
Section 1

Functions and governance

Overview

The Reserve Bank of New Zealand is the central bank. The Reserve Bank is constituted under the Reserve Bank of New Zealand Act 1989 (hereafter Reserve Bank Act).

As New Zealand's central bank, the Reserve Bank performs a number of functions, each of which contributes to the broadly defined goal of promoting monetary and financial stability. Doing so helps enable New Zealanders to conduct their business confident that they are using a currency that largely holds its value through time, and are using payments instruments and a financial system that are sound, efficient, and well regulated.

The Reserve Bank Act specifies that the primary function of the Reserve Bank is to conduct **monetary policy** to achieve and maintain a stable general level of prices; to maintain the purchasing power of New Zealand dollars, which are used for making payments and storing value. Closely linked to this role, the Reserve Bank is, by statute, the **sole issuer of currency** (bank notes and coins) in New Zealand and has a responsibility to maintain the integrity of that currency.

Banks are the key entities in the New Zealand financial system; they are the principal credit providers, deposit takers, and providers of payment services for households and the business community. The Reserve Bank is responsible for **the registration and prudential supervision of banks**, and does this, as specified in the Act, with a view to promoting a sound and efficient financial system. The Reserve Bank is also responsible for ensuring that it is well-positioned to respond to financial system distress, including the handling of bank failures and acting as Lender of Last Resort to the financial system. We aim to minimise the adverse impact of financial crises on the financial system and the wider New Zealand economy.

The Reserve Bank operates the **interbank settlement system** which banks use to settle obligations between each other, and it also manages the terms on which liquidity is made available to enable those obligations to be settled (this is, in fact, the way in which monetary policy is implemented). The Reserve Bank also operates the Austraclear payments

and securities settlement system, and is actively involved in overseeing the development of robust and efficient **payments systems**.

The Reserve Bank manages a substantial pool of **foreign exchange reserves** to enable it to intervene in the foreign exchange market, to assist in maintaining a functioning foreign exchange market and ensuring that critical cross-border transactions can be made, should that be considered necessary.

Each of these interconnected roles is discussed in greater detail later in this document.

Governance and management

The Reserve Bank Act sets the powers and responsibilities of the various entities responsible for the conduct of the Bank's functions. There are some complex interactions, which were carefully considered in the design of the legislation, and which have, for the most part, worked successfully. The framework is designed to provide considerable day-to-day operational autonomy to the Bank, an important role for the Minister of Finance in some key decisions, and a robust accountability structure in which the Bank's Board, the Minister, and Parliament all have important formal roles. Transparency is an important feature of the overall framework.

Assignment of responsibility for meeting objectives

Under the Act, the Governor is the Bank's chief executive officer, appointed by the Minister of Finance on the recommendation of the Board of directors. This structure provides a form of 'double veto', in that both the Minister and the Board must have confidence in any person appointed as Governor. The Governor is appointed for a term of five years, but can be reappointed for further terms, each of up to five years.¹ Authority for exercising the powers assigned

¹ The Act also requires the appointment of a Deputy Governor as a Deputy Chief Executive. That appointment is made by the Board on the recommendation of the Governor.

to the Bank rests with the Governor, who is hence personally accountable for the conduct of the Bank's business. This makes the Bank different in an important respect from Crown entities (many of which also exercise operational autonomy in implementing areas of public policy). In most Crown entities authority rests with the Board of the entity, not with the chief executive officer.

In many of the Bank's areas of responsibility the Minister of Finance has an important involvement in the setting of key parameters. These include agreeing with the Governor on the monetary policy target, agreeing on changes to the scope of the supervisory regime (particularly those which require Orders-in-Council or legislative amendments), and approval of any decision to place a failing bank into statutory management or to give directions to a registered bank. The Act also reserves certain other directive powers to the Minister, including the ability to require 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 and pre-specified procedures are set out in the Act.

Performance monitoring and accountability

Under the Act, the Board has prime responsibility for monitoring the performance of the Bank and the Governor on a continuous basis. It is, in effect, the agent of the Minister of Finance. In addition to its monitoring function, the Board also has the authority to give advice to the Governor on matters relating to the conduct of the Bank's functions and administration of the Bank.

