Statement of Intent

2018–2021

RESERVE
BANK
OF NEW ZEALAND
TE PŪTEA MATUA

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For the period 1 July 2018 to 30 June 2021

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Foreword

In this *Statement of Intent* (*SOI*) we outline our efforts to evolve into **A Great Team, Best Central Bank**. These efforts involve significant change in culture, capabilities, and communication. We are up for the challenge.

Starting at home, we will be strengthening the Bank's performance culture, to ensure we are constructive, effective, and an employer of choice.

We also intend to place New Zealanders' understanding of us on a wider footing. We will make our messages more accessible and relevant. Our tool sets will also rely more on digital and social media to reach our audience. And we will promote a deeper understanding at the Bank of tikanga Māori and te Reo Māori.

New Zealand's banknotes and coins retain a high level of confidence and use, with demand increasing despite the growth in electronic transactions. We have studied the public's use of cash, and will finalise a future operating model for its distribution and storage.

The Bank has a significant balance sheet of financial assets and liabilities. This is necessary to provide liquidity and stability to our financial system. It is essential that our management and tool sets are up to the demands of the activity. We intend to continue to invest in appropriate trading systems and complete a full review of our investment activities.

We will also look to improve business efficiency and soundness, especially knowledge management, through a multi-year investment strategy. Included in this effort is our plan to introduce a revamped payments system infrastructure, and make more use of digital services.

In terms of policy, the Reserve Bank has a wide range of responsibilities. This year, Parliament is finalising law changes that aim to give the Bank responsibility for contributing to maximising sustainable employment. This task is already incorporated in our *Policy Targets Agreement* with the Minister of Finance.

The law change will also move official interest rate setting decisions to a 'Monetary Policy Committee' (MPC), made up of Bank staff and external members. We are committed to implementing these changes, and aim to ensure that the MPC is effective and transparent – creating a greater understanding of the reasoning for, and impact of, our decisions.

There will also be an ongoing Government Review of the Reserve Bank of NZ Act, looking at how we prudentially regulate and supervise the financial system. Our staff will work jointly with NZ Treasury officials – amongst others – in a constructive manner, to ensure this work is completed over coming years.

To achieve our vision of **A Great Team, Best Central Bank** there is, and always will be, much to be done. Our people are committed to this vision, and will need to work together to succeed.

Adrian Orr
Governor

13 June 2018

Geoff Bascand
Deputy Governor

13 June 2018

Governance and structure

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:

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

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

Statement of Intent, funding

Under section 162A of the Act, the Reserve Bank must provide to the Minister of Finance a *Statement of Intent* (*SOI*) for each 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 current Funding Agreement is for 2015-16 to 2019-20. 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 2018-19 to 2020-21, of which the first two years, 2018-19 and 2019-20, are covered under the current Funding Agreement. The next Funding Agreement is to be agreed before the 2020-21 financial year commences.

Governance

The Act provides day-to-day operational autonomy to the Bank under the management of the Governor, an important role for the Minister of Finance in some key decisions, and a robust accountability structure that involves formal roles for the Bank's Board of Directors, the Minister and Parliament (via the Finance and Expenditure Committee). Transparency is an important feature of the framework.

Monitoring the Bank's performance

The Bank is recognised internationally for the openness and transparency of its processes and policies. Transparency assists the Bank to achieve its policy and operational goals effectively and efficiently, while allowing others to scrutinise the Bank's performance and to provide feedback, so helping the Bank to improve the way it works.

The principal mechanisms for externally communicating the Bank's views each year are:

- seven Official Cash Rate (OCR) decisions, four of them in the quarterly *Monetary Policy Statements*;
- two *Financial Stability Reports*;
- the Bank's *SOI*, *Annual Report* and financial statements;
- many addresses given by the Governors and other senior Bank staff; and
- the Bank's website (www.rbnz.govt.nz), digital publications and growing use of social media.

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

The Board of Directors reviews the Bank's performance and the discharge of its statutory obligations. In addition to providing the Governor with ongoing advice and feedback, the Board provides the Minister with quarterly reports and an annual report on the Bank's performance. The Board's annual report is published with the Bank's *Annual Report*.

The Audit Committee of the Board reviews the Bank's financial statements and provides advice to the Governor before the Governor and Deputy Governor sign the related management statements. It also monitors the Bank's external and internal audit functions. The Bank publishes its *SOI* at the commencement of each financial year. The *SOI*: sets out the Bank's principal functions, objectives, strategies and key performance indicators for the next three years; comments on strategies for managing organisational health and capability; sets out initiatives and projected income and expenditure for the first year of the three-year period; includes a statement of principles determining the annual dividend payable to the Minister; and outlines the Bank's Regulatory Plan for the year.

The *Annual Report* includes both the financial statements and an assessment of the performance of the Bank's various functions, in terms of both the day-to-day responsibilities and progress against priorities and key performance indicators published in the *SOI*. It is tabled in Parliament. Parliament's Finance and Expenditure Committee reviews the quarterly *Monetary Policy Statement*s, the six-monthly *Financial Stability Report*s and the Bank's *Annual Report*, and can ask the Bank to appear before it.

Under section 167 of the Act, the Minister may, from time to time, initiate an assessment of the Bank's performance and how it has exercised its powers under the Act.

The Bank is subject to section 162AB of the Act and Cabinet's regulatory impact analysis requirements, ensuring that proposals involving regulatory options are subject to careful and robust regulatory analysis, and that the Bank demonstrates that a regulatory solution is required in the public interest. The Bank undertakes extensive consultation on proposed legislation and regulations.

The Bank's financial statements are audited by external auditors, who are agents of the Controller and Auditor-General. The critical payment systems operated by the Bank are subject to review by external auditors quarterly in respect of the NZClear depository system, and annually in respect of ESAS (the Bank's Exchange Settlement Account System). An annual report is presented to NZClear members.

The Bank regularly engages experts to assess the Bank's processes, research and technical performance. In the past, assessments have been provided in the fields of: monetary policy development; financial system policy; forecasting processes; bank-failure management; computer systems and network security; management; and leadership assessment and development. The Bank funds a Professorial Fellowship in Monetary and Financial Economics at Victoria University of Wellington. Also, since 2002 two external advisers have been appointed by the Bank for two-year terms to assist in the provision of advice to the Governor regarding interest rate decisions. Prior to the release of a *Monetary Policy Statement*, these advisers participate in the deliberations leading to the development of the Statement.

The Bank's performance is also subject to international scrutiny. Every 12 to 18 months the International Monetary Fund (IMF) undertakes an 'Article IV' assessment of the New Zealand economy, which includes sections on monetary policy and financial system stability. The resultant report is made public. Every two years the Organisation for Economic Co-operation and Development (OECD) undertakes a similar assessment, which is also published. The IMF has also undertaken a Financial Sector Assessment Programme (FSAP) review, and published its report in May 2017.

