
Reserve Bank of New Zealand

Statement of Intent

For the period 1 July 2007 to 30 June 2010

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Introduction

Under section 162A of the Reserve Bank of New Zealand Act 1989 (the Act), the Reserve Bank is required, prior to each financial year, to provide the Minister of Finance with a *Statement of Intent (SOI)* traversing the following three years.

Section 162B of the Act states that the Reserve Bank's *SOI* must contain:

- key background information about the Bank and its operating environment;
- the nature and scope of the Bank's functions and its principal areas of operation;
- the nature of the Bank's specific objectives;
- the proposed strategies for achieving objectives and carrying out operations;
- the proposed strategies for managing the organisational health and capability of the Bank; and
- a statement of the projected income and expenditure for the first financial year in the period to which the *SOI* relates.

Vision

We promote a sound and dynamic monetary and financial system.

Values

Integrity – Being professional and exercising sound judgement

Innovation – Actively improving what we do

Inclusion – Working together for a more effective Bank

Foreword

When mapping our strategic priorities for this three-year *SOI*, we have set out to ensure that the Bank can deliver on its policy and operational goals in the face of significant change.

At the start of the Bank's current Five-Year Funding Agreement in July 2005, it was not envisaged that the economy would have grown as strongly as it has in the last two years, delivering the longest period of growth since 1968-75 and the lowest unemployment rate in 20 years. World demand and persistently high commodity prices, especially for dairy, are key drivers of this growth.

At the same time, there has been unprecedented access to international credit, from the savings of Asian and oil-producing economies. There have also been worldwide booms in housing and oil prices.

The outcomes have surprised forecasters. There have been large international exchange rate swings. The New Zealand dollar has recorded post-float highs. Job and income security, ready access to credit, and other factors have meant New Zealand households have taken to borrowing, investing in houses and general consumption to an extent never seen before. Our current account deficit with the rest of the world has deepened as export earnings have struggled to keep up with the growth in demand for imports.

It is now apparent that the downturn we would have expected at the end of a business cycle has been more benign than usual. New Zealand has stepped into its next growth cycle with less restructuring of balance sheets and shedding of debt and risks than we would normally have seen. The cycle has started with housing inflation still high, posing a significant risk of continued borrowing and consumption by households.

As our environment changes around us, the Bank must adapt, and that means investing in people and tools to enhance our ability to perform in that changed environment. This is most evident in our two key policy functions: Monetary Policy Formulation and Financial System Surveillance and Policy.

In these circumstances, it is critical that we continue to invest in upgrading our forecasting and policy tools, improve our understanding of household balance sheets, and improve the quality of our statistics. We have also reviewed and offered advice to Government on whether other tools could assist us in managing inflation.

While our monitoring of banks indicates their risks are well managed, we have expressed concern about the growth of their lending to the household sector, and the ultimate risk this could present to the financial system. As this *SOI* demonstrates, we are strengthening our analysis of risk in the financial sector. And we are participating in a government review of regulation of deposit-taking and other financial institutions.

Our role in the financial system requires investment in development and maintenance of systems that other parts of the Bank and the banking sector rely on. Our programme of renewal outlined in the Funding Agreement continues in this *SOI*: back-office systems that support the Bank's functions, such as the payments system, forecasting and data systems, web capability, financial reporting, and document management. We continue to upgrade our business continuity planning.

Almost all of this type of investment, reported in our *SOI* and *Annual Report*, goes on behind the scenes. Without it, we would do our job less effectively.

The Bank's Vision Statement, after recent review, states that "*We promote a sound and dynamic monetary and financial system*". We are committed to achieving this vision through our values of *Integrity*, *Innovation* and *Inclusion*. Such commitment will support the Bank in delivering its policy and operational goals in the face of challenging conditions.



