimulatory monetary policy that led to the lowest interest rates in 50 years, moderated New Zealand's recession in 2008 and 2009 and provided a platform for the current economic recovery.

But with strong impetus also from commodity export prices, residential and commercial construction and net immigration, the economy is now growing significantly faster than the growth rate of potential output, and inflationary pressures in the non-tradables sector are increasing. Withdrawing some of the monetary stimulus by raising interest rates closer to more normal levels will start to moderate growth of overall demand and avoid the damaging impact of high inflation on competitiveness, real incomes and output growth. Ensuring that inflation pressure is contained, and that output grows in line with the potential growth rate of the economy, will help to promote a more sustainable expansion.

But there are many challenges. The factors driving our strong economic performance also attract large portfolio flows into New Zealand dollars, and the resulting upward pressure on our exchange rate diminishes the competitiveness of export and import competing firms that are not exposed to sectors enjoying high international prices. House prices are overvalued on several measures and household debt levels are high. Annual inflation in the non-tradable sector is running at 3 percent, and pricing pressures in the construction sector and some service industries continue to increase.

On the financial stability side, New Zealand's financial system remains sound and well placed to support economic expansion. The banking system is well capitalised, funding and liquidity buffers are above required minimums, and non-performing loans continue to decline. There are signs that housing pressures are easing but risks remain.

We are working to best position the Bank to face the challenges ahead, and the strategic priorities in the *Statement of Intent* reflect this. The Bank's strategic priorities are framed around three themes: continuing to strengthen the Bank's performance, developing a more integrated approach to the Bank's policy, and improving infrastructure and reducing enterprise risk.

We are working to strengthen the Bank's overall performance by strengthening the support for decision making in the Bank, continuing to improve the performance culture, and by communicating more broadly. The Governing Committee is operating well and we have reviewed the terms of reference and composition of our policy and management committees. The Bank continues to work on building its management capability and staff engagement, and extending its communications across a broad front, including seeking feedback through a comprehensive stakeholder survey.

Several initiatives fall under developing a more integrated approach to the Bank's policy setting. Having credible monetary policy and well-anchored inflation expectations mean that the Bank is able to respond to economic shocks by adjusting interest rates less than otherwise would be the case. Continuing to build our understanding of the monetary policy/macro-prudential interface is an important part of our objectives. It will also be important to maintain close links with fiscal policy settings.

The Bank has significant responsibilities in relation to the supervision and regulation of banks, non-deposit taking finance entities, and insurance providers, as well as the anti-money laundering activities of banks. Maintaining the appropriate balance between self-responsibility of financial entities, market discipline, and regulatory oversight is an ongoing challenge. We intend to conduct a stocktake of the existing regulatory approach, with a view to consulting on enhancements that could improve the efficiency, clarity and targeting of our prudential standards. We will also develop a stress-testing framework for the banking system, to assess its resilience to possible future shocks.

Improving the organisation's infrastructure and reducing enterprise risk is a further focus for the years ahead. This involves assessing our future needs and architecture around the treasury management system and payments system, delivering a new series of more secure banknotes, and improving the facilities management and logistics associated with currency provision.

The Reserve Bank faces a full agenda in the years ahead as it seeks to fulfil its vision of being a high performing central bank, and best positioning the New Zealand economy and financial system for sustainable expansion.

Graeme Wheeler

Governor

What we do

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

- The Reserve Bank of New Zealand Act 1989
- The Insurance (Prudential Supervision) Act 2010
- The Anti-Money Laundering and Countering Financing of Terrorism Act 2009
- The Bills of Exchange Act 1908 and Cheques Act 1960.

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

SOI

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

This *SOI* covers the three years 2014/15 – 2016/17, of which the first year, 2014/15, is covered under the current Funding Agreement. The next Funding Agreement is to be agreed before the 2015/16 financial year commences.

Governance

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

The Minister

The Minister of Finance has responsibility for: agreeing the monetary policy target with the Governor; agreeing on changes to the scope of the supervisory regime; approving any decision to place a failing bank into statutory management or to give directions to a registered bank; and approving Orders-in-Council in relation to bank, non-bank deposit taker and insurance regulation. The Minister can also direct the Bank to intervene in the foreign exchange market or to impose, for a limited period, an alternative monetary policy target. In these cases, transparent procedures are set out in the Act. A Memorandum of Understanding between the Minister and the Governor, dated 13 May 2013, requires the Bank to consult with the Minister and the Treasury before implementing macro-prudential tools.

