Statement of Intent

2017–2020

RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Reserve Bank of New Zealand
Statement of Intent
2017–2020

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Reserve Bank of New Zealand Statement of Intent

For the period 1 July 2017 to 30 June 2020

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Environmental setting and strategic priorities

Environmental setting

The outlook for global economic growth has increased and become more broad-based over the past six months. Activity is expanding in most major advanced and emerging economies and there are signs of a pick-up in merchandise trade. However, major challenges still remain, with on-going surplus capacity in the global economy and extensive geopolitical uncertainty.

Stronger global demand has helped to raise commodity prices over the past year, which has led to some increase in headline inflation across New Zealand's trading partners. However, the level of core inflation has generally remained low. Monetary policy is expected to remain stimulatory in the advanced economies, but less so going forward.

New Zealand's economy grew a little over 3 percent during 2016, which is above the average pace of expansion over the past three decades. The expansion has been supported by accommodative monetary policy, strong population growth, and high levels of household spending and construction activity. The trade-weighted exchange rate has fallen since early 2017, which, if sustained, will help to rebalance growth towards the tradables sector.

Annual headline inflation was 2.2 percent in the March 2017 quarter. The sharp increase in inflation in the March quarter is largely due to higher fuel and food prices. These effects are expected to be temporary and may lead to some variability in headline inflation over the year ahead. Non-tradables and wage inflation remain moderate, but are expected to increase gradually. This will bring future headline inflation to the midpoint of the target band over the medium term. Longer-term inflation expectations remain well-anchored, at around 2 percent.

The New Zealand financial system remains sound and continues to perform its functions effectively. New Zealand banks maintain capital and funding buffers in excess of minimum requirements, and profitability, which has fallen modestly as a result of declining net interest margins, remains robust.

A key domestic risk continues to be the performance of the housing market. House price growth has slowed over the past eight months, but the outlook for the housing market remains uncertain. Mortgage interest rates remain low and while building activity has continued to increase, the rate of house building is insufficient to accommodate rapid population growth and address existing housing shortages.

The loan-to-value policy has improved the resilience of the banking system to a correction in the housing market. However, many households have taken on loans at high debt-to-income ratios and are vulnerable to an increase in interest rates or a decline in income. The Bank is consulting on whether a debt-to-income policy instrument should be included in the set of macro-prudential instruments.

The Bank's economic forecasts in the May 2017 *Monetary Policy Statement* show the New Zealand economy expanding at an average of around 3 percent annual growth over the next three years, with CPI inflation at the mid-point of the target range in the outer two years. These forecasts are based on several key assumptions, including that the global economy grows at around 3.5 percent per annum over the forecast period and that New Zealand house price inflation continues to moderate.

Strategic priorities

The *SOI* outlines the Bank's nine strategic priorities for 2017–20.

These strategic priorities, which are described in more detail on pages 12-14, continue to be framed around three broad themes:

- enhancing the Bank's policy frameworks;
- continuing to strengthen the Bank's internal and external engagement; and
- improving infrastructure and reducing enterprise risk.

These strategic priorities contain responses to new initiatives such as addressing outcomes of the International Monetary Fund's (IMF's) Financial Sector Assessment Programme (FSAP) review. A new strategic priority – to improve the resilience of the Bank's operations – highlights the on-going commitment to business continuity and cyber-security, both of which are important to enhancing and securing the resilience of the Bank's business.

Informing government

The Bank keeps the Minister of Finance regularly informed about its thinking on significant market and policy developments, especially where Cabinet decisions, legislation or regulation may be required. This involves providing substantive information on and a discussion of the rationale for any changes and their potential economic and fiscal impacts at an early stage of policy development. The Bank also provides assessments of the expected regulatory impacts of proposed policy developments.