Alan Bollard
Governor



Grant Spencer
Deputy Governor

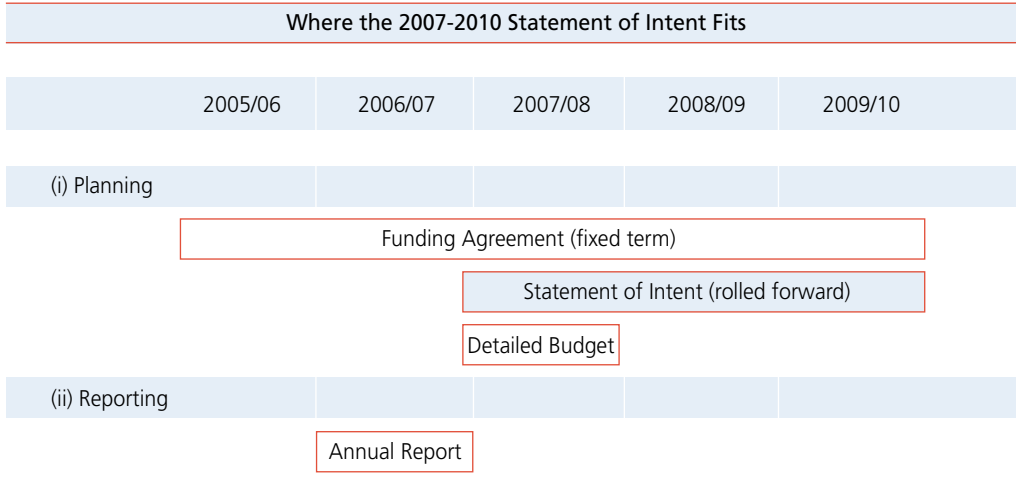
11 June 2007

What we do

The Reserve Bank of New Zealand is the nation's central bank established by the New Zealand Government. The Bank has three main functions which promote a sound and dynamic monetary and financial system aimed at meeting the Government's goal of improving New Zealand's economic performance. These functions are (1) the management of monetary policy to maintain overall price stability; (2) the maintenance of a sound and efficient financial system; and (3) the supply of legal tender to meet the currency needs of the public.

The functions and operations that the Bank performs to achieve these objectives are described in the following pages. In performing them the Bank ensures that it works effectively with Ministers, the Treasury and other relevant government departments on all matters where there is a shared interest.

Planning and reporting framework



A number of our Strategic Priorities for 2007/08 are multi-year priorities (see p7), set in the context of our longer-term planning funded through a five-year Funding Agreement.

The funding agreement, signed in April 2005 and subsequently ratified by Parliament, covers the five years to 30 June 2010. Funding rises from \$39 million in the first year (2005/06) to \$43 million in 2009/10. This increase in spending over the previous five-year period reflects various factors, including the need to:

- invest in the replacement and upgrading of our treasury and document management systems; our economic forecasting and data systems; and our core financial reporting system;
- strengthen our supervisory capability; and
- ensure that robust business continuity arrangements remain in place.

Reserve Bank Strategic Priorities for 2007/08

	Department	Priority
1	Bank-wide	Management Enable managers to continually develop leadership and management competencies. <i>Leadership and management competencies are assessed each 18 months by way of an independent, Bank-wide, staff survey.</i>
2	Economics	Model redevelopment Upgrade the current policy and forecasting model. <i>Over time, the success of the model redevelopment will be measured through improvements to the accuracy of forecasts.</i>
3	Economics	Macroeconomic policy framework Assess how to maintain price stability while avoiding unnecessary damage to the external sector. <i>Measurement of the effectiveness of the macroeconomic policy framework will be ongoing and periodically assessed in research papers.</i>
4	Financial Stability	Financial sector regulatory arrangements Help develop and implement new non-bank regulatory arrangements. <i>Implementation will be in accordance with the legislative programme of the Government with future reporting on the non-bank financial sector appearing in the Financial Stability Report.</i>
5	Financial Stability	Basel II implementation Develop and implement policy on bank capital requirements under Basel II. <i>Implementation of core elements of the Basel II regulatory framework will occur in 2008 with ongoing reporting in the Financial Stability Report.</i>

Governance and structure

Board of Directors

The Reserve Bank has a Board of Directors whose primary function is to review the performance of the Governor and the Bank. The Board holds regular meetings at which it receives extensive briefings on the Bank's activities, decisions, and policies. At these meetings, the Board also provides advice to the Governor on the range of Bank functions.

The Board, through an Audit Committee, reviews the Bank's financial statements and internal audit activity. Each year, the Board writes an 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*.

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

The Board typically meets formally nine times a year. The current Board members are Dr Arthur Grimes (Chair); Mr Paul Baines; Mr Hugh Fletcher; Mr John Goulter, DCNZM, JP; Mrs Alison Paterson, QSO (Deputy Chair); the Rt Hon Edmund Thomas, DCNZM, PC, QC; Dr Marilyn Waring; and Dr Alan Bollard (Governor). Board members are appointed for five-year terms and are eligible for reappointment.

Management structure

Under the Act, the Governor – who is also the Bank's Chief Executive – is accountable for the Bank's actions. In monetary policy, and in many other matters, decision-making authority resides with the Governor alone, although in practice he receives widespread advice. The Governor is appointed for a five-year term. The Act sets specific procedures for the appointment, reappointment, and dismissal of the Governor. The Governor can also be reappointed for further terms of up to five years.

The Reserve Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Operations, and the heads of the Bank's various departments, as outlined on page 9. The roles of Governor and Deputy Governor are required by statute. One other member of the senior management team, the Head of Operations, is designated an Assistant Governor. Currently the Deputy Governor is also the Head of Financial Stability.

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

Reserve Bank organisational structure

Governors	Department/Heads	Functions	Internal services
	Economics <i>John McDermott</i>	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability <i>Grant Spencer</i>	Financial stability	Market operations Foreign reserves management Financial system surveillance and policy
		Currency and Building services <i>Alan Boaden</i>	Currency operations Property management Security
Governor <i>Alan Bollard</i>		Financial services <i>Mike Wolyncewicz</i>	Settlement services Registry and depository services Accounting services Treasury services
		Knowledge services <i>Tanya Harris</i>	Library services Technology services Project management Web publishing
	Assistant Governor/ Head of Operations <i>Don Abel</i>	Human resources*	Human resources strategy and services
		Communications/ Board secretary <i>Mike Hannah</i>	Communications strategy and services Reputation management Board secretary services
		Risk assessment and assurance <i>Steve Anderson</i>	Risk assessment and assurance Audit services Legal services

* Head of Human resources position is to be filled following the appointment of Tanya Harris to Knowledge Services.