The Minister

The Minister of Finance has responsibility for: agreeing the monetary policy target with the Governor; approving any decision to place a failing bank into statutory management or to give directions to a registered bank; and seeking Cabinet approval for proposed regulations made under the Acts administered by the Bank. The Minister can also direct the Bank to intervene in the foreign exchange market or to impose, for a limited period, an alternative monetary policy target. In these cases transparent procedures are set out in the Act. A Memorandum of Understanding between the Minister and the Governor, dated 13 May 2013, requires the Bank to consult the Minister and the Treasury before implementing macro-prudential tools covered by that Memorandum.

An annual letter from the Minister of Finance to the Governor outlines the broad expectations of the Bank's relationship with the Minister and areas of particular interest for the year.

The Bank meets regularly with the Minister and the Treasury to discuss a range of issues, including developments in the prudential policy work area and other matters affecting financial stability.

Board of Directors

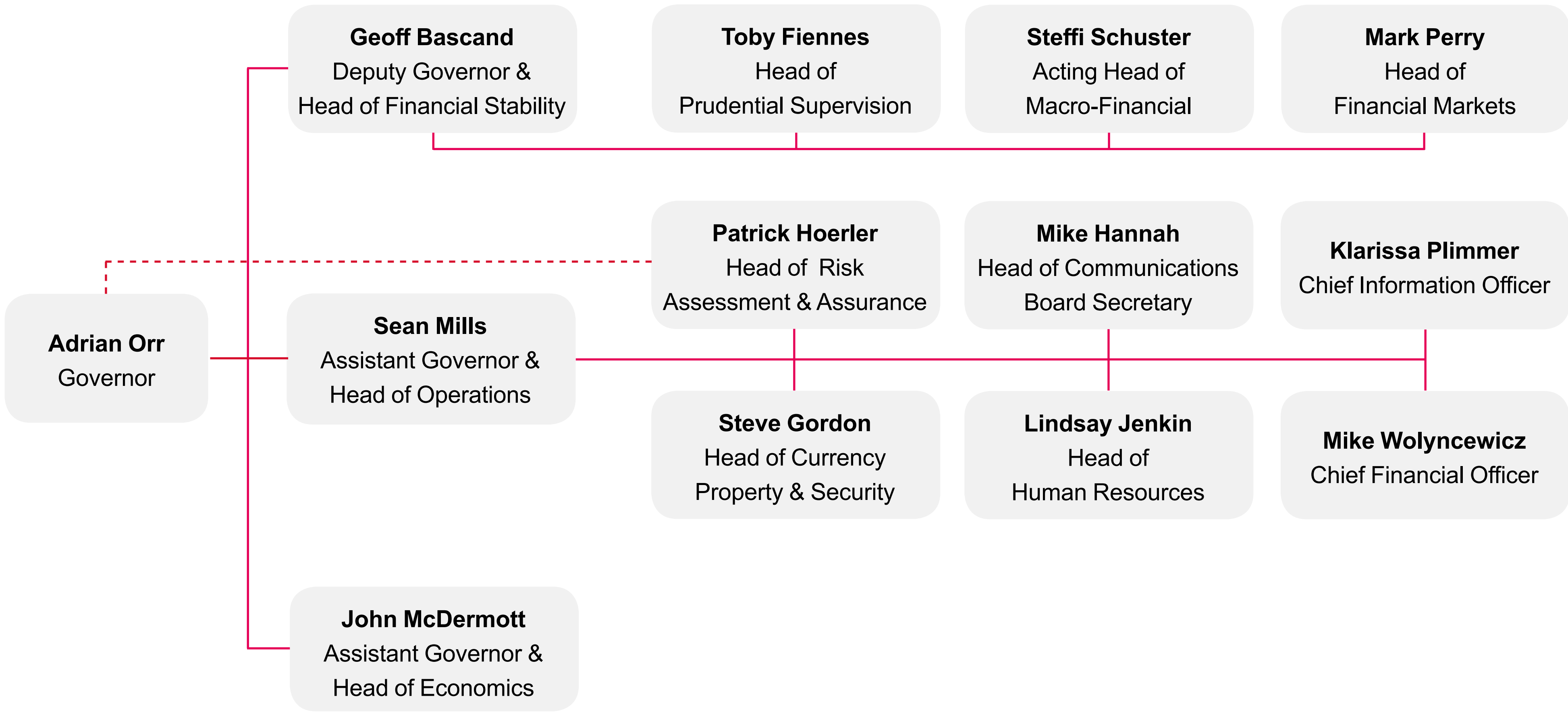
The Board of Directors' primary function is to keep under constant review the performance of the Bank and the Governor in carrying out their statutory functions. The Board's monitoring of the Bank's performance is guided by a Letter of Expectations from the Minister, and the Board reports regularly to the Minister during the year. The Board meets at least nine times a year, with two or more of the meetings taking place outside Wellington. As well as reviewing *Monetary Policy Statements* and *Financial Stability Reports*, the Board receives briefings on the Bank's activities and processes, policies, decisions, performance indicators, and financial and other risks, and the performance of the Bank's statutory functions and the exercise of its powers. At these meetings the Board may also provide advice to the Governor on the Bank's performance of its functions and the exercise of its powers.

Each year the Board prepares a report setting out its assessment of the Bank's and the Governor's performance. The report 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 audits.

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 recommendations.

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

Organisational structure*



* This organisational chart is reflective of the Bank at 1 July 2018.

Strategic direction

Purpose, vision and values

The Reserve Bank's purpose is to promote a sound and dynamic monetary and financial system. It seeks to achieve its vision – **A Great Team, Best Central Bank** – with values of:

- integrity – being professional and exercising sound judgement;
- innovation – actively improving what we do; and
- 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 efficient and well managed; and it invests in people and culture through effective training, development, recruitment and retention. 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 economic objective, which is stated in the new Policy Targets Agreement signed by Minister of Finance Grant Robertson and incoming Reserve Bank Governor Adrian Orr on 26 March 2018:

The Government's economic objective is to improve the wellbeing and living standards of New Zealanders through a sustainable, productive and inclusive economy. Our priority is to move towards a low-carbon economy, with a strong, diversified export base, that delivers decent jobs with higher wages and reduces inequality and poverty.