Board of Directors

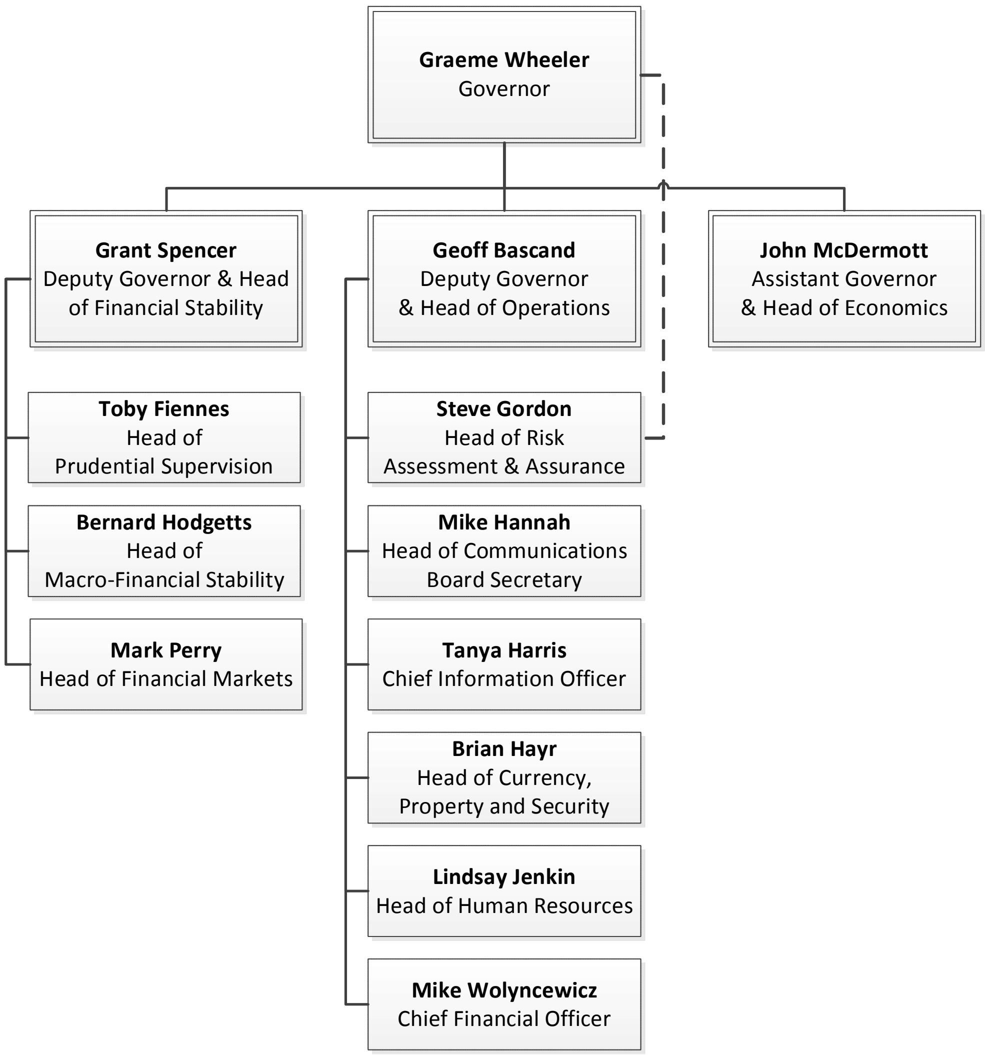
The Reserve Bank has a Board of Directors whose primary function is to review the performance of the Bank and the Governor in carrying out their statutory functions. The Board meets nine times a year, with five of the meetings taking place outside Wellington. The Board receives briefings on the Bank's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

Each year, the Board prepares a report setting out its assessment of the Bank's and the Governor's performance, which is provided as advice to the Minister of Finance and made public later in the Bank's *Annual Report*. Through its Audit Committee, the Board reviews the Bank's financial statements and internal and external audit.

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

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

Organisational structure



Strategic direction

Vision and values

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

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

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

Outcomes

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

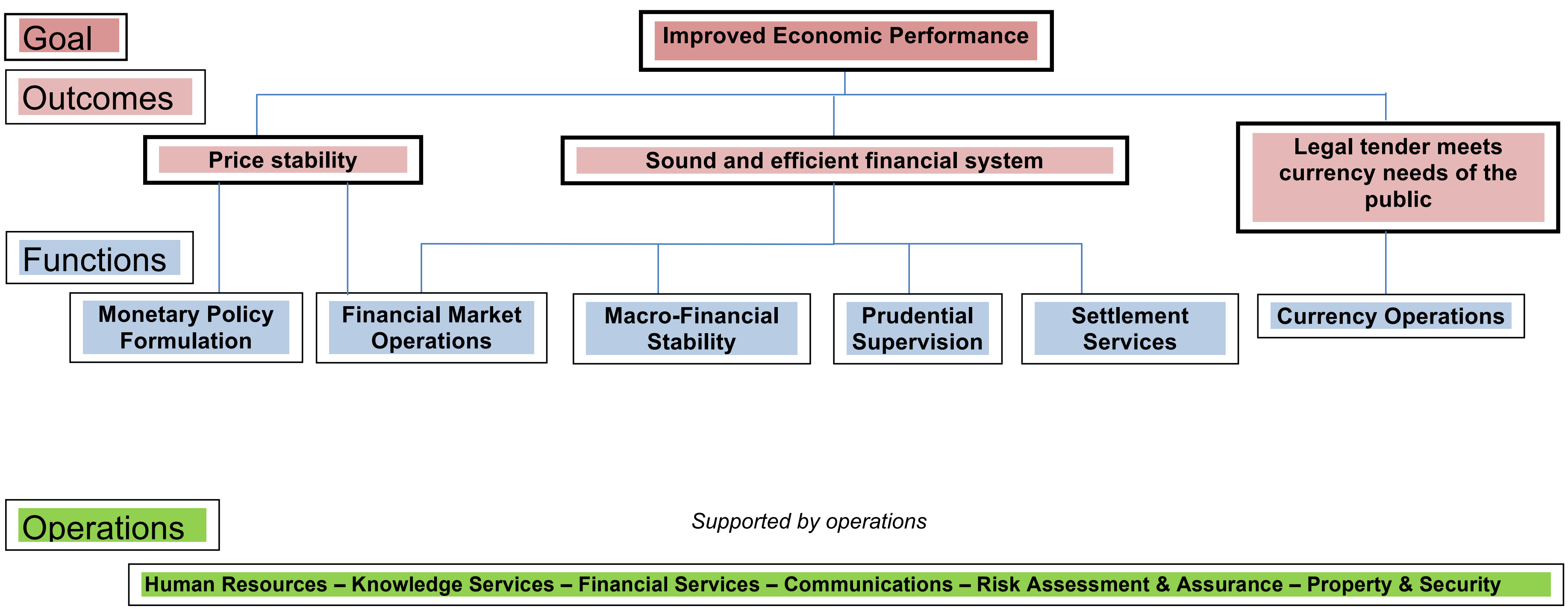
- Maintaining stability in the general level of prices
- Maintaining a sound and efficient financial system
- Providing legal tender to meet the currency needs of the public.

To achieve these outcomes, the Bank performs functions covering:

- Monetary policy formulation
- Financial market operations
- Macro-financial stability
- Prudential supervision
- Settlement services
- Currency operations.

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

The Reserve Bank - goal, outcomes, functions and operations



Goal, organisational outcomes, functions, functional outcomes, success measures

<table>
<tr><th></th><th></th><th>FUNCTION</th><th>FUNCTIONAL OUTCOMES</th></tr>
<tr><td rowspan="7">IMPROVED ECONOMIC PERFORMANCE</td><td rowspan="2">PRICE STABILITY MAINTAINED</td><td>Monetary Policy Formulation</td><td>• Stability in the general level of prices</td></tr>
<tr><td>Financial Markets</td><td>• 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.</td></tr>
<tr><td rowspan="3">SOUND AND EFFICIENT FINANCIAL SYSTEM MAINTAINED</td><td>Macro-Financial Stability</td><td rowspan="3">• A sound and efficient financial system that supports the functioning of the economy.