Functions and operations

Monetary policy formulation

Objective statement

To achieve and maintain stability in the general level of prices. A published Policy Targets Agreement (PTA) requires the Bank to maintain inflation, as measured by the Consumers Price Index, between 1 and 3 percent per annum on average over the medium term. It also requires that: "In pursuing its price stability objective, the Bank shall ... seek to avoid unnecessary instability in output, interest rates and the exchange rate."

Scope of operations

- Setting an Official Cash Rate (OCR) about every six weeks, around which the Bank lends to, and borrows from, registered banks, directly influencing other short-term interest rates.
- Publishing four OCR decisions at the same time as the Bank's quarterly *Monetary Policy Statements (MPSs)*, which set out the Bank's views on the economy and inflationary pressures, and the basis for the OCR decision.
- Publishing four other OCR decisions approximately halfway between each *MPS*.
- Intervening in the foreign exchange market to influence the level of the exchange rate, consistent with the objectives of the PTA.

Issues

- Ensuring that best-practice modelling methods and a wide range of data are used in generating forecasts and monetary policy advice.
- Considering policy options that will reduce cyclical pressures on the external sector while maintaining price stability.
- Adopting international best practice techniques for the treatment of uncertainty about the economy when setting monetary policy.
- Understanding how household consumption and savings behaviour and their interaction with household balance sheets affect inflation.
- Ensuring monetary policy is communicated to the widest group in the most appropriate manner.
- Ensuring that statistics prepared by the Bank are of high quality and meet user needs.

Initiatives and strategies

- Redevelop the current forecasting and policy model.
- Review macroeconomic policy options for reducing cyclical pressures on the external economy while maintaining price stability.
- Develop and maintain a range of best-practice structural and statistical models for use in forecasting and policy analysis.
- Analyse trends in the composition of household balance sheets, identify key drivers and model the impact on household spending and savings.
- Improve the quality, accessibility, relevance and reliability of Reserve Bank statistics.

Market operations and Foreign reserves management

Objective statement

To implement monetary policy; to assist in the efficient functioning of the New Zealand financial system; to manage official foreign reserves; and to manage the Crown's financial liquidity.

Scope of operations

- Ensuring the effective implementation of monetary policy through the Governor's decision on the level of the OCR.
- Managing official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes; managing liquidity in the banking system; providing and managing the Crown Settlement Account; and monitoring and reporting developments in the financial market to enhance monetary policy decision-making and financial stability monitoring.
- Acting 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.

Issues

- Providing advice to the Governor on financial market developments and issues for the formulation of monetary policy.
- Increasing the Bank's foreign exchange intervention capability to enhance the effectiveness of monetary policy implementation and the maintenance of orderly foreign exchange markets.
- Assessing the optimal balance sheet structure for the Bank.

Initiatives and strategies

- Complete the review of the structure of the Bank's balance sheet to ensure that it best meets the statutory requirements of the Bank (including monetary policy, currency, bank liquidity, and foreign reserves).¹ Implement any changes resulting from the review.
- Manage the new liquidity management regime. Complete the transition to steady state so that the banking system has adequate liquidity, and risks (both the Bank's and the market's) are being balanced appropriately.
- Undertake a review of the strategic risk management objectives for credit, market and liquidity risks.

¹ A joint project with Financial services

Financial system surveillance and policy

Objective statement

To register and supervise banks so as to maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.

Scope of operations

- Setting specific criteria for bank registration.
- Subjecting banks to a specific monitoring regime.
- Publishing regular *Financial Stability Reports (FSRs)* assessing the state of the New Zealand financial system in terms of soundness and efficiency.
- Having a capacity to respond if a bank fails or gets into financial distress, including giving directions to a registered bank; recommending to the Minister that a bank be placed in statutory management; and acting as lender of last resort to the financial system, providing liquidity in a crisis.
- Overseeing and setting specific criteria for designation of payment systems.

Issues

- Implementing the Bank's outsourcing policy.
- Implementing the Basel II capital adequacy regime for banks.
- Ensuring the Bank's capability to manage a bank failure or wider crisis.
- Ensuring appropriate mutual recognition, harmonisation, coordination, and cooperation with relevant domestic and foreign regulators.²
- Accommodating updates in global regulatory standards.
- Contributing to the review of institutional arrangements for prudential regulation of non-bank deposit-taking institutions and insurance providers, and to the review of anti-money laundering arrangements.³
- Reviewing the efficiency of the banking sector and the Reserve Bank's supervision methods.

Initiatives and strategies

- Continue to work with other agencies to strengthen prudential regulation of the financial sector.
- Complete the implementation of the Bank's policies on outsourcing and Basel II.
- Complete the formulation and implementation of the Bank's crisis management capabilities, assessing their robustness through failure management scenarios.
- Potentially become the prudential regulator for parts of the non-bank financial sector.
- Review the efficiency of the banking system to ensure that regulatory policy is appropriately calibrated.