The Bank targets three statutory requirements designed to foster confidence and stability in New Zealand's financial system, by:

- maintaining stability in the general level of prices;

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

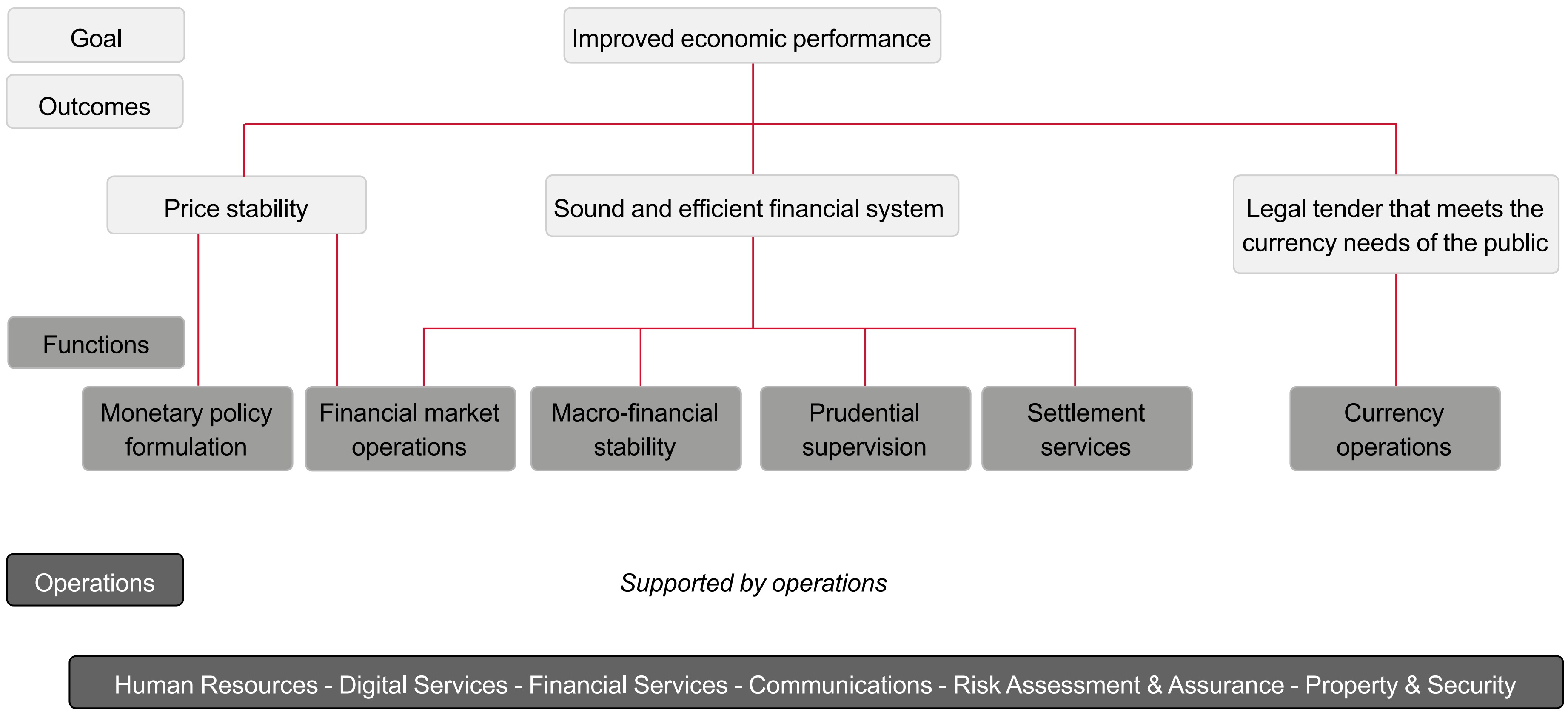
The Policy Targets Agreement also requires the Bank to conduct monetary policy so that it contributes to supporting maximum levels of sustainable employment within the economy.

To achieve these outcomes the Bank performs functions covering:

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

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

The Reserve Bank – goal, outcomes, functions and operations



Reserve Bank strategic priorities for 2018–2021

These are key priority areas for the Bank, while other workstreams are reflected elsewhere in the *SOI*.

I. Strengthen leadership and engagement

1. Strengthen the Bank's performance culture

The Bank will ensure that its workforce is well equipped for the challenges facing a modern central bank by strengthening its performance culture. Supported by sound workforce planning, it will lift leaders' performance to improve agility, capability and productivity. It will encourage managers to create innovative and inclusive working environments that grow a creative and diverse workforce. Leaders will be accountable for outcomes such as employee engagement, wellbeing at work, and the performance of all colleagues will be assessed within the Bank's internal high-performance framework.

2. Enhance dialogue with stakeholders to promote understanding and trust

The Bank will promote more in-depth dialogue with stakeholders to foster shared understanding and stakeholders' trust in the Bank. It will expand its channels for two-way communication, listening to stakeholders through more frequent, customised surveys and explaining its policies and actions through its digital channels, while continuing a broad speech programme and range of web publications. It will also contribute to this objective through the Government's Review of the Reserve Bank Act.

II. Enhance the Bank's policy frameworks and capabilities

3. Monetary policy

The Bank will complete the legislative requirements of the new monetary policy framework involving both the Monetary Policy Committee and contributing to employment outcomes. It will establish the new Committee, including recruiting external members, and put in place appropriate protocols and procedures. The Bank will support the

Committee to fulfil its mandate through a decision-making framework that balances the price stability and employment objectives, and by facilitating the relevant understanding of labour market measures and dynamics. The Bank will clearly communicate the new framework to the public and financial markets.

4. Prudential regulation

The Bank will complete its review of bank capital and continue full implementation of the outsourcing policy, which are critical ingredients for a sound and efficient financial system in New Zealand. The second phase of the Reserve Bank Act Review will focus on improving the Bank's broader financial policy framework. Areas to be covered will include objectives, governance and decision-making, the Bank's prudential regulation regime, macro-prudential policy, funding, and the crisis resolution framework. The Bank will complete the work jointly with the Treasury consulting with the public. A successful review would be expected to lead to improvements in New Zealand's financial regulation and crisis resolution frameworks with any changes in these areas having broad legitimacy and support.

III. Enable business capabilities

5. Establish the future custody and distribution model for currency

The Bank is reviewing its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met effectively and efficiently in the future. The Currency Cycle Transformation Programme is in place to oversee the underlying work plan, which includes assessing the current operating model, considering the impacts of financial technology trends for currency demand, and examining different approaches to the custody and distribution of currency. Phase 1 involves completing a detailed strategic assessment by 30 June 2018. Phase 2 is focused on leveraging the strategic assessment learnings to create future options and ultimately to set out a proposed optimal model for formal consultation.

6. Roadmap for balance sheet optimisation and financial management systems

The Bank will complete a best-practice review of foreign and domestic markets' mandates to optimise risk/reward/liquidity in its balance sheet operations. This review will focus on the risk and return on capital, asset allocation, liquidity and collateral management. The Bank will also complete the implementation of market-standard trade valuation methods and enhanced risk reporting to enable improvements in balance sheet and liquidity management.

7. Technology capability transformation

The Bank will ensure that its technology and supporting IT operating models are effective and relevant for modern central bank operations by defining technology roadmaps, capabilities, services and business partners for the next five years. It will also implement the necessary changes to service performance, commercial management and our project and portfolio management. Consideration of cloud services for near-term critical infrastructure obsolescence and the development of the Bank's Information Architecture roadmap are key priorities.

8. Complete the payments system review

The Bank will complete the implementation of a system to replace its Exchange Settlement Account System, providing real-time gross settlement services, and the implementation of a replacement system for securities settlement and depository services (NZClear).