Macro-Financial Stability
• Financial stability, promoted by:
- increased resilience of the financial system during periods of extreme credit growth and rising leverage or abundant liquidity; and
- dampening of excessive growth in credit and asset prices.

• International and local confidence in New Zealand's financial system.

Settlement Services
• An efficient, reliable and secure payments system that supports the smooth functioning of the economy</td></tr>
<tr><td>Prudential Supervision</td></tr>
<tr><td>Settlement Services</td></tr>
<tr><td>CURRENCY NEEDS OF THE PUBLIC ARE MET</td><td>Currency Operations</td><td>• Legal tender that meets the currency needs of the public</td></tr>
</table>

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

SUCCESS MEASURES

Monetary Policy Formulation

- Reserve Bank forecasts of annual CPI inflation should be comfortably within the target range in the second half of the forecast horizon, and near the 2 percent target midpoint.
- Measures of underlying inflation should generally remain within the target range.
- Unnecessary instability in output, interest rates and the exchange rate should be avoided.
- *Monetary Policy Statements* are informative and accurately assess the Bank's performance in meeting the objectives of the Policy Targets Agreement.

Financial Markets

- Short-term wholesale interest rates are maintained at levels close to the OCR.
- No evidence of payment disruptions due to a shortage of settlement cash in the system, e.g., persistent accessing of the Overnight Reverse Repo Facility.
- Over the medium term, domestic market operations generate a positive return.
- Foreign reserves are maintained at target levels, with liquidity and credit standards met throughout.
- The Foreign Reserves Management portfolio yields a net return on assets that meets or exceeds the benchmark portfolio.
- The foreign exchange open position is managed such that:
  (a) the bulk of active foreign exchange purchases (sales) are undertaken around peaks (troughs) in the exchange rate cycle; and
  (b) the net return on the non-core open foreign exchange position is positive over the cycle.

- Significant risks to domestic financial systems stability are identified and monitored.
- Appropriate and effective policy instruments to counter risks to financial stability are deployed in a timely manner, and any potential impacts on monetary policy are understood.
- An assessment of the soundness and efficiency of the financial system is published twice yearly in the *Financial Stability Report*, including the reasons for, and the impact of, any use by the Bank of macro-prudential policy instruments.
- Information on the risk assessment framework, including the macro-prudential indicators that are used to guide policy settings, is published in a manner that assists the assessment of financial stability.
- Statistics are collected that enable an appraisal of the soundness and efficiency of the financial system, and are published in accordance with the dates published on the RBNZ website.

- The bank, non-bank deposit taker and insurance regulatory regimes, and in particular the regulatory changes implemented during the year, promote the soundness and efficiency of the financial system in a cost-effective manner, as demonstrated by sound regulatory impact analysis.
- The Reserve Bank's prudential oversight of banks, non-bank deposit takers, insurance companies and payment systems identifies emerging financial stresses in a timely manner; and the Bank is prepared, where necessary, to effectively resolve institutional failures in conjunction with Government.
- The Bank demonstrates a consultative and transparent approach to its policy development, supported by robust analysis that is understood by regulated institutions and stakeholders.
- In its decisions on whether to grant licences to new applicants, the Bank takes a consistent approach within the legislative framework, without successful challenges.
- The Bank's AML/CFT supervisory activities demonstrate an appropriate risk-based approach to supervision of reporting entities within the Bank's sector.
- The *FSRs* provide a comprehensive assessment of the health of the New Zealand financial system.

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

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

Environmental setting and strategic priorities

Over the past two years the New Zealand economy has outperformed most of the world's advanced economies. New Zealand's growth rate over the two years to December 2013 averaged 2.6 percent, or around twice the average of the group of 35 advanced economies in the IMF classification over this period.

New Zealand's economic expansion has considerable momentum, with real GDP expected to grow by over 3.5 percent over calendar 2014. Several factors are contributing to the expansion. These include the Reserve Bank's accommodative monetary policy that has helped to generate the lowest retail interest rates in 60 years. Other important factors are the high level of export prices, together with low international inflation, that resulted in the strongest terms of trade since 1973; the 40 percent growth in residential investment over the past two years (much of it due to building activity in Christchurch and Auckland); and the large increase in net immigration, which has increased by 32,000 in the year to March 2014.

Nevertheless, some key policy challenges remain. The exchange rate remains overvalued and continues to be a headwind for the export and import competing sectors; the current account remains in deficit despite the strong terms of trade; housing market imbalances continue to need addressing; and inflationary pressures, although moderate, are expected to increase over the next 18 months.

The New Zealand financial system remains sound and well placed to support the expansion of the economy. The banking system is well capitalised, funding and liquidity buffers are comfortably above required minimums, and non-performing loans continue to decline. At the same time, some risks are also apparent. House prices are overvalued on several measures, and levels of debt in the household sector relative to income are high and rising.

The Bank considers that monetary policy and prudential settings remain appropriate at this stage for the economic and financial risks facing New Zealand, taking into account restrictions on high loan-to-value ratio residential mortgage lending and the adjustments to interest rates under way.

Strategic priorities

The Bank adopted 10 strategic priorities for 2014-17 to enhance its capacity to respond to this challenging environment. Many of these strategic priorities run across several functions and departments.

These strategic priorities, which are described in more detail on pages 9-11, are framed around three broad themes:

- Continuing to strengthen the Bank's performance
- Developing a more integrated Bank approach to the Bank's policies
- Improving infrastructure and reducing enterprise risk.

Informing Government

The Bank keeps the Minister of Finance regularly informed about its thinking on significant policy developments, especially where Cabinet decisions, legislation or regulation may be required. This includes early notification of the Bank's thinking on regulatory and related policy developments and cases where the Minister may need to exercise his powers. The Bank also advises on the regulatory impact of proposed policy developments.