Relevant to the 2017–20 *SOI*, this would include information on:

- how key macro-economic relationships and behaviours have changed, and the implications for the operation of monetary policy;
- the effects of any economic or environmental changes on the practical application of the Policy Targets Agreement, ahead of a new

agreement being agreed by the Minister of Finance and the Reserve Bank Governor next year;

- assessments of financial system stability risks and the suitability of policies to reduce the likelihood and impact of a bank failure in New Zealand, including the potential implications for the Crown's balance sheet;

- assessments of the effectiveness of the macro-prudential tools outlined in the Memorandum of Understanding agreed in 2013, and views on including a debt-to-income-ratio tool in the macro-prudential policy toolkit; and

- progress with key policy developments and reviews – including the Insurance (Prudential Supervision) Act 2010 review, the Bank's review of bank capital, and responses to the IMF's FSAP review.

Graeme Wheeler
Governor

16 June 2017

Grant Spencer
Deputy Governor

16 June 2017

What we do

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

- Reserve Bank of New Zealand Act 1989 (the Act).
- Insurance (Prudential Supervision) Act 2010.
- Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) Act 2009.
- 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 an *SOI* for that financial year and at least the next two financial years. The *SOI* is set in the context of the Bank's longer-term planning and funding. The Bank is funded through a five-year funding agreement between the Minister of Finance and the Governor, which is ratified by Parliament. The 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 years 2017–18 to 2019–20 of the five-year Funding Agreement.

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* (*MPS*s);
- two *Financial Stability Reports*;
- the Bank's *SOI*, *Annual Report* and financial statements;
- *Bulletin* articles and *Analytical Notes*;
- the Bank's website (www.rbnz.govt.nz);
- around 120 addresses given by the Governors and other senior Bank staff;
- many publications, videos, web-based animations and other publications, and growing use of social media; and
- occasional publications and issue-specific books and brochures.

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 that 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 *MPS*s, the six-monthly *FSR*s and the Bank's *Annual Report*, and can ask the Bank to appear before it on request.

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 regulation.

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, two external advisers assist in the provision of advice to the Governor regarding interest rate decisions. Prior to the release of an *MPS*, these advisers participate in the deliberations leading to the formulation of the *MPS*.

The Bank's performance is also subject to international scrutiny. Every 12 to 18 months the 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 IMF has also undertaken an FSAP review in the past year, and published its report in May

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.