² The Reserve Bank is working with other trans-Tasman agencies to give effect to the Trans-Tasman Council on Banking Supervision. The Council was formed in 2005 at the initiative of the New Zealand Minister of Finance and the Australian Treasurer, and consists of the chief executives of the respective Reserve Banks and Treasuries, and the Australian Prudential Regulatory Authority (APRA). Its role is to monitor and coordinate trans-Tasman home-host regulatory issues. A key goal for the Council is to promote the maximum coordination, cooperation and harmonisation of trans-Tasman bank regulation where sensible, so as to best minimise compliance costs. The Council, though, is not based on statute and so does not derogate in any way the Reserve Bank's responsibilities. The Reserve Bank continues to maintain and develop the capacity to preserve New Zealand's systemic financial interests. Harmonisation with APRA has been aimed at promoting effective and efficient bank regulation.

³ For detailed information on the Review of Financial Products and Providers, including the objectives of the review, the process and the agencies involved, refer to the Ministry of Economic Development's website www.med.govt.nz. The relevant document is entitled 'Review of Financial Products and Providers: Overview of the Review and Registration of Financial Institutions.'

Currency operations

Objective statement

To meet the currency needs of the public by ensuring the supply and integrity of bank notes and coins.

Scope of operations

- Procuring, storing, processing and issuing bank notes and coins to the banking system, as the sole issuer of currency.
- Maintaining the quality and verifying the authenticity of currency in circulation.
- Issuing legal tender collectors' currency through an outsourcing arrangement with New Zealand Post.

Issues

- Optimising the use of the new note-processing machine to maintain the quality and authenticity of notes in circulation.

Initiatives and strategies

- Finalise cash distribution arrangements in the event of a pandemic or similar disaster.
- Investigate possible enhanced security features for bank notes.

Depository and settlement services

Objective statement

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

Scope of operations

Operating the Exchange Settlement Account System (ESAS) and Austraclear systems, including the infrastructure required for settlement of foreign exchange transactions through Continuous Linked Settlement (CLS) Bank.

Issues

- Undertaking a significant systems upgrade to ensure that the payments infrastructure continues to operate efficiently.
- Improving business continuity planning and disaster recovery capabilities, and responding to higher international operating standards.
- Responding to changing industry requirements regarding the times at which settlements take place.

Initiatives and strategies

- Complete the upgrade for ESAS and Austraclear systems before 31 December 2007.⁴
- Implement new accountability arrangements for ESAS and Austraclear through reporting and formal consultation on plans.
- Engage with the settlements industry and respond to long-term needs.
- Improve business continuity planning and disaster recovery capability by arranging for out-of-Wellington business support for payment systems, and ensure greater flexibility in backup computing and service provision arrangements.

⁴ See also 'Knowledge services', p16

Organisational health and capabilities

Human resources

Objective statement

To provide strategic human resource advice and support services.

Scope of operations

- Assisting departments with recruitment, contract negotiation, employment relations, legislative advice and terminations.
- Organising specific bank-wide training and development programmes, key person risk planning, secondment and study arrangements.
- Facilitating the annual remuneration review and performance management programmes.

Issues

- Ensuring high-quality staff for the Bank through training and recruitment.
- Identifying areas where skills can be enhanced and developed to meet future business requirements.

Initiatives and strategies

- Enable managers to continually develop leadership and management competencies across the Bank.
- Continue a formal review of key-person risk within the Bank and how it can be mitigated.
- Review the Bank's staff appraisal and personal development programme.

Knowledge services

Objective statement

To provide strategic information management and information technology services.

Scope of operations

Developing and maintaining core technology infrastructure; business analysis and applications; helpdesk and web support; library and records management; and project management services.

Issues

Managing capital expenditure to upgrade IT capability, provide efficient payments services, enhance data management and reporting systems, and improve business continuity, and to proactively replace legacy business solutions.

Initiatives and strategies

- Enhance the Bank's web functional capability to provide a more secure information-sharing medium.
- Upgrade the Bank's data management capability to provide a more flexible and user-friendly solution.
- Extend the Bank's knowledge management strategy by automating frequently used processes and implementing tools that allow easy sharing of information and documents across teams; and evaluating digital capture of archive records and physical documents.
- Upgrade internally developed computer applications over the next three years in order to ensure the versions of software used are fully supported and, where possible, use standardised language.
- Continue enhancing the Bank's business continuity infrastructure, through reviewing arrangements for an out-of-Wellington business support for critical functions and ensuring greater flexibility in backup computing arrangements.
- Complete the upgrade for the ESAS and Austraclear systems and supporting network infrastructure before 31 December 2007.⁵

⁵ See also 'Depository and settlement services', p14

Financial services

Objective statement

To provide support services for the Bank's key financial operations, including financial reporting and management reporting; compliance with corporate governance and accountability responsibilities; settlement operations; and treasury accounting and compliance reporting.