This information includes:

- macroeconomic management over the coming economic cycle, including implementation of monetary policy and policies directed towards financial stability and their interaction with fiscal and wider policy settings;
- ongoing macro-prudential arrangements, including work to increase transparency and public understanding about macro-prudential tools, and having regard to the interaction between macro-prudential tools and efforts to increase the responsiveness of housing supply;
- continued collaboration with the Treasury in areas of joint interest, including coordinated (although not necessarily agreed) advice;
- developments in the international economy and financial markets;
- New Zealand's key economic issues, especially those affecting the exchange rate, inflation, savings, external balance and financial stability;
- prudential oversight of New Zealand's banks, insurance companies and non-bank deposit takers.

Reserve Bank strategic priorities for 2014-17

I. Continuing to strengthen the Bank's performance

Priority	Explanation
1. Strengthening the support for decision making in the Bank	The Bank will continue to refine its decision-making processes and structures to support high quality decision-making. With growth of the Bank's regulatory responsibilities, and the establishment in 2013 of the Governing Committee, managers are conscious of the need to coordinate policies and processes. The Bank has therefore been reviewing decision-making responsibilities and processes for all committees. This year the Bank's policy committees will operate with new terms of reference, membership, and expectations on how best to contribute to the Bank's decisions. Management committees, including the Senior Management Group, have also been reviewed and will be tasked with strengthening communication inside and outside the Bank.
2. Continuing to improve performance culture	The Bank's senior management places significant emphasis on developing managers' leadership capability and performance. Managers will use the clear performance objectives and the Bank's competency framework to monitor staff performance and provide appropriate development opportunities. The links between performance and remuneration will continue to be strengthened. The Bank's recent Staff Engagement Survey gives management further insight into what is needed to raise staff engagement levels and be a high performing workplace. Three key areas to focus on, Feeling valued, Feeling connected and Being able to perform and grow, have been identified and seven key actions will be implemented in these areas. These actions will be highlighted and tracked through the Bank's internal communications programme and completed by the end of December 2014.
3. Communicating on a broader front	The Bank will ensure that it communicates clearly and effectively to improve understanding of and support for its policy choices. It will further expand its programme of on- and off-the-record speeches by a wider range of speakers, to many sectors and regional audiences, as well as briefings, media interviews, and videos on the Bank's operations and policy statements. The Bank will build its understanding of stakeholders' perceptions of the Bank's roles, policy decisions and performance through many sources, including audience feedback to the large off-the-record speech programme, the news media, a biannual Stakeholder survey, and potential online engagement channels. The production and release of a new series of banknotes will be a particular focus for clear, effective and proactive communication.

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

Priority	Explanation
4. Understanding the monetary policy / macro-prudential interface	The Bank will continue a programme of research to increase its understanding of the linkages between monetary and financial stability policies, and the implications for decision-making across these two policy functions. Aspects of the work programme will include policy coordination, the impact of interest rates on financial stability and the modelling of the interactions between monetary policy, prudential policy instruments, and the economy. The work will also seek to draw insights for internal policy processes within the Bank. This research programme will be a joint initiative led by the Economics Department and the Macro-Financial Department.
5. Reviewing, streamlining and improving the prudential regulatory framework	The Bank will complete a stocktake of prudential regulations for banks and non-bank deposit takers, and of the insurance solvency standards. Following the stocktake the Bank will consult on enhancements that it considers will improve the efficiency, clarity and targeting of the Bank's prudential standards.
6. Developing a comprehensive stress-testing framework for the New Zealand banking system	The Macro-Financial and Prudential Supervision departments will undertake a programme of work towards the development of a comprehensive stress testing framework that can be used to gauge the resilience of the banking system to a broad range of economic and financial shocks. As part of this initiative, the Bank will work this year with the domestically-owned banks to complete stress tests of their credit portfolios; and with the Australian Prudential Regulation Authority and the major Australian banks to stress-test their balance sheets. The latter exercise further develops earlier stress tests undertaken in collaboration with the Australian Prudential Regulation Authority in 2010 and 2012.

III. Improving infrastructure and reducing enterprise risk

Priority	Explanation
7. Researching appropriate infrastructure for offshore market intelligence, transactions and risk management	Given the range of currencies in which the Bank's foreign reserves are held, managed and traded, the Bank requires excellent relationships and timely and accurate market intelligence. The Bank will review whether its solely New Zealand-based operating model is the optimal operating structure, and in particular will assess if offshore infrastructure can enhance risk management and return, alongside improved market intelligence and enhanced professional development.
8. Developing a roadmap and architecture for the Bank's financial management and payments systems	The Bank operates payment systems that are critical to the operation of the economy, and also operates an internal treasury system that supports decision-making and accounting for transactions undertaken for the foreign reserves, domestic markets, and currency functions. The effectiveness of these systems is affected by developments in international settlement norms and valuation methodologies, changes to the settlements landscape in New Zealand, and rapid technological change. The Bank will develop a set of options for changes to the architecture of these systems, including a roadmap for future investment and support. In the case of payment systems, the Bank will consult with users.
9. Delivering New Zealand's new banknotes	The release of Series 7 banknotes in 2015 remains an important priority for the Bank. After securing a printing contract and confirming print schedules and subsequent release dates, the banknote upgrade project will move into its next major phase (phase three). This will involve banknote development, print trials, quality assurance, and production. It will also involve increased public awareness, extensive communications, stakeholder engagement and industry preparedness through 2015. The Bank will be concurrently refurbishing its Wellington processing facilities and plant to manage the significant growth in activity from 2015 through to 2018.
10. Developing a plan for optimising the facilities management and logistics for currency	The Bank will re-evaluate its long-term requirements and plans for processing facilities and property, to support the custody, reserves management, distribution and logistics of currency. The Bank has reviewed risks associated with its current vaults in the Wellington building and has identified a need to replace them. Due to design constraints there is no practical possibility to upgrade the facility. This risk has been magnified with last year's seismic activity. Over the next five years, as the Bank introduces the new Series 7 banknotes, it will be transitioning currency reserves between eight sites, including Wellington and five offshore sites. The complexity of managing currency in multiple sites, and the impact on enterprise risk, operational efficiency and effectiveness, will be incorporated into the planning for new facilities. The Bank has developed a new currency reserves policy that sets the framework for mitigating these enterprise risks. This year, planning will focus on developing longer-term facilities options and business cases, if required, for inclusion in the Bank's five-year funding proposal.