Strategic priorities in action

Strategic priorities	2018/19 success looks like …	Medium term outcomes (2-3 years) are …	And in the long term …
Strengthen the Bank's performance culture	• Technical leadership pilot completed and decision made to roll out further • Constructive-achievement leadership development programme completed • Engagement survey completed. • Future workforce review and planning started	• Leaders: Constructive-achievement profiles improved • Wide group of Band 5 and 6 staff completed Master Experts course • Employee engagement survey results improved • Bank-wide Culture survey completed	• Constructive Culture embedded • Employer of choice recognition externally • Inclusive and high performing team
Promote understanding and trust through enhanced dialogue with stakeholders (including best regulator-regulated relationship)	• Renewed Bank-wide stakeholder framework is in place • Digital technology developments identified and being implemented • Tikanga-Māori and te Reo programme initiated • Communicate Bank priorities to regulated industries	• Stakeholder understanding and trust is improved • A fit-for-purpose website and digital channels are implemented • Tikanga-Māori awareness is embedded internally	• The Bank's digital communications are best practice • Te Reo and tikanga Māori are embedded in RBNZ culture • Staff are well informed and engaged • External stakeholders understand our role and trust our work
Monetary policy	• Greater understanding of NZ labour market and maximum sustainable employment • Smooth transition to new policy decision committee • New framework for co-ordinating monetary, financial and fiscal policy will be established	• A well-informed MPC that speaks with clarity • Greater understanding of welfare implications of monetary policy	Become a world leader in: • Communicating monetary policy to public • Understanding monetary policy trade-offs • Monetary, financial and fiscal policy co-ordination

Strategic priorities	2018/19 success looks like …	Medium term outcomes (2-3 years) are …	And in the long term …
Prudential regulation	• Phase 2 Steering group and Working Group are established • Policy work and consultation on first two key topics completed • Complete capital review • Complete outsourcing review	• Recommendations on the legislative framework and conduct of prudential policy in New Zealand • Well capitalised banks • Work plan for open bank resolution	• High quality regulatory regime that has broad legitimacy and support • Ability to manage bank failures effectively
Establish the future custody and distribution model for currency	• Strategic assessment of our currency needs and operations is completed • The business case for implementing the currency operations has been agreed and advanced	• Identified a fit-for-purpose currency operating model. • Shared and agreed the new operating model with all stakeholders	• The resilience and efficiency of the currency operating model is effective and sustainable • Understanding of the future impacts of FinTec
Roadmap for balance sheet optimisation and financial management systems	Complete implementation of: • The Trade Valuation Solution, focusing on risk reporting and trade valuation adjustments • Pre-trade counterparty credit limit management project • Domestic Markets automated auction platform	• Clarity of purpose and performance • Enhanced trading information • More robust systems	• Manage our balance sheet to agreed, optimally defined, purposes
Technology capability transformation	• Cloud infrastructure design complete • Security monitoring service implemented • Cloud infrastructure and information architecture roadmaps defined • Whole of bank centralised project management practice initiated • IT commercial strategy defined	• Digital Services transformation programme complete, new functions and capabilities embedded. • Technology infrastructure migrated to 'as-a-service' and application transformation is underway. • Improved customer service delivered by a performance focused team	• Provide secure, contemporary technology that enables our business • Decisions based on advanced analytics and information sharing • High quality services based on a cloud first and 'as-a-service' operating model
Complete the payments system review	• Careful planning, risk assessment and progression of payment systems replacement in order to mitigate the probability of upgrading the current platform	• Modern technology in place • Efficient Payment and Settlement Services operating model, reduced manual processes and enabling significant industry change	• Sound and efficient financial system • The Bank provides thought leadership to Payments industry on FinTec

Functions – initiatives and strategies

Price stability

Monetary policy formulation

Objective

To "maintain a stable general level of prices over the medium term and contribute to supporting maximum sustainable employment." – *Policy Targets Agreement* signed by the Minister of Finance and the Governor, 26 March 2018.

Under the *Policy Targets Agreement*, the price stability target is "to keep future annual CPI [consumer price index] inflation between 1 and 3 percent over the medium-term, with a focus on keeping future inflation near the 2 percent target mid-point". The *Agreement* also requires that the Bank shall "have regard to the efficiency and soundness of the financial system" and "seek to avoid unnecessary instability in output, employment, interest rates and the exchange rate".

Scope of operations

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

- set the Official Cash Rate (OCR) seven times a year with the aim of keeping future inflation near the mid-point of the target band of 1 percent to 3 percent and supporting maximum sustainable employment. Other unscheduled adjustments to the OCR may occur in response to unexpected or sudden developments;
- publish a *Monetary Policy Statement* each quarter at the same time as four of the OCR decisions. This statement sets out the Bank's views on the economy, employment and the balance of inflationary pressures, and therefore the basis for the OCR decision;
- announce the other three OCR decisions along with a one-page assessment, six weeks after each *Monetary Policy Statement*; and
- where appropriate and feasible, intervene in the foreign exchange market to influence the level of the exchange rate, consistent with the objectives of the *Policy Targets Agreement*.

Environment and policy issues

New Zealand's economy expanded at an annual average rate of 2.9 percent during 2017, below the pace of growth in 2016 but slightly above the average pace of expansion since 2010. The expansion was supported by the low policy interest rate, strong population growth, and the pick-up in global economic growth and associated recovery in export commodity prices. However, the economy also faced several headwinds. The housing market slowed in 2017, reflecting changes to loan-to-value ratio (LVR) restrictions, tightening in bank lending standards, and higher mortgage rates. Capacity constraints in the residential construction sector restrained growth. Although the exchange rate declined in 2017, it remains at an elevated level, dampening activity in the tradables sector. While global growth increased, it continues to be supported by accommodative monetary policy, and spare capacity lingers in several major advanced economies. However, monetary stimulus has peaked, and several major central banks have begun to increase policy rates.

Conditions in the New Zealand labour market have strengthened further. Employment grew by 3.7 percent in the year to the December 2017 quarter, substantially faster than growth in the working-age population of 2.3 percent. The unemployment rate declined by 0.8 percentage points to 4.5 percent, and the labour force participation rate increased slightly to 71 percent.

The economy is close to its potential level of output. Inflation was higher in 2017 relative to recent years, with prices increasing 1.6 percent in the year to the December 2017 quarter. Non-tradables inflation was broadly steady during the year, with housing-related components continuing to make the largest contribution. Tradables inflation has increased since late 2016, driven by higher fuel and food prices. Inflation in other tradable goods' prices has remained low. Survey measures of short-term inflation expectations have increased, and inflation expectations are now close to the 2 percent target mid-point across all horizons.

Monetary policy has remained accommodative in the past year, with the policy rate remaining unchanged at a record low 1.75 percent. Accommodative monetary policy has been necessary in order to support continued growth in domestic demand and employment, which will contribute to a sustained lift in non-tradables inflation and ensure that future inflation settles near the mid-point of the target range. Monetary policy will remain accommodative for a considerable period.

In addition to the changes included in the new Agreement, the Government has announced its intention to amend the Act to require the Bank to direct monetary policy to support maximum sustainable employment alongside the Act's existing mandate to maintain stability in the general level of prices. The Government also intends to create a formal decision-making committee for monetary policy, with both internal Bank staff and external members, as part of the Review of the Act.