A 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

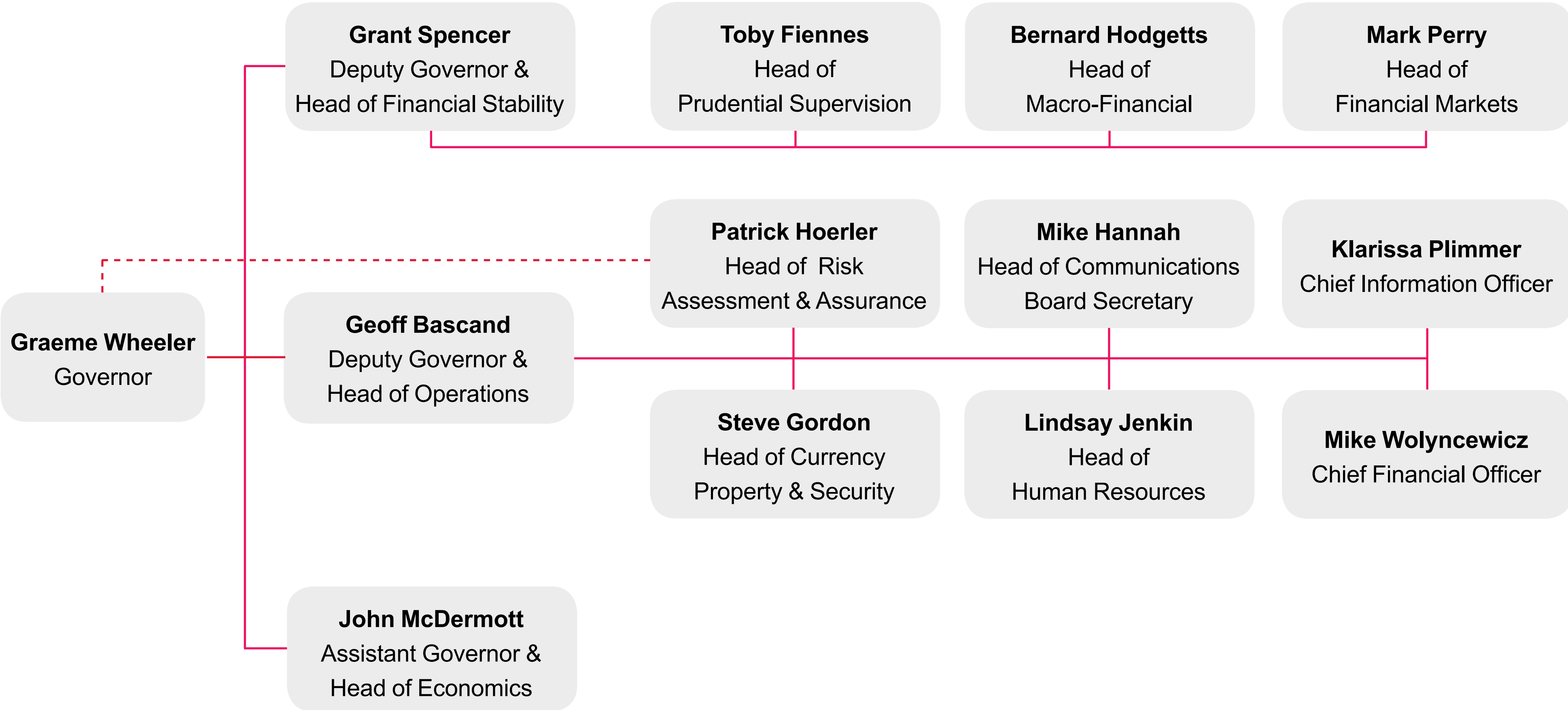
The Reserve Bank has a Board of Directors whose primary function is to keep under constant review the performance of the Bank and the Governor in carrying out their statutory functions. The Board's monitoring of the Bank's performance is guided by a Letter of Expectations from the Minister and the Board 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 *MPS*s and *FSR*s, the Board receives briefings on the Bank's activities, 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 recommendation.

At the time of writing the Board has seven non-executive directors, and the Governor is an executive member of the Board. The current Board members are: Professor Neil Quigley (Chair); Kerrin Vautier CMG (Deputy Chair); Keith Taylor ONZM (Chair of the Board of Directors' Audit Committee); Dr Rod Carr; Bridget Coates; Jonathan Ross; Tania Simpson; and Graeme Wheeler (Governor). 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 2017. Deputy Governor Geoff Bascand will become Head of Financial Stability and Deputy Chief Executive of the Reserve Bank on 27 September 2017. Mr Bascand replaces Grant Spencer, who will be Acting Governor for six months from that date, after Mr Wheeler's term as Governor ends.

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 – of being the best small central bank – with values of:

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

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

Outcomes

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

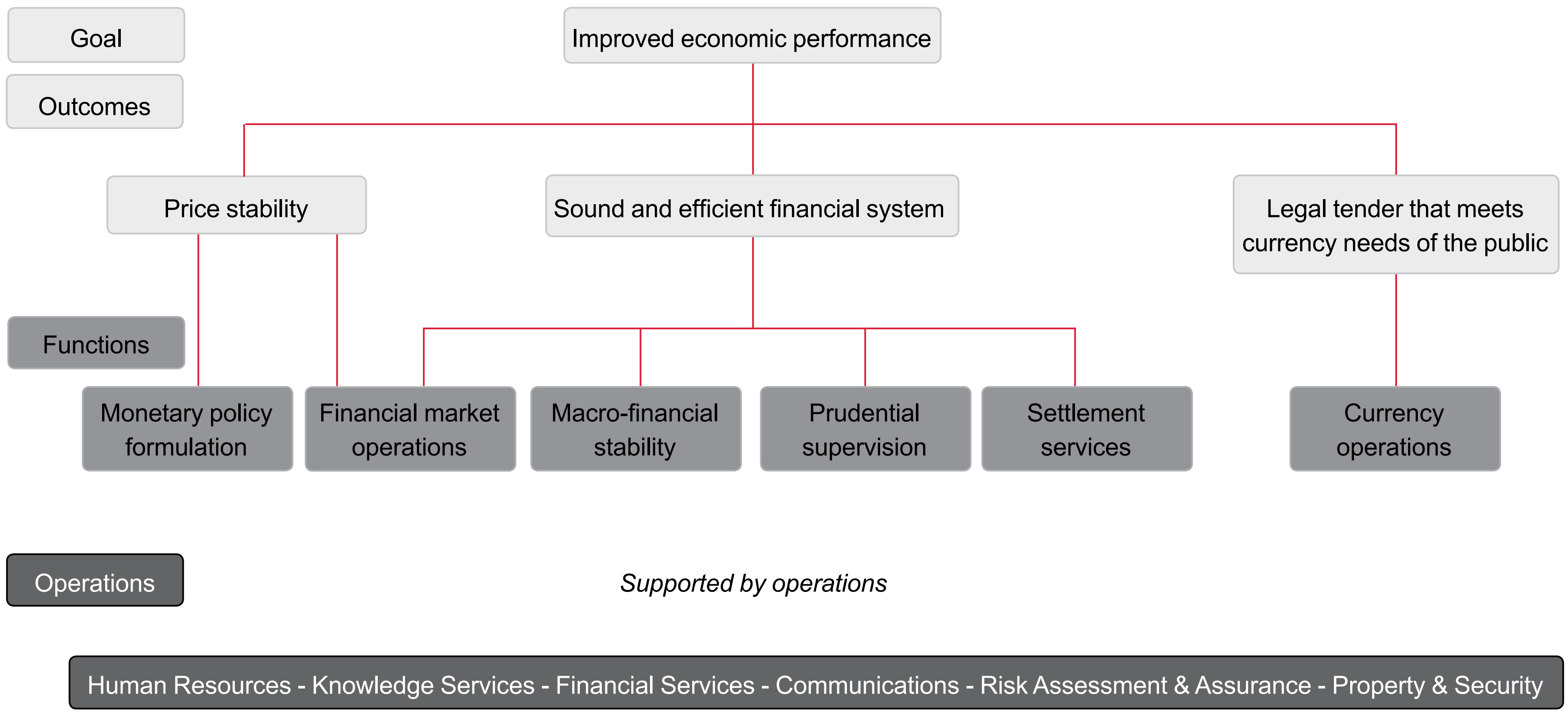
- maintaining stability in the general level of prices;
- maintaining a sound and efficient financial system; and
- providing legal tender to meet the currency needs of the public.

To achieve these outcomes the Bank performs functions covering:

- monetary policy formulation;
- financial market operations;
- macro-financial stability;
- prudential supervision;
- settlement services; 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 2017–2020

I. Enhancing the Bank's policy frameworks

1. Deepen our understanding of evolving conditions affecting the New Zealand economy and the implications for monetary policy

The primary objective of the Bank's monetary policy is to maintain price stability as defined in the *Policy Targets Agreement*. In pursuing its mandate, the Bank remains focused on understanding how international and domestic factors influence economic activity and inflation in New Zealand, and their implications for monetary policy. The Bank will continue to innovate its forecasting and policy framework, to ensure that its policy advice is robust to the uncertainties that prevail about the state of the business cycle and its outlook. The Bank also aims to communicate clearly and effectively to ensure there is wide understanding of its framework and its policy choices.

2. Review and refine the macro-prudential framework

The Bank will review the macro-prudential policy framework in line with the five year requirement specified in the Memorandum of Understanding between the Bank and the Minister of Finance. The work programme will review objectives and policy instruments and the operational framework under which policy is conducted, drawing on local and international experience. The role of debt-to-income ratios for housing lending will be assessed following a public consultation.