Functions - initiatives

Price stability

Monetary policy formulation

Refer to Strategic Priorities, pp. 14-15.

I. Continuing to strengthen the Bank's performance

1. Strengthening the support for decision making in the Bank
3. Communicating on a broader front

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

4. Understanding the monetary policy / macro-prudential interface

Objective

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

The current Policy Targets Agreement (PTA) between the Minister of Finance and the Governor requires that the Bank "keep future CPI inflation outcomes between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint". It also requires that: "In pursuing its price stability objective, the Bank shall ... seek to avoid unnecessary instability in output, interest rates and the exchange rate."

Scope of operations

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

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

Environment and policy issues

New Zealand's economic expansion is becoming more broad-based and has considerable momentum. The key drivers of economic growth include a period of record prices for New Zealand's export commodities, continued strong growth in construction sector activity, large net immigration flows, and an extended period of low interest rates. Growth is gradually increasing in New Zealand's trading partners, although these improvements in major economies have required exceptional support from monetary policy.

While headline inflation has been moderate to date, the projected strong economic expansion is expected to lead to increases in inflation pressure that will require increases in interest rates towards levels at which they are no longer adding to demand pressures.

There has been some improvement in New Zealand's macro-imbalances since the global financial crisis. The Government's fiscal position has improved, as have household savings and the size of the current account deficit relative to GDP. Several challenges remain, as outlined on page 12.

The Bank has expanded its toolkit by deploying selected macro-prudential instruments to better target macro-imbalances and the risks they pose for financial stability.

Within this environment, key issues for monetary policy are:

- The scale and pace of reconstruction in Canterbury, and the consequences for inflation and growth.
- The factors behind the continued strength of the New Zealand dollar and the impact of currency appreciation on the tradables sector.
- The demand-supply imbalance in the housing market, particularly in Auckland and Christchurch.
- How policy coordination may affect the implementation of monetary and macroprudential policies.

Initiatives and strategies

The Bank's Economics Department has five key work streams for 2014. They are:

1. *Macroprudential and monetary policy interface*: undertake analysis and develop frameworks to better understand the interaction between macroprudential and monetary policy.
2. *Best-practice institutional frameworks:* undertake analysis to inform on best-practice institutional arrangements governing monetary and macroprudential policies.
3. *Support the formulation of monetary policy:* understand how events such as a construction and housing boom, fiscal consolidation and international developments will shape the next business cycle.
4. *Monetary policy research:* undertake analysis to improve the Bank's understanding of the New Zealand economy and key monetary policy issues.
5. *Exchange rate analysis:* reviewing the Bank's frameworks for assessing the long-term sustainable level of the exchange rate and analysis on the cyclical impact of the exchange rate on New Zealand economic activity and inflation.

Success measures

See page 11.

Price stability | **Sound and efficient financial system**

Financial market operations

- **Domestic markets**
- **Foreign reserves management**

Refer to Strategic Priorities, pp. 14-16.

I. Continuing to strengthen the Bank's performance

1. Strengthening the support for decision making in the Bank
3. Communicating on a broader front

III. Improving infrastructure and reducing enterprise risk

7. Research appropriate infrastructure for offshore market intelligence, transactions and risk management
8. Develop a future roadmap and architecture for the Bank's financial management and payments systems

Financial markets

Objectives

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

Scope of operations

The Bank:

- Provides advice on financial market issues and developments for the formulation of monetary policy.
- Implements monetary policy through market operations to ensure that market interest rates are consistent with the OCR.
- Manages official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes.
- Manages liquidity in the banking system.
- Manages the Crown Settlement Account.
- Acts as lender of last resort to the financial system if necessary, as well as assisting in the resolution of any financial market or banking crisis.

Environment and policy issues

Stability in global financial markets has led to relatively benign funding conditions for New Zealand banks and institutions, in both domestic and offshore markets.

Interest rates are forecast to gradually increase in some advanced economies (apart from Europe) in the 2015 calendar year, but remain significantly below recent historical levels. This accounts for the low returns being achieved on the Bank's foreign reserves portfolio.

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

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

- Providing robust liquidity facilities for New Zealand banks, in the context of a global regulatory environment that requires full collateralisation and/or central clearing and trade reporting of over-the-counter (OTC) derivatives.
- Improving returns on the Bank's foreign reserves, where the value of the New Zealand dollar is influenced by bouts of international risk-seeking and risk aversion.
- Monitoring and responding to the global upward trend in interest rates (outside of the EU) as monetary policies in major economies are normalised.

Initiatives and strategies

- Review whether the Bank's solely New Zealand-based operating model for managing foreign exchange reserves is the optimal operating structure. In doing so, it will assess whether risk management and return can be enhanced through a full-time European presence.
- Develop a set of options for changes to the architecture of treasury and associated financial systems that will result in a robust, future-orientated operating platform.
- Develop and implement further financial tools and instruments to improve management of the financial risks that the Bank is exposed to, with specific consideration of whether to set up a stand-alone collateral management desk.

Success measures

See page 11.

Sound and efficient financial system

Macro-financial stability

Refer to Strategic Priorities, pp. 14-15.

I. Continuing to strengthen the Bank's performance

1. Strengthening the support for decision making in the Bank
3. Communicating on a broader front

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

4. Understanding the monetary policy / macro-prudential interface
6. Developing a comprehensive stress testing framework for the New Zealand banking system.

Objectives

Promote the financial stability of the domestic financial system by:

- identifying and assessing emerging system risks in a timely manner;
- advising on the deployment of macro-prudential policy instruments that may help dampen system risks, including extremes in credit cycles, asset prices, and liquidity conditions;
- analysing and reporting on the soundness and efficiency of the financial system; and,
- collecting and publishing accurate and timely statistics that enable informed decision making.

Scope of operations

The Bank:

- Identifies, monitors and reports on the risks facing the financial system, including those arising from credit cycles, asset prices, and liquidity conditions.
- Publishes a *Financial Stability Report (FSR*) twice a year, and other reports, assessing the soundness and efficiency of the New Zealand financial system.
- Implements macro-prudential policy; considers its interactions with monetary policy; and reports on the effectiveness of the instruments deployed.
- Produces and publishes accurate and timely statistics on the financial system to support the Bank's policy functions.