Within this environment, key developments that the Bank will monitor are:

- developments in the global political environment and foreign macroeconomic policies and their effects on the New Zealand economy through trade, confidence and financial market channels;
- the effects of changes in New Zealand government policy on the economy;
- consumer behaviour and its underlying drivers;

- capacity pressures in the economy, particularly the construction sector;
- developments in the labour market and their relationship to broader economic conditions; and
- the price- and wage-setting behaviour of firms.

Initiatives and strategies

The Bank's Economics department has five key work streams for 2018.

1. Implement changes to the Bank's monetary policy framework: upgrade systems and processes to implement changes in the Act.
2. Support the formulation of monetary policy: understand new developments in a range of areas including digital technology and fiscal policy, and their consequences for output, consumption, labour market outcomes and monetary policy.
3. Enhance the Bank's modelling capabilities: make greater use of micro-data analysis and machine learning and assess the implications of changes to the Bank's monetary policy framework for our current modelling infrastructure.
4. Monetary policy research: undertake research and engage widely with stakeholders and experts to expand our understanding of the labour market and policy rules to guide monetary decision-making.
5. International and exchange rate analysis: monitor the normalisation of foreign monetary policies and assess implications for the New Zealand economy.

Success measures

- The Bank implements monetary policy in a manner that can reasonably be expected to:
  a. see CPI inflation outcomes between 1 percent and 3 percent in the medium term, with a focus on keeping future inflation near the 2 percent target mid-point; and
  b. contribute to supporting maximum sustainable employment.
- Measures of underlying inflation generally remain within the *Policy Targets Agreement* target range.
- The Bank implements monetary policy in a manner that seeks to avoid unnecessary instability in output, employment, interest rates and the exchange rate, while having regard to the efficiency and soundness of the financial system.
- *Monetary Policy Statements* are informative and assess the Bank's performance in meeting the objectives of the Agreement.

Price stability

Financial market operations

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

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 capabilities.

Scope of operations

The Bank:

- provides advice on financial market and international economic 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 Official Cash Rate;
- manages official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes;
- manages liquidity in the banking system;
- manages the Crown Settlement Account; and
- acts as lender of last resort to the financial system if necessary, as well as assisting in the resolution of any financial market or banking crises.

Environment and policy issues

- The global economic growth outlook has improved in the past year as excess capacity has continued to be absorbed in most major economies. The OECD has revised up its global growth forecast to 3.9 percent for 2018 and 2019. Labour market conditions have continued to tighten, but wage inflation in most international economies remains subdued. Inflationary pressures are building and financial markets are becoming more focused on the risks of asset re-pricing as monetary policy settings become more normalised.
- Following the record low equity volatility seen in the past year, more recent sharp increases have yet to cause a significant reassessment of the global economic outlook. Commodity markets have seen a consolidation in prices, within lower volatility ranges generally.
- New Zealand financial markets have also been largely unaffected by the recent offshore financial market volatility. The New Zealand-

dollar exchange rate and bank funding costs have been relatively stable.

- Generally, monetary policy normalisation in advanced economies has yet to generate a significant rebalancing in monetary conditions. This partly reflects the broader United States-dollar weakness that occurred during a period when policy rates in the United States were gradually increasing, while Europe and Japan continued to provide significant monetary stimulus. Despite global geopolitical uncertainties and brief volatility spikes as a result of these events, asset markets remained buoyant.

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

- positioning for a return to normalised monetary policy globally; the potential for reduced liquidity and increased volatility in major global markets as inflation and interest rates increase; and understanding and managing the spillover effects on New Zealand domestic markets;

- improving the valuation and risk management of financial market instruments, which will enable the Bank to respond more effectively to rapidly evolving financial markets, including regulatory developments; and

- enhancing the Bank's ability to respond with effective liquidity facilities for New Zealand banks, ensuring an operating environment that is sufficiently flexible and robust and can withstand unexpected shocks in both offshore and domestic markets.

Initiatives and strategies

- Complete foreign and domestic markets policy and mandate reviews by June 2019. This will involve first-principle and peer reviews, enabling effective responses to changing global financial market conditions, normalising monetary policy and optimising risk/reward in balance sheet operations.

- Complete the implementation of the Trade Valuation Solution (TVS) project, focusing on risk reporting based on market-standard financial instrument valuations. Implement the solution for pre-trade counterparty credit limit management and the domestic markets automated auction platform.

- Increase the Bank's influence on policy formulation through enhanced, thematic analyses of global economic and financial market developments.

- Implement the Residential Mortgage Obligations framework in order to improve collateral standards, enhance the Bank's risk position and promote capital markets' activity in the product. Introduce a simple, transparent and comparable framework to residential mortgage-backed securities that could offer an additional funding channel for local banks, providing them with more flexibility if liquidity and/or funding conditions change.

Success measures

- Short-term wholesale interest rates are maintained at levels close to the Official Cash Rate.

- There is no evidence of payment disruptions due to a shortage of settlement cash in the system, eg persistent accessing of the Overnight Reverse Repo Facility.

- In the medium term, domestic market operations generate positive returns.

- 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) is 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.

Sound and efficient financial system

Macro-financial stability

Objectives

To 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 instruments to reduce system risks arising from 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 high-quality, relevant and timely statistics that enable informed decision-making.

Scope of operations

The Bank:

- identifies, monitors and reports on the risks facing the financial system, including those arising from credit cycles, asset prices and liquidity conditions;
- publishes a *Financial Stability Report* twice a year, and other reports, assessing the soundness and efficiency of the financial system;
- implements macro-prudential policy, considers its interactions with monetary policy, and assesses and reports on the effectiveness of the instruments deployed; and
- produces and publishes high-quality, relevant and timely statistics on the financial system to support the Bank's policy functions.

Environment and policy issues

House price inflation has moderated in the past year, particularly in Auckland, reflecting the effects of LVR restrictions, a general tightening in bank lending standards, and somewhat higher mortgage interest rates since early 2017. The Bank undertook a modest easing in LVR restrictions from January 2018, noting that further adjustments will depend on financial stability risks remaining contained. Household indebtedness has stabilised in the past year, but debt-to-income ratios for some new borrowers remain relatively high by international standards.

Dairy prices have increased from low levels in the past two seasons. The dairy sector remains heavily indebted to banks and faces a number of headwinds that continue to make it a key source of risk to the financial system.

As part of Phase 2 of the Government's Review of the Act, the Bank and the Treasury will review the macro-prudential policy framework, which has now been in place for five years. Aspects of the framework that will be reviewed include the scope, objectives and governance of macro-prudential policy, the macro-prudential toolkit, and processes used to support transparency, accountability and review. The Review will also consider the potential role of a debt-to-income instrument following public consultation in 2017.

The Bank remains committed to an active programme of stress-testing of the banking system, and sees stress-testing as an integral part of banks' internal risk management. The Bank expects to conduct further exercises in the coming years, and will also increase its emphasis on improving the public understanding of the role and limitations of stress-testing.