Scope of operations

- Settling transactions and treasury accounting and compliance reporting in support of liquidity management and foreign reserves functions.
- Preparing financial statements, and monthly management and Board reporting.
- Facilitating the Bank's strategic planning and annual budgeting processes.
- Delivering financial support services and balance sheet management advice.
- Liaising with external auditors.

Issues

- Eliminating settlement risk for the Bank's own foreign exchange transactions.
- Adopting International Financial Reporting Standards (IFRS).
- Maximising efficiency through process improvement and systems changes.

Initiatives and strategies

- Finalise the review of the Bank's balance sheet and implement changes arising from that review.
- Finalise the business case for utilising services of CLS Bank to settle the Bank's foreign exchange transactions and, if approved, implement the service.
- Adopt IFRS from 1 July 2007.
- Continue to enhance workflows, reports, and processes for financial operations and securities transaction activities.
- Review options for replacement of the Bank's general ledger system.

Communications

Objective statement

To provide strategic advice and management for the Bank's external and internal communications, to assist in maintaining its reputation and credibility.

Scope of operations

- Developing communication and relationship strategies, and managing the Bank's relationship with key audiences, including the news media.
- Writing, editing and publishing Bank documents, and providing editorial oversight of the Bank's website.
- Sponsoring education initiatives.
- Coordinating responses to Official Information Act requests, Ministerial correspondence, Parliamentary Questions, and public enquiries.
- Supporting the Board by providing Board Secretary and administrative services.

Issues

- Managing the communication of the Bank's external and internal messages, to assist in maintaining the Bank's credibility and reputation.
- Communicating the outcome of the review of institutional arrangements for prudential regulation of non-bank deposit-taking institutions and insurance providers.
- Ensuring the Bank provides up-to-date, relevant public information books, brochures and factsheets, and its corporate communications standards are up to date.
- Further enhancing internal communications, including contributing to the intranet redevelopment.

Initiatives and strategies

- Deliver the Bank's communications to target audiences through the most appropriate channels; in particular, key messages on monetary policy and the outcome of the review of institutional arrangements for prudential regulation.
- Provide the Bank with timely advice on reputational risks and opportunities, and with strategies for their mitigation or utilisation.
- Develop further initiatives for internal communications, including contributing to the intranet redevelopment.
- Publish an updated suite of public information books, brochures and factsheets, and review and update the Bank's corporate communications standards.
- Maintain crisis capability.

Risk assessment and assurance

Objective statement

To assist in the maintenance of effective and efficient risk management and to audit operations and internal control systems.

Scope of operations

- Assisting management to identify and analyse sources of risk.
- Assisting management to design risk management systems and processes.
- Monitoring risk management implementation and providing risk management advice to Governors.
- Providing ongoing internal audit review and evaluation of the Bank's operations and control systems.
- Providing legal services.

Issues

- Ensuring risks are being managed by management in a proactive, coordinated, prioritised and cost-effective manner.

Initiatives and strategies

- Continue to monitor the Bank's approach to risk management.
- Continue to carry out a comprehensive internal audit programme to provide assurance on the Bank's control environment.

Property management and Security

Objective statement

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

Scope of operations

- Maintaining the Bank-owned building at 2 The Terrace, Wellington, and managing leases on eight of the 14 floors.
- Maintaining a secure working environment.

Issues

- Ensuring the Bank's building meets current and future needs for accommodation.
- Establishing and maintaining off-site accommodation for business continuity planning.
- Completing the implementation of an integrated access control and cctv monitoring system.

Initiatives and strategies

- Plan and refurbish the building to meet current and future Bank needs for accommodation.
- Maintain the building at the required standard, with fully let tenanted areas.
- Assist in the establishment and maintenance of off-site accommodation for business continuity planning purposes.
- Upgrade the civil defence capability of the Bank and provide support to tenants.

Financial management

Financial structure

Balance sheet overview and funding of the Bank's operations

The Reserve Bank is both a statutory agency and a financial institution. It 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, settlement cash held by financial institutions, foreign currency loans from The Treasury and by the Government's equity contribution to the Bank.

The nature and extent of the Bank's principal activities that impact on the Bank's balance sheet are described in the Bank's 2005/06 *Annual Report* on pages 76-78. The Bank's foreign reserve management, New Zealand dollar liquidity management and currency operations are the functions that materially impact the size and structure of the Bank's balance sheet.

Under the Act, the Minister of Finance and the Governor are required to enter into a funding agreement to specify the amount of the Bank's income that may be used to meet the Bank's expenses in each financial year. The funding agreement comes into force only after it is ratified by Parliament.

The Act makes provision for each funding agreement to apply for a period of five consecutive financial years. This contrasts with the arrangements for government departments, which are funded on an annual basis. The funding arrangements for the Bank are designed to strike an appropriate balance between providing the Bank with a high degree of operational independence, while also providing strong incentives for effective management of the Bank's operating expenditure, and ensuring accountability for the Bank's use of resources. Capital expenditure is funded by the Bank from its own resources, with depreciation of fixed assets included in annual operating expenses.