Environment and policy issues

Macro-prudential policy is aimed at reducing the risks to financial system stability that can arise from factors such as unsustainable credit and asset price growth, and rising household or business sector leverage. Many countries experienced boom-bust cycles in credit and asset prices in recent years, which were extremely destabilising for banking systems and created large economic costs. They also posed a significant fiscal burden for governments.

During 2013, the Bank deployed macro-prudential policy for the first time – in the form of loan-to-value restrictions – to contain emerging risks in the housing sector. Experience is now being gained on the effectiveness of the instrument, how it relates to monetary policy settings, and when it will be appropriate to withdraw the instrument. This experience will help inform the appraisal and future deployment of this and other macro-prudential instruments.

In recent years, the Bank's prudential supervision mandate has been expanded to the insurance and non-bank deposit taking sectors. This, along with the need to continue to enhance the analysis of the wider risks to financial stability, requires the collection of a broader and richer range of financial data. This requirement needs to be achieved in a manner that does not result in unnecessary reporting costs for reporting entities.

The key policy issues for macro-financial stability are:

- The ongoing need to understand the risks and threats facing the financial system, and the resilience of the financial system to emerging risks.
- Understanding the interface between macro-prudential policy and monetary policy, so that each policy coordinates with the other, while focusing on its primary objective.
- Monitoring the effect of loan-to-value restrictions on the housing market and assessing when their removal may be appropriate.
- Expanding existing financial system data collections, in order to meet current and future prudential, policy and statistical needs.

Initiatives and strategies

To address these issues, the Bank will:

- Continue to develop the implementation framework for macro-prudential policy by researching the circumstances when the deployment of other macro-prudential instruments might be appropriate.
- Complete the programme of work to understand the linkages between monetary and macro-prudential policies, and the implications for decision making across the two policies.
- Develop a comprehensive stress-testing framework for the New Zealand banking system that can be used to gauge the resilience of the system to a broad range of economic and financial risks.
- Monitor the effectiveness of the loan-to-value restrictions, and advise on their withdrawal when judged appropriate.
- Continue to enhance the reporting of financial system stability and efficiency, and the assessment of policy, as contained in the *Financial Stability Report* and other reports.
- Expand the collection of financial market statistics, including developing an insurance sector statistical survey; enhancing the collection of managed funds data; developing a New Zealand securities database; and completing the implementation of new balance sheet data for the banking sector.

Success measures

See page 11.

Sound and efficient financial system

Prudential supervision

Refer to Strategic Priorities, pp. 14-15.

I. Continuing to strengthen the Bank's performance
   1. Strengthening the support for decision making in the Bank
   3. Communicating on a broader front

II. Developing a more integrated approach to the Bank's policy
   5. Reviewing, streamlining and improving the prudential regulatory framework
   6. Developing a comprehensive stress-testing framework for the New Zealand banking system

Objectives

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

Scope of operations

The Bank:

- Registers and supervises banks, setting and applying appropriate prudential criteria.
- Licenses and supervises insurers, setting and applying appropriate prudential criteria.
- Licenses and monitors non-bank deposit takers (NBDTs), setting and applying appropriate prudential criteria.
- Sets and oversees criteria for designation of payment and settlement systems.
- Implements the prudential regulatory framework for non-bank deposit takers and insurers.
- Supervises reporting entities within the Bank's sector under the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) legislation.
- Applies a framework for undertaking enforcement action in the event of identified non-compliance.

Environment and policy issues

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

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

The Non-bank Deposit Takers Act was passed in 2013, introducing licensing and further prudential requirements. Implementation is now under way. Insurers are now fully subject to the Bank's regulatory and supervisory regime. Reporting entities within the bank, insurance and non-bank deposit taking sector, supervised by the Bank, must now formally comply with statutory AML/CFT obligations.

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

- Assessing the scope to better streamline and improve the prudential regulatory framework.
- Increasing the Bank's supervisory activity to improve risk analysis within and across the banking sector.
- Strengthening the Bank's capacity to respond to financial crises, including with the implementation of the Open Bank Resolution (OBR) policy.
- Continuing to develop policy to strengthen the Bank's oversight of financial market infrastructures.
- Coordinating with other AML/CFT supervisors to ensure consistency in approach and guidance.

Initiatives and strategies

To address these issues, the Bank will:

- Develop and complete a comprehensive stress-testing framework for New Zealand banks, and coordinate with the Australian Prudential Regulatory Authority on Australian-owned banks.
- Complete a stocktake of prudential regulations for banks and non-bank deposit takers, and of the insurance solvency standards, then consult on enhancements to improve the efficiency, clarity and targeting of prudential standards.
- Increase supervisory engagement with executives and directors of regulated banks.
- Complete the review of banks' outsourcing arrangements and consider merits of changing the policy settings.
- Initiate amendments to the statutory management powers in the Reserve Bank of New Zealand Act 1989 to clarify aspects of the legislative framework for OBR.
- Assess and determine licence applications for non-bank deposit takers under the Non-bank Deposit Takers Act 2013, and progress changes recommended by the review of the prudential regime for Non-bank Deposit Takers that was completed in 2013.
- Work on proposals for a modified framework for the formal oversight of payment and settlement systems that are of systemic importance.
- Develop and implement the supervisory regime for insurers.

Success measures

See page 11.

Sound and efficient financial system

Settlement services

Refer to Strategic Priorities. p. 16.

III. Improving infrastructure and reducing enterprise risk

8. Developing a roadmap and architecture for the Bank's financial management and payments systems

Objective

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

Scope of operations

The Bank:

- Operates the Exchange Settlement Account System (ESAS) and the New Zealand central securities depository system (NZClear).
- Operates the infrastructure required for settlement of interbank payments (Settlement Before Interchange), and that required for foreign exchange transactions through CLS Bank.

Environment and issues

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

The key issues facing the Bank's Settlement Services are the need to:

- Ensure continuity of the interface between the SWIFT payment system and the Bank's system, as the current interface will not be supported beyond late 2015.
- Determine the potential future provision of services and investment in systems.
- Plan to upgrade payment systems in coming years. Technology is changing quickly and existing systems are complex and need to be upgraded in order to support developments in the payments industry. A plan will be prepared to ensure systems are developed to meet evolving requirements.