The Reserve Bank has continued to expand and modernise its collection of financial system statistics in recent years. The Bank has implemented a new banking sector prudential data dashboard. The Bank Financial Strength Dashboard is a user-friendly, interactive, online tool that enables users to monitor the financial health of banks. The Bank will review and improve the Dashboard in light of user feedback.

The key policy issues for macro-financial stability are:

- understanding the risks and threats facing the financial system and assessing the resilience of the system in light of those risks;

- enhancing the public understanding of financial stability matters, such as stress-testing;
- continuing to monitor risks posed by the housing market and the case for further adjustments to LVR restrictions;
- reviewing the role, effectiveness and design of the macro-prudential framework; and
- ensuring that financial system data continues to meet current and future prudential policy and statistical needs.

Initiatives and strategies

To address these issues, the Bank will:

- work with the Treasury in 2018 to review the macro-prudential policy framework;
- reflect on insights gained from recent stress-testing exercises, increase public communications on the role of stress-testing, and work with banks to further refine stress-testing methodologies;
- continue to enhance *Financial Stability Report*s via an active programme of research that focuses on issues related to both the stability and the efficiency of the financial system; and
- continue to review and enhance its financial system statistics.

Success measures

- Significant risks to domestic financial system stability are identified and monitored.
- Appropriate instruments to counter risks to financial stability are deployed in a timely and effective manner, and any potential impacts on monetary policy are understood.
- 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.
- Assessments of the soundness and efficiency of the financial system are published twice-yearly in the *Financial Stability Report*s, including the reasons for, and the impacts of, any use by the Bank of macro-prudential policy instruments.
- Statistics are collected to enable an appraisal of the soundness and efficiency of the financial system, and are published in accordance with the principles and protocols of New Zealand's Official Statistics System.
- The Bank contributes to a thorough assessment of the existing macro-prudential framework and makes considered recommendations for how the framework can be improved.

Sound and efficient financial system

Prudential supervision

Objectives

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

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 the designation of payment and settlement systems;
- supervises reporting entities within the Bank's remit under the AML/CFT legislation; and
- applies a framework for undertaking enforcement action in the event of identified non-compliance.

Environment and policy issues

New Zealand's financial system remains sound and well placed to support growth in the economy. New Zealand banks maintain capital and funding buffers in excess of minimum requirements and profitability is strong. Insurance sector solvency is stable, albeit at a lower level than that of peer jurisdictions, while key financial market infrastructures operate effectively.

The recently conducted Financial Sector Assessment Programme review concluded that the banking system appears well placed to withstand large but plausible shocks, as judged by a range of stress-tests. The International Monetary Fund also recognised the improvements that have been made to New Zealand's regulatory framework, particularly since the global financial crisis, but noted that insufficient resources are an impediment to further alignment with international standards. The IMF made a number of recommendations designed to improve the regulatory and supervisory framework for the banking sector, including macro-prudential policy, as well as recommendations that relate to the Reserve Bank's functions in relation to insurance, financial market infrastructures and crisis management.

In late 2017 the Government announced the Review of the Act. The Review is being conducted in two parts – Phase 1 covers high-priority changes to monetary policy and Phase 2 covers a broader reform of the Act, including the financial stability function. Phase 2 will be a comprehensive review of the Act and will consider a broad range of topics, including objectives, governance and decision-making, macro-prudential policy and crisis management.

International regulatory standards continue to evolve. Developments in the capital and liquidity standards of the Basel Committee on Banking Supervision are of particular relevance, as they are important international standards for guiding New Zealand policy.

Australian-owned financial institutions comprise a major part of New Zealand's financial system, and accordingly we maintain close relationships with Australia's financial regulatory authorities. In addition to their inherent business risks, many of the firms we regulate are also facing significant change and disruption risk. Whether from new technologies, new entrants or new business models, operational risk issues are gaining increasing prominence.

Money laundering and terrorist financing risks also continue to evolve. New Zealand's AML/CFT regime will be broadened (to accountants, lawyers, real estate agents and high-value dealers) in 2018-19, and the entire regime is due to be assessed by the Financial Action Task Force in 2020.

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

- the Government's decision to initiate the Review of the Act, which provides an opportunity to revisit the regulatory architecture and supervisory approach, taking into account the findings of the IMF FSAP review 2017 and international regulatory developments;
- continuing to assess the health of the financial system and responding to risks arising from: high levels of indebtedness among households and dairy farmers; volatility in global funding markets; and emerging operational risks such as cyber-attacks and conduct-related matters; and
- continuing to strengthen the three pillars of the Bank's regulatory approach. This includes improving the accessibility of bank information for market participants (market discipline), enhancing the bank directors' attestation regime (self-discipline) and reviewing the appropriateness of bank capital requirements (regulatory discipline).

Initiatives and strategies

To address these issues the Bank will:

- jointly with the Treasury, undertake the Review of the Act. This will involve developing and delivering a work programme on the topics of the Review, stakeholder consultation, and advice to Ministers and Cabinet;
- continue to conduct a wide-ranging and consultative review of the Reserve Bank's capital requirements for banks;
- launch and monitor the effectiveness of the Dashboard to ensure it meets its objective of improving disclosures, thereby enhancing the potential for market discipline;
- closely supervise each bank as it transitions to full compliance with the Reserve Bank's outsourcing policy by 30 September 2022, according to a plan agreed with the Reserve Bank;
- conduct a thematic review of banks' risk management practices including their oversight of bank culture and management of operational, compliance and conduct risk;

- implement a new framework for systemically important financial market infrastructures, including crisis-management powers, by continuing to draft and consult on proposed legislation, and support the passage of the legislation through Parliament; and

- continue the implementation of a risk-based and structured approach to banking and insurance supervision. Supervisory activities will therefore include monitoring risks in regulated entities using both public and private reporting, and deepening engagement with executives and directors of regulated entities.

Success measures

- The Bank demonstrates a consultative and transparent approach to its policy development, supported by robust analysis that is understood by regulated institutions and stakeholders.

- Phase 2 of the Review of the Act is seen as open and transparent, with relevant issues identified for review.

- The Reserve Bank's prudential oversight of banks, NBDTs, insurance companies and payment systems identifies emerging financial stresses in a timely manner; and the Bank is prepared, where necessary, to resolve institutional failures effectively in conjunction with government.

- The bank, NBDT and insurance regulatory regimes, and in particular the regulatory changes, promote the soundness and efficiency of the financial system in a cost-effective manner, as demonstrated by sound regulatory impact analyses of policies that the Reserve Bank intends to adopt, and regular reviews of existing policies and supervisory practices.

- The Bank's AML/CFT supervisory activities demonstrate an appropriate and effective risk-based approach to the supervision of reporting entities.

Settlement services

Objective

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

Scope of operations

The Bank:

- operates the real-time gross settlement system (ESAS) and the New Zealand central securities settlement and depository system (NZClear); and

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

Environment and issues

The Bank operates payment 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 issue facing the Bank's settlement services is the need to update payment systems. Technology is changing quickly and existing systems need to be upgraded in order to improve system resilience and security, and support developments in the payments industry. A work programme is well under way to ensure that systems and infrastructures are updated or replaced to meet evolving requirements.