3. Review key elements of the prudential policy framework to better meet the Bank's soundness and efficiency objective

The Bank will review the findings and recommendations of the IMF FSAP review. This will dovetail with other key reviews under way or planned, covering capital requirements for banks, the 'dashboard', crisis preparedness, and the insurance prudential framework. The Bank will build on its work with the banking industry to define and foster best practice in technical stress-testing frameworks and practices drawing on insights gained from recent stress-testing exercises.

II. Continuing to strengthen the Bank's internal and external engagement

4. Embed the Bank's high-performance culture

The Bank has largely established its high-performance frameworks. The priority now is to deliver stronger management performance and greater staff engagement. This will be achieved through a greater empowerment and skill development of staff, and accountability for results by managers. High performance and engagement will be underpinned by the Bank's values of integrity, innovation and inclusion, and support a talented, diverse workforce. The Bank will seek and measure continual improvement in efficiency and business results.

5. Engage and communicate with stakeholders

The Bank will maintain a high level of engagement with its stakeholders. It will communicate broadly on its policies, the reasons for them and the impacts of its activities through a wide range of engagements and channels. The Bank will measure the effectiveness of engagement through an External Stakeholder Engagement survey in 2018.

III. Improving infrastructure and reducing enterprise risk

6. Implement the payments system review

The Bank will complete the implementation of a system to replace ESAS, providing real-time gross settlement services, and a replacement system for securities settlement and depository services (NZClear). It will engage with industry to support its readiness for new systems in 2018–19.

7. Implement the roadmap for best-practice central bank balance sheet and financial management

Treasury systems support two key policy functions: foreign reserves management (including currency intervention) and the implementation of monetary policy (liquidity management). Systems' requirements have evolved significantly since the global financial crisis, and the Bank is updating key functionality. The Bank will complete the implementation of its Treasury Systems (Roadmap) Strategy to enhance the management of risks and returns and aid decision-making by providing market-standard trade valuation, position and collateral management, and enhanced risk and performance reporting.

8. Develop a plan for the future custody and distribution arrangements for currency

Building on earlier work, the Bank is reviewing its currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future. The review will assess the current operating model, consider the potential impacts of financial technology trends for currency demand, and identify different approaches for the custody and distribution of currency. The Bank will consult and collaborate with key stakeholders to ensure that the review's recommendations are understood, supported and developed to viable implementation plans.

9. Improve the resilience of the Bank's operations

The Bank will review and strengthen the resilience of its operations (including its Auckland office) to business continuity and cyber-security threats, and regularly assess its operations against industry best practices.

Functions – initiatives and strategies

Price stability

Monetary policy formulation

Relationship to strategic priorities

I. Enhancing the Bank's policy frameworks

1. Deepen our understanding of evolving conditions affecting the New Zealand economy and their implications for monetary policy

II. Continuing to strengthen the Bank's internal and external engagement

4. Embed the Bank's high performance culture

5. Engage and communicate with stakeholders

Objective

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

The current *Policy Targets Agreement* between the Minister of Finance and the Governor requires that the Bank "keep future CPI [consumer price index] inflation outcomes between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint". It also requires that "In pursuing its price stability objective, the Bank shall have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate".

Scope of operations

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

- set the OCR seven times a year with the aim of keeping future average inflation near the mid-point of the target band of 1 percent to 3 percent. Other unscheduled adjustments to the OCR may occur in response to unexpected or sudden developments;

- publish an *MPS* each quarter at the same time as four of the OCR decisions. The *MPS* sets out the Bank's views on the economy 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 *MPS*; 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 3.1 percent during 2016, which is above the average pace of expansion since 2010. The expansion was supported by the low policy interest rate, strong population growth and high levels of consumer spending and construction activity. However, the economy faced a number of headwinds during 2016, including subdued world demand, low export commodity prices and an elevated exchange rate. At time of writing, the exchange rate had fallen significantly since early 2017, which if sustained will help to rebalance growth towards the tradables sector. Global growth continues to be supported by extraordinarily accommodative monetary policy as spare capacity lingers in several major advanced economies. However, monetary stimulus is expected to have peaked with policy rates in the United States expected to rise further in 2017, while those of other major central banks are expected to remain on hold.