If operating expenses (net of specified revenue) in any year exceed the amount provided in the funding agreement, the Bank is required to fund that excess from equity. Where actual net expenditure is less than the amount provided in the funding agreement, the amount of that underspending is retained by the Bank and added to equity.

The current funding agreement covers the five years ending 30 June 2010.

Annual distributions paid by the Bank

The Act requires the Bank to calculate the amount of income that is available for distribution, which is known as notional surplus income. The Minister of Finance, after consulting the Bank's Board, decides whether the notional surplus income should be added to the Bank's reserves or paid to the Government. An amendment to the Act in 2004 changed the formula for calculating the amount for distribution. The new formula excludes unrealised valuation gains from the amount available for distribution. This change has resulted in the amount of surplus available to be paid as dividend (or credited to the Bank's reserves) becoming more volatile, even where the balance sheet structure is unchanged. We are therefore exploring whether there might be better ways to handle any unrealised foreign currency gains and losses in the calculation of notional surplus income.

Drivers of the Bank's financial performance and changes in financial structure

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

- the value of currency in circulation;
- interest rates earned on the Bank's investment in government securities and other securities;
- the size and performance of the Bank's foreign reserve management and market operations functions;
- operating expenditure incurred by the Bank; and
- the dividend paid by the Bank, which impacts the level of equity available for investment.

In recent years, each of these drivers of financial performance has undergone significant change and further changes can be anticipated as the economy and financial markets evolve and the Bank's financial management practices develop. Significant changes in the recent past include:

- Receipt of additional equity of \$1 billion on 1 July 2004 to enable the Bank to absorb the risks from any foreign exchange intervention undertaken at its discretion.
- Steady growth in currency in circulation from \$2.5 billion in 2001 to \$3.5 billion in 2007.
- Agreement with the Minister of Finance to increase the Bank's holdings of foreign reserves that can be liquidated at short notice to support the functions of the Bank, including monetary policy objectives and the maintenance of orderly markets. The Bank is steadily increasing the amount of its reserves for crisis management purposes to the equivalent of SDR2.45 billion.⁶ Most asset positions are held passively, and limited discretionary foreign exchange and interest rate positions are able to be undertaken.
- In the past, the Bank's holdings of foreign reserves were funded entirely by long-term foreign currency loans from The Treasury. In 2006/07, this changed so that foreign reserve assets are now partly funded using some of the Bank's equity, proceeds from issuing currency in New Zealand and part of settlement account balances held at the Bank by financial institutions. Cross-currency interest rate swaps have been used to hedge foreign currency risk. The Bank now has more flexibility to effect changes in the financing and profile of foreign reserves than where funding is provided exclusively by foreign currency loans from The Treasury. This change in funding will not significantly change the Bank's net income.
- During 2006/07, the Bank changed the way it manages its New Zealand dollar liquidity management operations by significantly increasing the level of settlement cash held by financial institutions. This change added around \$6 billion to assets and liabilities reported on the Bank's and Crown's balance sheets.⁷ While this change should have minimal impact on the Bank's net income over the medium term, there will be some increase in the volatility of year-on-year income from liquidity management operations.
- The level of operating expenditure has increased, reflecting significant capital expenditure in renewing or replacing existing systems; improvement of business continuity capabilities; and additional staff to respond to financial stability policy and operational development.

During 2006/07, the Bank made substantial progress towards completing a comprehensive review of the Bank's balance sheet to ensure that the Bank's financial structure and operations best meet the Bank's statutory responsibilities. As noted above, New Zealand-dollar-denominated funding is now used to partly finance foreign reserves. One significant aspect of the review of the Bank's balance sheet is still in progress at the time of writing

⁶ The SDR (Special Drawing Right) serves as the unit of account of the International Monetary Fund and some other international organisations. Its value is based on a basket of key international currencies.

⁷ The rationale for this change is explained in the document 'Reform of the Reserve Bank of New Zealand's Liquidity Management Operations', June 2006, which is available on the Bank's website www.rbnz.govt.nz.

this *SOI*. Consideration is being given to changing the Bank's exposure to exchange rate risk in order to better meet its statutory objectives. The Bank expects to conclude its analysis of this issue shortly.

The Bank will adopt New Zealand International Financial Reporting Standards from 1 July 2007. The main implications arising from the changes to accounting policies are set out in the section entitled "Financial projections".

Principal financial risk management considerations

As a financial institution 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 because of the Bank's holdings of foreign exchange 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 all of the transactions and processing areas of the Bank.

More detailed information on the Bank's approach to managing these risks is outlined on pages 88–101 in the 2005/06 *Annual Report*.

Financial projections

The following table outlines the Reserve Bank's budgeted income and expenditure for 2007/08. The budgeted income and expenditure have been prepared using the accounting policies used in the preparation of the Bank's financial statements for the year ended 30 June 2006, updated for the adoption of International Financial Reporting Standards.⁸ The principal accounting policy changes arising from the adoption of New Zealand equivalents to International Financial Reporting Standards are:

Accounting changes directly impacting the Bank's equity:

- valuation of holdings of New Zealand government securities at market value, with unrealised gains and losses on those holdings booked to equity.