Initiatives and strategies

The Bank will complete the Payment Systems Replacement Programme. This involves collaborating with service providers to implement software to replace the current systems used to provide real-time gross settlement services (ESAS) and securities settlement and depository services (NZClear), and to set up and support the IT infrastructure on which these systems operate.

The Bank will engage with systems' users to rigorously test the functionality and resilience of these replacement systems and prepare for a smooth transition of the new systems and business operations to the 'live' production environment.

Success measures

- The availability of payment systems operated by the Bank during core operating hours is at least 99.90 percent (this is the target availability specified in the systems' terms and conditions), as measured over a year.

- Customer satisfaction with operations and systems' 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 payment systems' external audits.

- International standards for payment and settlement systems (Committee on Payment and Settlement Systems and International Organization of Securities Commissions) are complied with, subject to variations for local New Zealand conditions.

Currency operations

Objective

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

Scope of operations

The Bank:

- procures, stores and processes banknotes and coins and issues them to the banking system;

- monitors the quality, and verifies the authenticity, of currency in circulation; and

- issues legal tender collectors' currency through an outsourcing arrangement.

Environment and issues

Currency in circulation continues to grow each year, alongside the substantial growth in alternative electronic consumer payment methods. Given that cash remains an important means of making payments in New Zealand, the issues facing currency operations are the need to:

- determine the medium- to longer-term demand for currency and ensure that the custody and distribution arrangements effectively and efficiently support this demand;

- mitigate counterfeiting risks. The rapid innovation in copying and printing techniques heightens the need for counterfeit awareness and resilience. While our new, more secure series 7 Brighter Money banknotes have now been rolled out, many previous polymer series introduced 18 years ago remain in circulation;

- continue to manage the supply and issuance of the new banknote series while removing the previous series' banknotes from circulation as they are returned to the Bank;

- ensure that the security, safety and operational efficiency of the Bank's cash operations are not compromised during any periods of significant distribution disruption and/or increased cash demand;

- ensure that effective contingency arrangements are in place for business continuity purposes.

Initiatives and strategies

To address these issues, the Bank will:

- continue the Currency Cycle Transformation Programme, which has been established to review New Zealand's currency operating model, including research into digital currency developments, and supporting infrastructure; and

- review the continued roll-out of series 7 Brighter Money and the rate of removal of the previous banknote series from circulation.

Success measures

- All orders for notes and coins from banks that meet the Bank's guidelines are fulfilled 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 is fewer than 10 per million notes in circulation.

- Currency is available to the public to meet planned and unplanned demand.

Operations – enabling the Bank

People and culture

As the Bank looks to the future, its focus is on developing and growing its people through exciting and challenging work, aspirational goals and an inclusive and engaging working environment. We will also promote a deeper understanding at the Bank of tikanga Māori and te Reo Māori.

Work has already been done to enhance the Bank's performance culture and so ensure that its people respond positively to opportunities for change as they arise. As part of its high-performance culture, the Bank measures employee engagement annually and supports actions on areas that colleagues identify as important to them, such as recognising innovation, keeping informed and encouraging collaboration. Leaders are held accountable for capability-building, individual and team high performance, and employee engagement and wellbeing at work. Business results and performance measures remain positive, and the Bank is committed to continuing to strengthen and measure its performance culture.

Communications

The Bank will enhance its communications with stakeholders by taking up opportunities both to listen to them more frequently in depth, and to better explain its decisions and actions. This year the Bank conducted its second External Stakeholder Engagement Survey. The Bank will release the results from this survey, and draw on them to enhance engagement with the general public and specific stakeholder groups.

The Bank is also embarking on a three-year plan to expand its stable of digital communications, using innovative technologies to enhance visibility and understanding of the Bank's key communications among its general audience.

The Bank will continue to explore how far it might move into two-way web and social media dialogue.

To maintain an engaged staff, the Bank needs to inform its people frequently of its strategies and their rationale. As some internal communication channels come to the end of their lifecycles and need replacing, research and development is planned to look at alternative options, including ways to increase two-way communication among Bank staff.

Digital services

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

Key initiatives for Digital Services this year will be:

- continuing to provide technological support for the implementation of the TVS;
- continuing to support the implementation of replacement systems used to provide real-time gross settlement services (ESAS) and securities settlement and depository services (NZClear);

- implementing security operation and incidence and response containment processes, and continuing to strengthen our cybersecurity systems;
- delivering highly available cloud and other enabling technologies to achieve operations management excellence in infrastructure and delivery;
- building information and data strategies to allow for the growth and integrity of our critical data assets; and
- building our internal capabilities and developing leaders to continue to improve our high-performance culture.

Internal financial services

High-quality financial systems and processes are needed to manage the Bank's complex balance sheet. These systems support workflows, reports and processes for operations in financial markets and currency operations. Outputs must be delivered to the highest standards of integrity and accuracy and within agreed deadlines.

The Bank will continue to develop a consistent framework for performance measurement against business plans to support a high-performance culture, so that senior management has enhanced monitoring and management of business resources.

The Bank will complete the implementation of the TVS project to enhance the management of risks and returns and aid decision-making, by providing market-standard trade valuations, and enhanced risk and performance reporting. During 2018-19 the Bank will upgrade its treasury system (Findur) to the latest version.

From 1 July 2018 the Bank intends to adopt early a new accounting standard for financial instruments (PBE IFRS 9) – see page 34.

Risk assessment and assurance

The Bank faces a wide range of risks, some general in nature and others unique to central banks' operations. Risk Assessment and Assurance adds value through the application of a systematic enterprise approach to risk management and assurance activities that provides insights, and supports the Bank in the pursuit of its objectives, strategic initiatives and performance.

Risk Assessment and Assurance facilitates regular reviews of the Bank's risk profile and assesses the effectiveness of its management of risks in the context of its objectives.

The legal function within the department oversees the broad range of legal risks facing the Bank from both regulatory and operational perspectives, and supports the Bank with legal advice. A particular focus at present is the Phase 2 Review of the Act.

Risk Assessment and Assurance is involved in the development and implementation of key projects, and focuses on activities to enhance processes and controls that strengthen the Bank's operations. The key themes for this year are: coordinating and improving procurement practices across the Bank; strengthening business continuity capability for its time-critical business functions through its Auckland office; and refining its approach to operational risk governance. These activities will be complemented with the refinement of the Bank's enterprise risk management framework and will mature the Bank's risk culture.

Property and security

The Bank continually assesses its security access and control systems to ensure that they are robust.

The Bank owns its premises at 2 The Terrace, Wellington, and will continue to manage the facility effectively and efficiently. This includes optimising the leasing of floor capacity that is surplus to the Bank's needs, developing a property strategy for the future, and proactively maintaining property-related assets.

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 2016–2017* (pages 64–65). 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 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 2020. It provides funding of $66.3 million for 2017-18 and $61.3 million for 2018-19.

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 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.