The economy is close to its potential level of output. Inflation was 1.3 percent in the December 2016 quarter, returning inflation to within the target band after being below the Bank's target range for eight quarters due to negative tradables inflation. While strength in domestic activity contributed, the increase was largely a result of a lift in tradables prices, with the decline in oil prices during 2015 dropping out of the annual calculations. Short-term inflation expectations have increased but remain low, reflecting the extended period of weak headline inflation driven by persistent negative tradables inflation and stronger-than-expected labour supply growth. However, measures of longer-term inflation expectations remain anchored at 2 percent.

Monetary policy has been accommodative in the past year due to the low inflation expectations and heightened uncertainty associated with the outlook for global conditions. The policy rate was reduced by 75 basis points during 2016 in order to stimulate domestic activity and ensure that future inflation settles near the mid-point of the target range. Monetary policy will remain accommodative for a considerable period.

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

- whether short-term inflation expectations increase further following recent inflation outturns, and flow through to price- and wage-setting behaviour;
- 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;
- high net immigration in New Zealand and its impacts on the economy;
- the pattern of consumer behaviour and its underlying drivers;
- demand and supply imbalances in the housing market;

- constraints that may affect the timing and extent of construction activity; and
- the supply and demand factors influencing global commodity prices, in particular dairy prices.

Initiatives and strategies

The Bank's Economics department has four key work streams for 2017.

1. Support the formulation of monetary policy: build on our understanding of the drivers of low inflation and their consequences for output, consumption and labour market outcomes, and the implications for monetary policy.

2. Monetary policy research: continue to improve our understanding of the New Zealand economy and key monetary policy issues.

3. International and exchange rate analysis: understand the impacts of foreign macroeconomic policies on world business cycles and their flow-on effects to New Zealand.

4. *Policy Target Agreement* renewal and governance review: engage effectively with external agencies on the upcoming renewal of the agreement and the review of the Bank's monetary policy governance framework.

Success measures

- The Bank implements monetary policy in a manner that can reasonably be expected to see CPI inflation outcomes between 1 percent and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

- Measures of underlying inflation generally remain within the target range.

- The Bank implements monetary policy in a manner that seeks to avoid unnecessary instability in output, interest rates and the exchange rate, while having regard to the efficiency and soundness of the financial system.

- *MPS*s are informative and accurately assess the Bank's performance in meeting the objectives of the *Policy Targets Agreement*.

Price stability

Financial Market Operations

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

Relationship to strategic priorities

II. Continuing to strengthen the Bank's internal and external engagement

4. Embed the Bank's high performance culture

5.Engage and communicate with stakeholders

III. Improving infrastructure and reducing enterprise risk

7. Implement the roadmap for best-practice central bank balance sheet and financial 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 capability.

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 OCR;
- manages official foreign reserves for use in times of financial distress or when foreign exchange intervention is needed for monetary policy purposes;
- manages liquidity in the banking system;
- manages the Crown Settlement Account; 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 crisis.

Environment and policy issues

Increased geopolitical risk and unexpected shifts in political sentiment have been evident in the past year. The Brexit vote, through which Britain decided in June to leave the European Union, surprised markets and was followed by a change in the United States administration later in the year. These events 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 uncertainties and brief volatility spikes as a result of these events, financial market volatility moderated during the year and global economic growth consolidated. Commodity prices rose from recent lows – raising inflation and growth expectations – and asset markets remained buoyant.

Market liquidity conditions continue to be under pressure. This is in part due to the ongoing implementation of changes to the global regulatory environment creating, on occasions, segmented market pricing and increased demand for high-quality and liquid assets.