Initiatives and strategies

To address these issues, the Bank will:

- Upgrade the interface between the SWIFT system and the Bank's system.
- Consult with the payments industry on their service and systems requirements of the Bank's payment operations, and develop a roadmap for the design and delivery of the Bank's payment and settlement services and systems.

Success measures

See page 11.

Legal tender that meets the currency needs of the public

Currency operations

Refer to Strategic Priorities, p. 16.

III. Improving infrastructure and reducing enterprise risk

10. Re-examining Currency, Property and Security

Objective

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

Scope of operations

The Bank:

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

Environment and issues

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

- Avert counterfeiting risks, given the current polymer banknote series is 14 years old and the rapid innovation in copying and printing.
- Manage a significant change programme as the Bank prepares to launch Series 7 banknotes and prepares its existing facilities and external stakeholders.
- Ensure that the security, safety and operational efficiency of the cash operations are not compromised during a period of significant activity (2015-2018).
- Ensure appropriate long-term secure premises for the Bank's currency holdings.

Initiatives and strategies

To address these issues, the Bank will:

- Continue to plan for the release and distribution of the new banknote series.
- Communicate and engage with stakeholders on the release of the Series 7 banknotes.
- Prepare the Wellington site for Series 7 banknotes.
- The Bank will re-evaluate its long-term requirements and plans for processing facilities and property, to support the custody, reserves management, distribution and logistics of currency.

Success measures

See page 11.

Operations - enabling the Bank

People and culture

Refer to Strategic Priorities, p 14.

I. Continuing to strengthen the Bank's performance

1. Strengthening the support for decision making in the Bank
2. Continuing to improve performance culture.

The Bank's vision of being a high-performing small central bank requires excellence in its people, processes and resources. The Bank is committed to continuing to improve its performance culture.

The quality of the Bank's management is a critical factor in strengthening the Bank's performance. The Bank will continue building leadership and management competencies through specific development programmes; and staff will have bank-wide training and development opportunities.

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

Communications

Refer to Strategic Priorities, pp. 14, 16.

I. Continuing to strengthen the Bank's performance

1. Strengthening the support for decision making in the Bank
2. Continuing to improve performance culture
3. Communicating on a broader front

III. Improving infrastructure and reducing enterprise risk

9. Delivering New Zealand's new banknotes

The Bank will ensure that it communicates clearly and effectively to improve understanding of, and support for, its policy choices in a challenging economic environment. It will further expand its programme of speeches to many sectoral and regional audiences, as well as briefings, media interviews, and online videos and publications on the Bank's operations and policy statements.

The Bank will use its internal communications programme as an integral part of its work to improve performance culture.

The Bank will build on its understanding of stakeholders' perceptions of the Bank's roles, policy decisions and performance through several sources, including a biannual Stakeholder survey, news media coverage, and audience feedback to our speech programme; and will investigate potential online engagement channels. The production and release of Series 7 banknotes will be a particular focus for clear, effective and proactive communication.

Knowledge services

Refer to Strategic Priorities, pp. 14, 16.

I. Continuing to strengthen the Bank's performance

3. Communicating on a broader front

III. Improving infrastructure and reducing enterprise risk

8. Developing a roadmap and architecture for the Bank's financial management and payments systems

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

Key initiatives for the department this year will be to:

- provide project management support for the introduction of the new Series 7 banknotes;
- develop a strategy roadmap for the Bank's treasury system;
- support the review of the payment systems;
- strengthen the reliability of its information technology systems, including the business continuity infrastructure for critical functions, its IT Security Framework, and a new IT back-up system;
- improve the electronic delivery of information, and refresh the Bank's web content management system.

Internal financial services

Refer to Strategic Priorities, p. 16.

III. Improving infrastructure and reducing enterprise risk

8. Developing a roadmap and architecture for the Bank's financial management and payments system

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

In 2013-14, the Bank successfully completed an upgrade of its treasury system. The Bank will:

- develop a roadmap for the design and architecture of its treasury systems;
- implement systems changes to meet new international requirements for settlement and recording of derivative transactions and related collateral management; and,
- prepare a plan and financial forecasts to support the Bank's negotiations for the next five-year Funding Agreement that commences on 1 July 2015.

From 1 July 2014, the Bank will be required to apply New Zealand Equivalents to International Public Sector Accounting Standards (NZ-IPSAS) rather than International Financial Reporting Standards (IFRS). The change in financial reporting framework will not have a significant impact on the Bank's financial reporting, although NZ-IPSAS and IFRS could diverge over time.

Risk assessment and assurance

Refer to Strategic Priorities, p. 16.

III. Improving infrastructure and reducing enterprise risk

8. Developing a roadmap and architecture for the Bank's financial management and payments system
10. Re-examining Currency, Property and Security

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

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

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

Property, security

Refer to Strategic Priorities, p. 16.

III. Improving infrastructure and reducing enterprise risk

10. Developing a plan for optimising facilities management and logistics for currency

Bank management is reviewing the operational requirements around property management and security, so as to maintain the infrastructure of the properties at a level that promotes efficiency and a safe and secure environment for all staff, tenants and visitors.

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

Financial management

Financial structure

Balance sheet overview and funding of the Bank's operations

The Bank receives no direct funding through the central government budgetary process. Instead, the Bank's main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the Bank's equity.

The nature and extent of the Bank's principal activities that affect its balance sheet are described in the *Annual Report 2012 – 2013* (pages 56 to 57). Foreign reserves management, New Zealand dollar liquidity management, and currency operations materially affect the size and structure of the Bank's balance sheet.

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

The current Funding Agreement covers the five-year period ending 30 June 2015. It provides funding of $55.2 million for 2013/14 and $56.4 million for 2014/15.

Annual distributions paid by the Bank

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

Statement of dividend principles

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

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

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

Accounting standards

From 1 July 2014, the Bank will be required to apply New Zealand Equivalents to International Public Sector Accounting Standards (NZ-IPSAS) rather than International Financial Reporting Standards (IFRS). The change in financial reporting framework will not have a significant impact on the Bank's financial reporting, although NZ-IPSAS and IFRS could diverge over time.