Accounting changes impacting the Bank's statement of income:

- valuation of inventory (including repatriated notes and coins) at replacement cost rather than net realisable value;
- recognition of an asset in respect of the surplus in the Bank's defined benefit superannuation scheme, with an annual expense for changes in the value of that asset;
- use of bid and offer prices to value assets and liabilities rather than market mid-rates;
- recognition of the face value of collectors' currency issued as a liability rather than income together with a contingent liability; and
- tenanted floors in the Bank's building classified as investment property rather than property plant and equipment. Changes in the value of investment property are booked to the Bank's statement of income.

The key assumptions underlying the budget for the year ended 30 June 2008 are that:

- the Bank's current functions will continue;
- foreign reserves will be increasingly funded from the Bank's resources rather than loans from The Treasury;
- there will be no material changes to the Bank's liquidity management operations;
- interest and exchange rates will be those prevailing as at 23 April 2007;
- the Bank has no material open foreign currency positions during the year; and
- there is no change in the value of the Bank's land and buildings.

Key changes from the budget for 2006/07 are:

- decreased currency costs due to the one-off issue of new 'silver' coins in 2006/07; and
- reduced other income compared to 2006/07, when the Bank received funds from the sale for scrap of demonetised 'silver' coins.

The increase in budgeted staff costs is attributable to the impact of the new accounting policy for defined benefit superannuation scheme expenses, an employer subsidy for KiwiSaver, a reduction in staff costs incurred on project work that is capitalised, a slight increase in overall staff numbers and an increase in staff remuneration.

⁸ The Bank's accounting policies are disclosed in its *Annual Report* for 2005/06 on pages 69-78. This includes a description of the material accounting policy changes arising upon adoption of New Zealand equivalents to International Financial Reporting Standards from 1 July 2007.

The budget for 2007/08 was prepared in April 2007, based on the assumptions stated above. Actual outcomes could differ materially from budgeted outcomes. In particular, the extent and timing of any open foreign exchange positions, together with changes in interest and foreign exchange rates could have a significant impact on actual financial results.

The following table sets out projected income and expenditure for the Bank for the year ended 30 June 2008.

Projected financial performance 2007 – 2008

<i>For the year ended 30 June</i>	Budget	Estimated Actual*	Budget
	2007/08	2006/07	2006/07
	\$m	\$m	\$m
Operating income:			
Foreign currency investment margin**	22.6	11.9	26.4
Local currency investment margin	332.7	336.5	320.0
Net investment income	355.3	348.4	346.4
Other income	7.3	23.1	20.0
Total operating income	362.6	371.5	366.4
Operating expenses:			
Personnel	24.0	21.9	22.1
New currency issued	4.6	11.1	10.1
Asset management	6.9	6.6	6.7
Administration	1.6	1.7	1.9
Other	11.5	10.6	12.5
Total operating expenses	48.6	51.9	53.3
Operating surplus	314.0	319.6	313.1
Net expenditure under the Funding Agreement	41.3	28.8	33.4
Funding Agreement Under-Expenditure (Over-Expenditure)	-0.3	5.2	0.6
Funding Agreement	41.0	34.0	34.0

* Estimated Actual figures for 2006/07 incorporate actual results to 31 May 2007, together with an estimate of results for the month of June 2007.

** To 31 May 2007, foreign currency investment margin was reduced by \$16.4 million arising from revaluation of foreign currency loans from The Treasury. In essence, this revaluation reflects that greater margins could be earned if these loans were drawn down now, rather than when they were taken out.

One feature of the projected income and expenditure is that, as anticipated, the Bank forecasts that the net operating expenses will be \$41.3 million against a level of \$41.0 million provided for in the funding agreement. The difference of \$0.3 million will be funded from the Bank's equity. The primary reason for the Bank exceeding the funding agreement level for the 2007/08 year is the deferral of costs from the 2006/07 year related to the joining of CLS Bank.

The additional \$0.3 million of expenditure in 2007/08 will be drawn from underspending in the previous two years of the funding agreement. At 30 June 2007, the cumulative underspending of the current funding agreement is forecast to be \$8.4 million, which in part reflects the deferral of expenditure for joining CLS Bank.

Net expenditure by function

<i>For the year ended 30 June</i>	Net Expenditure*	
	Budget	Estimated Actual
	2007/08	2006/07
	\$000	\$000
Functions:		
Monetary policy formulation	9,799	8,684
Market operations	6,271	4,163
Financial system surveillance	8,824	8,300
Currency operations**	7,870	-889
Foreign reserves management	8,242	7,565
Settlement services	354	818
Registry and depository services	-842	-675
Other outputs	735	830
Net expenditure	41,253	28,796

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

** The material reduction in Currency Operations in 2006/07 is a function of proceeds received from salvaging demonetised coins.

Monitoring the Bank's performance

The Reserve Bank has been, and will continue to strive to be, a world leader in 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 improve the way it works.