Under legislation passed in 2003, the Bank's Board consists of between five and seven non-executive directors appointed by the Minister of Finance for five-year terms, and the Governor. The Board is now chaired by one of the non-executive directors, elected by the Board from among their number each year. The Board is also now required to issue an annual report setting out its assessment of the Bank's and the Governor's performance. An Audit Committee, comprising four non-executive members of the Board, monitors the accounting practices, accounting policies, and internal control systems of the Bank. The Committee also

reviews the internal audit function and has direct access to the external auditor.

The Board plays an important ongoing monitoring role, offering advice to and asking questions of the Governor in the routine conduct of business, including, for example, after each Official Cash Rate (OCR) decision. Under more extreme circumstances, the Board is required to advise the Minister of Finance if it is satisfied that the Bank has not adequately carried out its functions, the Governor has not adequately discharged the responsibilities of office, or the Governor's performance in ensuring that the Bank carries out the Policy Targets Agreement has been inadequate. In these circumstances, the Board may recommend to the Minister of Finance that the Governor be removed from office. Where the Minister of Finance is satisfied that the criteria set out in the Act for the removal of the Governor have been met, he or she may advise the Governor-General to remove the Governor.

The Bank and the Governor are also subject to ongoing assessment by Parliament's Finance and Expenditure Committee. The Committee's capacity to scrutinise the Bank's monetary policy activities has been enhanced in recent years by the appointment of a part-time economist to advise the Committee. However, there is probably still scope for the Committee to undertake more intensive scrutiny of the Bank, both regarding the conduct of its functions and in respect of the Bank's use of resources.

Both the Reserve Bank Act and the State Sector Act also provide powers under which the executive can require a review or performance audit of the Bank and its functioning.

Transparency arrangements

Transparency strengthens the incentives for sound policy by enabling interested parties to assess for themselves the appropriateness of the objectives and the measures taken to meet those objectives. It is also a mechanism for conferring a greater sense of legitimacy on the Bank's powers: operational autonomy comes with a responsibility to exercise those powers under the scrutiny of the public.

The operational objective of monetary policy is publicly disclosed in the Policy Targets Agreement. Moreover, the Bank is required to issue at least every six months a *Monetary Policy Statement* that specifies the policies by which the Bank intends to achieve the policy target, states the reasons for adopting those policies, and reviews and assesses monetary policy implementation. In practice, the Bank has for some years issued *Monetary Policy Statements* quarterly. These documents help provide a focus for the extensive market and media scrutiny of the Bank's monetary policy analysis and interest-rate setting.

In the area of bank registration and supervision, the Bank is required to publish a statement setting out the principles on which it acts in carrying out its registration function and in setting prudential requirements. In addition, the Bank consults extensively on material changes in its supervisory policy and practice. The new *Financial Stability Report* also helps expose our thinking on the nature of the risks facing the New Zealand financial system to ongoing scrutiny from interested parties.

The Bank's Annual Report, including externally audited financial statements, sets out the Bank's actions for the year under review and its financial performance (against budget).² The Bank is also required to provide a *Statement of Intent* before the start of each financial year. The *Statement of Intent* sets out the Bank's objectives for the next three years and the budget for the first year of that period. The Bank must have regard to any comments made by the Minister on the *Statement of Intent*.

Organisational structure

The Bank's functions are generally conducted within departments, although a number of functions are managed across different departments, either by way of committee or through cross-department project management. The management structure is set out on the following page.

Many of the issues that the Bank deals with straddle a number of departments. Accordingly, the Bank makes extensive use

of committees comprising a range of senior staff in addition to those directly responsible for the decisions being made.

The main committees are:

- Governor's Committee, which meets weekly to consider the management and day-to-day operation of the Bank;
- Monetary Policy Committee (MPC), which meets weekly to advise the Governor on economic and financial developments;
- Official Cash Rate Advisory Group (OCRAG), which comprises a subset of MPC plus two part-time external advisers, and which has responsibility for advising the Governor on OCR decisions;
- Financial System Oversight Committee, which meets fortnightly to consider policy issues relating to the soundness and efficiency of the financial system;
- Asset and Liability Committee (ALCO), which meets monthly to review risks and risk management frameworks around the Bank's balance sheet and its operations in financial markets;
- Communications Committee, which meets weekly to consider communications issues; and
- Business Continuity Management Advisory Committee, which meets approximately monthly to review issues associated with the Bank's business continuity preparedness.