Drivers of the Bank's financial performance and financial position

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

- *The value of currency in circulation.*

  Currency in circulation is a non-interest-bearing liability. Trading banks are charged for currency issued to them and the Bank earns interest, known as seigniorage, on investment of these amounts paid by trading banks. At 30 April 2014, currency in circulation was $5.1 billion.

- *The size of the Bank's open foreign exchange position and related changes in foreign exchange rates.*

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

  Holding unhedged foreign reserves means that the Bank's net equity will fluctuate with changes in the exchange rate: foreign exchanges losses may be incurred when the New Zealand dollar is strong, and gains may be recorded when the New Zealand dollar is weak. The unhedged position increases volatility in the Bank's financial performance and financial position.

  At 30 April 2014, the Bank held an open foreign exchange position of SDR 1.39 billion (NZ$2.5 billion). At 30 June 2013, the open foreign exchange position was SDR 1.36 billion (NZ$2.6 billion) at 30 June 2013.

- *Interest rates earned on the Bank's investment in government securities and other securities.*

  The Bank's holdings of New Zealand government securities are valued at market value, with unrealised gains and losses on those holdings booked to equity. Interest income and realised gains and losses on disposal of New Zealand government securities are booked to the Bank's Income Statement.

- *The size and performance of the Bank's foreign reserve management and market operations functions.*

  The Bank holds foreign reserves that can be liquidated at short notice to support its functions, including monetary policy objectives and the maintenance of orderly markets. Foreign reserves are valued at market value. Changes to foreign exchange rates and international interest rates will affect the market value of those reserves, and valuation changes are booked to the Bank's Income Statement.

  At 30 April 2014, the Bank had foreign reserve assets equivalent in value to NZ$8.4 billion.

- *New Zealand government deposits held at the Bank.*

  The Bank provides a settlement account facility to the Crown. The size of New Zealand government deposits held in the Crown Settlement Account (CSA) is a big driver of the Bank's balance sheet. Larger CSA deposits are swapped into foreign currency and invested by the Bank offshore. However, net earnings are not materially affected by this activity. At 30 April 2014, the Bank held New Zealand government deposits of NZ$2.7 billion.

- *Operating expenditure incurred by the Bank.*

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

- *The level of equity available for investment and the dividend paid by the Bank.*

  The Bank requires equity to absorb any losses that may arise from carrying out its functions, and equity is reviewed annually to determine the Bank's annual dividend. The dividend for the 2012-2013 year was $175 million, and reported equity at 30 April 2014 was $2.5 billion.

Principal financial risk management considerations

With more than $20 billion in assets, the Bank faces a wide range of financial risks. These arise mainly because of the Bank's operations in the domestic financial system, and its holdings of foreign currency reserves. The risks include:

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

More detailed information on the Bank's approach to managing these risks is outlined on pages 68-79 in the *Annual Report 2012-2013*.

Financial projections

The following table outlines the Bank's budgeted income and expenditure for 2014/15. The key assumptions underlying the budget for the year ended 30 June 2015 are that:

- the Bank's current functions will continue;
- there are no material changes to the structure of the Bank's balance sheet between 31 January 2014 and 30 June 2015;
- projected interest and exchange rates will be those advised by the Treasury for the purposes of preparing the Government's Budget for 2014/15;
- there will be no change in the credit worthiness of the Bank's counterparties; and
- there will be no material changes to the Bank's liquidity management operations.

Projected financial performance 2014–2015

For the year ending 30 June	**Budget 2014-15 $m**
Operating income:	
Net investment income	244.3
Other income	10.6
Total operating income	**254.9**
Operating expenses:	
Personnel	34.6
Asset management	6.8
Net currency issued	7.0
Professional and contract services	8.0
Other	12.0
Total operating expenses	**68.4**
Operating surplus	**186.5**

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

As at 31 January 2014, a 10 percent appreciation in the value of the New Zealand dollar would reduce the Bank's comprehensive income[2] by $233 million, and conversely a 10 percent depreciation in the value of the New Zealand dollar would add $284 million to comprehensive income. A 1 percent across-the-board increase in interest rates would reduce comprehensive income by about $202 million, and a 1 percent across-the-board reduction in interest rates would increase comprehensive income by about $216 million.

[2] Comprehensive income includes earnings booked to the Bank's Income Statement and also changes booked directly to Equity. The majority of sensitivity to changes in foreign exchange rates is booked to the Income Statement, whereas the majority of interest rate sensitivity arises on the Bank's portfolio of New Zealand government securities and is booked directly to Equity. Refer to page 73 of the Bank's *Annual Report 2012-2013* for a detailed sensitivity analysis as at 30 June 2013.

Net expenditure[3] budget 2014-2015

For the year ending 30 June	Net expenditure Budget 2014-15 $000s
Functions:	
Monetary Policy formulation	11,192
Domestic market operations	5,497
Macro-financial stability	8,124
Prudential supervision	13,249
Foreign reserves management	6,148
Settlement services	(1,340)
Currency operations	14,901
Net expenditure	57,771
Net expenditure provided for in the Funding Agreement	56,400
Funding Agreement over-expenditure	(1,371)

Budgeted net operating expenditure for 2014/15 of $57.8 million exceeds the amount of $56.4 million provided in the funding agreement. This reflects the strategic priority of improving infrastructure and reducing enterprise risks, particularly in the Bank's currency operations, which requires substantial investment. This includes holding additional contingency reserves out of Wellington as well as modernising the facilities and purchasing new note processing machines in advance of introducing Series 7 banknotes in 2015/16. Higher levels of operating expenditure in our currency operations reflect significantly increased issuance costs as the volume of currency on issue has expanded. For the year ended 30 April 2014, the value of currency in circulation increased by 9.6 percent. The budget for 2014/15 also includes provision for a communications and education campaign for the launch of Series 7 banknotes, which will occur in the 2015/16 financial year.

Cumulative net operating expenditure will be less than the cumulative amount provided for in the funding agreement for the five year period ended 30 June 2015. For the first three years of that funding agreement, cumulative net operating expenditure was $8.6 million less than the amount provided in the funding agreement for that three year period.

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