The principal mechanisms for externally communicating the Bank's views include:

- the six-weekly OCR decisions, quarterly *MPSs*;
- the six-monthly *FSRs*;
- the Bank's *SOI*, *Annual Report* and financial statements;
- the quarterly *Bulletin*;
- the Bank's website (www.rbnz.govt.nz);
- occasional publications such as the *Briefing to the Incoming Minister*, and issue-specific books and brochures; and
- addresses given by the Governor and other senior Bank staff.

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

The Reserve Bank's Board 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 is also required to report annually on the Bank's performance. The Board's report is published in the Bank's *Annual Report*.⁹

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 statement. It also monitors the Bank's internal audit function.

The Reserve Bank publishes its *SOI* at the commencement of each financial year. The *SOI* sets out the Bank's principal functions and its objectives for the next three years; comments on strategies for managing organisational health and capability; and sets out projected income and expenditure for the first year of that three-year period.

The Reserve Bank's *Annual Report* includes an assessment of the performance of the Bank's various functions, in terms of both the day-to-day responsibilities and progress against priorities published in the *SOI*.

Parliament's Finance and Expenditure Committee reviews the quarterly *MPS* and the Bank's *Annual Report*, and can ask the Bank to appear before it on request.

The *Annual Report*, which includes the financial statements, is tabled in Parliament.

⁹ For example, see pages 16-20 in the 2005-2006 *Annual Report*.

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 Reserve Bank's financial statements are audited by an external auditor who is the agent 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 Austraclear depository system, and annually in respect of ESAS.

From time to time, the Reserve Bank 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, two external advisers assist in the provision of advice to the Governor regarding his interest rate decisions. During the week prior to the release of the *MPS*, these two advisers fully participate in the deliberations leading to the formulation of the *MPS*.

The Reserve Bank's performance is also subject to international scrutiny. Every 12–18 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. Likewise, every two years, the Organisation for Economic Co-operation and Development undertakes a similar assessment, which is also published. The recent IMF Financial Sector Assessment Programme investigation is expected to be repeated in New Zealand every six or seven years.

Appendix A

Key document references

Title	Purpose	Location
Policy Targets Agreement	Agreement between the Governor and the Minister of Finance specifying the inflation target in detail	www.rbnz.govt.nz/monpol/pta
<i>Monetary Policy Statement*</i>	Quarterly publication of the Bank's view of how the Bank proposes to meet its monetary policy targets, including extensive economic projections	www.rbnz.govt.nz/monpol/statements/index.html
<i>Financial Stability Report*</i>	Six-monthly publication of the Bank's view on the soundness and efficiency of the New Zealand financial system	www.rbnz.govt.nz/publications/finstab/
<i>Annual Report*</i>	Key accountability document, plus presentation of financial statements	www.rbnz.govt.nz/about/whatwedo/0094054.html
Board of Directors' <i>Annual Report</i>	Board of Directors' report on the Bank's performance	Reproduced in the Bank's <i>Annual Report</i> http://www.rbnz.govt.nz/about/Whatwedo/rbnz_2006ar_2.pdf
Briefing on the Reserve Bank of New Zealand*	Description of the role and functions of the Reserve Bank, prepared for an incoming government	www.rbnz.govt.nz/about/whatwedo/0122541.html
Reserve Bank of New Zealand Act 1989	Reserve Bank's statutory authority	www.rbnz.govt.nz/about/ourlegislation/
Funding Agreement	Basis of Bank's funding, setting how much of the Bank's revenues can be retained by the Bank	www.rbnz.govt.nz/about/whatwedo/1846117.html
<i>Statement of Intent*</i>	A statement of what the Bank intends to achieve over the next three years, with forecast income and expenditure for one financial year	www.rbnz.govt.nz/about/whatwedo/1764296.html
Letter to Minister of Finance on foreign exchange market intervention policy	Description of how the Bank may intervene in the foreign exchange market under section 16 of the Reserve Bank Act to influence the exchange rate	www.rbnz.govt.nz/foreignreserves/intervention/index.html
Letter from Minister of Finance to the Bank on foreign exchange intervention	Provision of delegated authority for the Bank to intervene in the foreign exchange market under section 17 of the Reserve Bank Act, should that market become dysfunctional	http://www.rbnz.govt.nz/foreignreserves/intervention/0148293.html
<i>Reserve Bank Bulletin*</i>	Quarterly publication of articles relevant to central banking in New Zealand	www.rbnz.govt.nz/research/bulletin
Statement of Principles*	Explanation of the Reserve Bank's approach to bank registration and supervision	www.rbnz.govt.nz/finstab/banking/regulation/bs1.pdf
<i>This is the Reserve Bank*</i>	Introductory brochure about the Reserve Bank	www.rbnz.govt.nz/about/whatwedo/0109157.html
Central Banking in New Zealand*	Brochure about the Reserve Bank and its governance arrangements	www.rbnz.govt.nz/publications/index.html
Vision Statement and Values	Expression of the Bank's organisational aims and culture	Inside front cover of <i>Annual Report</i>

* Also available in print from: the Knowledge Centre, Reserve Bank of New Zealand, PO Box 2498, Wellington, New Zealand. knowledge@rbnz.govt.nz, www.rbnz.govt.nz