² The Auditor-General is responsible for the audit of the Reserve Bank's accounts.

Management Structure

as at 31 August 2005

Governors	Department/Heads	Functions	Internal Services	
Governor <i>Alan Bollard</i>	Assistant Governor/ Head of Economics <i>Grant Spencer</i>	Economics	Monetary policy formulation	
	Deputy Governor/ Head of Financial Stability <i>Adrian Orr</i>	Financial Stability	Market operations Foreign reserves management Financial system surveillance	
		Currency and Building Services <i>Brian Lang</i>	Currency operations	Property management Security
		Financial Services <i>Mike Wolyncewicz</i>	Settlement services Registry and depository services	Accounting services Treasury services
	Assistant Governor/ Head of Operations <i>Don Abel</i>	Knowledge Services <i>Yogesh Anand</i>		Library services Data services Computer services
		Human Resources <i>Tanya Harris</i>		Human resources strategy and services
		Communications <i>Mike Hannah</i>		Reputation management Communications
		Risk Assessment and Assurance <i>Steve Anderson</i>		Audit services Risk assessment and assurance

Board of Directors

Non-Executive

Dr Arthur Grimes	Chair RBNZ Board of Directors <i>Economic Consultant</i> First appointed 13 March 2002 – current term expires 12 March 2007
Alison Paterson QSO	Deputy Chair RBNZ Board of Directors and Chair RBNZ Board of Directors Audit Committee <i>Company Director</i> First appointed 1 February 1995 – current term expires 31 January 2010
Paul Baines	<i>Company Director</i> First appointed 1 July 1999 – current term expires 30 June 2009
Hugh Fletcher	<i>Company Director</i> First appointed 10 June 2002 – current term expires 9 June 2007
John Goulter DCNZM JP	<i>Company Director</i> First appointed 9 February 2000 – current term expires 8 February 2010
The Rt Hon Edmund Thomas DCNZM PC QC	<i>Retired Judge</i> First appointed 1 March 2003 – current term expires 29 February 2008
Dr Marilyn Waring	<i>University Professor</i> First appointed 4 February 2004 – current term expires 3 February 2009

Executive

Dr Alan Bollard	<i>Governor</i>
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Financial and risk management

Funding structure

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 and by the Government's equity contribution to the Reserve Bank. Currency in circulation is, in effect, an interest-free loan from the public, and the proceeds are invested by the Reserve Bank in government bonds. The Bank's equity was materially augmented last year, to enable the Bank to absorb the risks from any foreign exchange intervention undertaken at its discretion. (The policy change in this area is discussed in the next section.)

Under the Act, the Minister of Finance and the Governor are required to enter into funding agreements to specify the amount of the Bank's income that may be used to meet

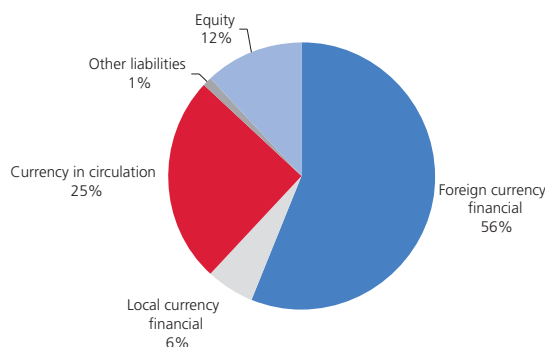
the Bank's expenses in each financial year. The funding agreement must be tabled in Parliament and does not become effective until ratified by a resolution of Parliament.

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 effective operational independence, while also ensuring accountability for the Bank's use of resources.

The current funding agreement, signed in April this year, and subsequently ratified by Parliament, covers the five years to 30 June 2010. For the current year (2005/06) approved funding amounts to \$39 million, rising to \$43 million in 2009/10. This represents a material increase in spending over the previous five-year period, reflecting various factors including, *inter alia*, the need to invest in the redevelopment

Summary Balance Sheet³

	2005 June (\$m)	2004 June (\$m)
Assets:		
Foreign Currency Financial	8,086	5,681
Local Currency Financial	4,866	4,777
Other Assets	44	39
Total Assets	12,996	10,497
Liabilities and Equity:		
Foreign Currency Financial	7,308	5,574
Local Currency Financial	790	1,382
Currency in Circulation	3,183	2,920
Other Liabilities	161	200
Equity	1,554	421
Total Liabilities and Equity	12,996	10,497



of systems, to strengthen our supervisory capability, and to ensure that robust business continuity arrangements remain in place. The Bank engages in a systematic annual internal budgeting process and is always looking for ways to achieve efficiency gains, which would enable our outcomes to be reached in a more cost-effective manner.