Accounting standards

The Bank applies Public Benefit Entity accounting standards based on International Public Sector Accounting Standards. The Bank's accounting policies are described on pages 57–65 of the *Annual Report 2016–2017*.

From 1 July 2018 the Bank intends to early adopt a new accounting standard for financial instruments (PBE IFRS 9). The main impact of the new standard will be that unrealised gains on the Bank's investment in New Zealand government securities will cease being recognised in equity[1] and, as a result, the volatility of the Bank's reported equity and the sensitivity of the Bank's comprehensive income to changes in interest rates will reduce.

Drivers of the Bank's financial performance and financial position

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

- **the value of currency in circulation:** currency in circulation is a non-interest-bearing liability for the Bank. Banks are charged for the face value of currency issued to them and the Bank earns interest, known as seigniorage, on the investment of these amounts paid by banks. At 30 April 2018 currency in circulation was $6.4 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 respond more effectively to foreign exchange crises, and to smooth extreme exchange rate movements. The Bank has a benchmark holding of SDR1.0 billion unhedged foreign currency reserves, with the ability to hold more or less than the benchmark during the exchange rate cycle. Holding unhedged foreign reserves means that the Bank's net equity will fluctuate with changes in the exchange rate; foreign exchange losses may be incurred when the New Zealand dollar is strong, and gains may be recorded when the New Zealand dollar is weak. The unhedged position increases the volatility in the Bank's financial performance and financial position. At 30 April 2018 the Bank held an open foreign exchange position of SDR1.5 billion (NZ$3.1 billion);

- **interest rates earned on the Bank's investment in government securities and other securities:** interest income from the Bank's investment in New Zealand government securities and other securities is 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 affect the market values of those reserves, and valuation changes are booked to the Bank's Income Statement. At 30 April 2018 the Bank had a foreign exchange intervention capacity of USD6.9 billion (NZ$9.9 billion);

1 Under the previous accounting standard (PBE IPSAS 29), the Bank's investment in New Zealand government securities is classified as 'available for sale securities' with unrealised gains on those securities booked to equity. Under PBE IFRS 9 the Bank's investment in New Zealand government securities will be classified as 'held to collect' and will be measured at amortised cost. Changes in the market value of those securities that are intended to be held to maturity will no longer be recognised in the Bank's comprehensive Income Statement.

- **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 is a big driver of the Bank's balance sheet. Large deposits are swapped into foreign currency and invested by the Bank overseas. However, net earnings are not affected materially by this activity. At 30 April 2018 the Bank held New Zealand government deposits of NZ$5.8 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; and

- **the level of equity available for investment and the dividend paid by the Bank:** the Bank requires equity to absorb any losses that may arise from carrying out its functions, and equity is reviewed annually to determine the annual dividend. The dividend for the 2016-17 year was $145 million, and the reported equity at 30 April 2018 was $3.1 billion.

Principal financial risk management considerations

With more than $27 billion in assets, the Bank faces a wide range of financial risks. These arise mainly because of the Bank's operations in the domestic financial system and its holdings of foreign currency reserves. The risks include:

- credit risks and market risks associated with day-to-day dealings with financial institutions, while managing liquidity in the financial system;

- risks associated with the Bank's holdings of foreign currency reserves, including credit risk, liquidity risk, interest rate risk and exchange rate risk; and

- operational risks in the transactions and processing areas of the Bank.

More detailed information on the Bank's approach to managing these risks is outlined on pages 77–88 of the *Annual Report 2016–2017*.

Financial projections

The following table outlines the Bank's budgeted income and expenditure for 2018-19. The key assumptions underlying the budget for the year ended 30 June 2019 are that:

- there are no significant changes to the Bank's current functions;

- there are no material changes to the structure of the Bank's balance sheet between 30 April 2018 and 30 June 2019;

- projected interest and exchange rates are those advised by the Treasury for the purposes of preparing the Government's Budget for 2018-19;

- there is no change in the creditworthiness of the Bank's counterparties; and

- there is no material change to the Bank's liquidity management operations.

Projected financial performance

Projected financial performance 2018–19

For the year ending 30 June	Budget 2018–19 $m
Operating income:	
Net investment income	275.9
Other income	14.2
Total operating income	**290.1**
Operating expenses	
Bank operations:	
Personnel	37.2
Asset management	7.7
Professional and contract services	9.8
Other	14.6
Total operating expenses, Bank operations	**69.3**
Direct currency issue expenses:[2]	
Net currency issued	13.1
Delivery expenses	0.4
Series 7 banknote transition expenses	0.2
Other currency-related expenses	0.2
Total direct currency issue expenses	**13.9**
Operating surplus	**206.9**

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 30 April 2018 a 10 percent appreciation in the value of the New Zealand dollar would reduce the Bank's comprehensive income[3] by $286.3 million, and conversely a 10 percent depreciation in the value of the New Zealand dollar would add $350.0 million to comprehensive income. A 1 percent across-the-board increase in interest rates would reduce comprehensive income by about $322.7 million, and a 1 percent across-the-board reduction in interest rates would increase comprehensive income by about $363.2 million.

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

3 Comprehensive income includes earnings booked to the Bank's Income Statement and also changes booked directly to equity. The majority of the sensitivity to changes in foreign exchange rates and changes in interest rates is booked to the Income Statement. Refer to page 82 of the Bank's *Annual Report* 2016–2017 for a detailed sensitivity analysis as at 30 June 2017.

Net expenditure[4] budget 2018–2019

For the year ending 30 June	Net expenditure Budget 2018–19 $000s
Monetary policy formulation	5,887
Domestic market operations	7,011
Macro-financial stability	9,355
Prudential supervision	10,824
Foreign reserves management	15,840
Settlement services	(1,075)
Net operating expenditure before currency operations	**47,842**
Currency operations	21,161
Net operating expenditure	**69,003**

Budgeted net operating expenditure for 2018-19 comprises Bank net operating expenses of $55.1 million and direct currency issued expenses of $13.9 million.

While budgeted expenditure for 2018-19 exceeds the amounts specified in the funding agreement of $50.8 million and $10.5 million respectively, the Bank is funding the additional expenditure from under-spending in earlier years. (For the first two years of the funding agreement, aggregate under-expenditure was $22.6 million.) The accumulated under-spending in the early years of the funding agreement was due to the capitalisation of staff time on major projects, higher than budgeted profits for NZClear, and the slower than forecast rate of the replacement of Series 6 bank notes with the more expensive Series 7 bank notes. As previously signalled, the Bank is planning to stay within the aggregate funding levels agreed for the full five years of the funding agreement, with expenditure in the latter half of the period exceeding the annual levels specified in that agreement.

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

Funding agreement

	Net expenditure Budget 2018–19 $000s	Funding agreement 2018–19 $000s	Funding agreement over-expenditure $000s
Net operating expenditure excluding direct net currency issue expenses	55,051	50,800	4,251
Direct net currency issue expenses[5]	13,952	10,500	3,452
Total net operating expenditure over funding agreement	**69,003**	**61,300**	**7,703**

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