The Act requires the Bank to calculate both an actual realised net income, and a notional surplus income (loosely, the amount by which actual realised income exceeds the level of operating expenditure specified in the funding agreement). 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. In addition, to encourage a prudent use of resources, the Act provides that any expenditure savings made against the funding agreement levels must be added to the Bank's reserves, while any deficiencies must be deducted.

Legislative amendments last year changed the basis of calculation of the Bank's net income to include only realised valuation gains and losses, excluding unrealised items. This change was designed to accommodate the Bank's new foreign exchange intervention policy (discussed in the following section), but has had some unanticipated effects. In particular, for an unchanged balance sheet structure, the

surplus available to be paid as dividend (or credited to the Bank's reserves) has become more volatile. We are exploring whether there might be better ways to ring-fence unrealised intervention gains and losses.

Total operating expenses for the 2004/05 year amounted to \$37.5 million, 3 per cent below the budgeted amount of \$38.4 million. Net expenditure under the funding agreement amounted to \$29.1 million, almost \$4 million below the limit of \$33.0 million.

Management of risks

As a government agency with major policy responsibilities and considerable discretionary power, and as a financial institution with a large balance sheet (\$13 billion of assets), the Reserve Bank faces a wide range of risks.

Risks associated with our policy responsibilities (policy mistakes or misjudgements) are perhaps the most important. Serious misjudgements could have far-reaching ramifications for the economy, and undermine our future effectiveness by undermining confidence in the institution.

We seek to manage the risks associated with monetary policy errors in a number of ways. We supplement economic forecasts with an active process of talking to the business community and monitoring the forecasts of other analysts. We also attempt to incorporate a broad diversity of views in the policy formulation process, both by involving a range of staff in advising the Governor and by engaging

³ 'Foreign Currency Financial' and 'Local Currency Financial' mean financial assets and liabilities denominated in either foreign currency (eg United States dollar bonds) or local currency (eg New Zealand government securities) respectively.

two part-time external advisers to supplement advice from staff. The Bank also periodically engages foreign central bankers and academics to provide peer reviews of our monetary policy process. In respect of our financial stability policy responsibilities, the Bank consults broadly, with other government agencies and with affected private sector institutions, before implementing changes to the policy framework. There is also liaison with overseas banking supervisors, particularly APRA.

The Bank also faces a number of financial risks. These mainly arise because of the Bank's operations in the domestic financial system and because of our holdings of foreign exchange reserves. The risks include:

- credit risks and market risks associated with our day-to-day dealings with financial institutions in the process of managing liquidity in the financial system.
- risks associated with our holdings of foreign currency reserves, including credit risk, interest rate risk, and exchange rate risk.
- risks associated with the processing and storage of currency, including the risks of theft.
- the risks associated with facilitating large-value securities transactions via Austraclear.
- operational risks in all of the transactions and processing areas of the Bank.

The Bank is a relatively small organisation (around 210 full-time equivalent staff) engaged in a wide range of activities. That exposes us to a constant risk around the loss of key highly-experienced staff and the associated institutional knowledge.

In order to ensure that all of the Bank's risks are well identified, monitored, and managed, the Bank has developed a strong risk management culture and a number of management systems and internal controls based on best international practice and honed through experience. Consistent with this emphasis, we also place considerable emphasis on ensuring that we have procedures and systems in place to enable the Bank to maintain its core functionality in the event of physical crises, including localised loss of access to our building and wider regional disasters.

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

- The Risk Assessment and Assurance Department, responsible for general risk monitoring. The internal audit role and the Legal Counsel also reside in this department.
- The Risk Unit within the Bank's Financial Stability Department, which provides specialised advice on interest and exchange rate risk, credit risk, and liquidity risk, and the appropriate limits the Bank needs to have in place to ensure the prudent and effective conduct of its operations.

In addition, the Board and its Audit Committee contribute to the Bank's risk management processes and have an overview responsibility for the internal and external audit processes.