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

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

- Completing the implementation of the Trade Valuation Solution. This system will improve the valuation of the Bank's assets and liabilities and deliver the benefits of: market-standard pricing, enhanced risk measurement, improved position and trade management and increased business agility.
- Improving liquidity positioning and increasing returns on the Bank's foreign reserves assets through the implementation of an asset swap programme that will also hedge the balance sheet liability costs associated with any significant rise in the foreign short-term wholesale funding rate (LIBOR).
- Improving the valuation of residential mortgage-backed securities (RMBSs) and introducing simple, transparent and comparable (STC) terms and conditions that may also facilitate a secondary market in RMBSs. This 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 OCR.

- No evidence of payment disruptions due to a shortage of settlement cash in the system, e.g. persistent accessing of the Overnight Reverse Repo Facility.

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

- Foreign reserves are maintained at target levels, with liquidity and credit standards met throughout.

- The foreign reserves management portfolio yields a net return on assets that meets or exceeds the benchmark portfolio.

- The foreign exchange open position is managed such that:

  (a) the bulk of active foreign exchange purchases (sales) 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

Relationship to strategic priorities

I. Enhancing the Bank's policy frameworks

2. Review and refine the macro-prudential framework

3. Review key elements of the prudential policy framework to better meet the Bank's soundness and efficiency objective

II. Continuing to strengthen the Bank's internal and external engagement

5. Engage and communicate with stakeholders

Objectives

Promote the financial stability of the domestic financial system by:

- identifying and assessing emerging system risks in a timely manner;
- advising on the deployment of macro-prudential 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 an *FSR* 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

Restrictions placed on the loan-to-value ratios (LVRs) of new mortgage lending have helped to limit the risk to the banking system of a downturn in the housing market. House price inflation has eased, particularly in Auckland, since a tightening of LVR restrictions on investor lending in October 2016. However, there remains a risk of housing market pressures re-emerging given continued low interest rates and strong inward migration. Household indebtedness continues to increase, and a larger share of lending is being conducted at high debt-to-income ratios. This increases the risk of a significant rise in mortgage defaults in the event of rising interest rates or a general economic downturn.

While macroeconomic indicators in advanced economies have recently been positive, there is extensive geopolitical uncertainty. There is a heightened risk of market sentiment deteriorating rapidly, making it more difficult and expensive for the banking system to obtain offshore funding. Since the global financial crisis the banking system has reduced its reliance on offshore funding due to strong growth in customer deposits. However, credit growth has recently been outstripping household deposit funding, leaving the banking system more exposed to volatility in international markets.

The Bank is continuing to work with the banking system to improve stress-testing frameworks and is drawing on insights from recent stress tests to improve the design of future stress-testing exercises. The Bank has promoted stress tests as an integral part of banks' internal risk management frameworks.

The Bank has upgraded and enhanced its collection of financial data to reflect its wider prudential supervision mandate and ensure coverage of the full range of risks to financial stability. The Bank has redeveloped its banking sector statistics in the past four years and has been increasing its range of published statistics. In April 2017 the Bank began reporting more comprehensive and detailed data — aligning the data collection with international standards and best statistical practice. The Bank expects to re-develop its data collections and statistics from non-banks and investigate options to ensure data are collected as efficiently as possible.

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;

- monitoring emerging developments in housing markets and lending standards to assess the risks to financial stability and the case for any adjustments to macro-prudential policy tools;

- assessing the ongoing effects of LVR restrictions and reviewing the effectiveness of the macro-prudential framework; and

- expanding and reshaping financial system data collections to meet current and future prudential policy and statistical needs.

Initiatives and strategies

To address these issues, the Bank will:

- analyse and consult on the addition of a debt-to-income-ratio tool to the macro-prudential framework, subject to approval by the Minister of Finance;

- contribute to a 2018 review of the macro-prudential policy framework, as required under the Memorandum of Understanding on Macro-Prudential Policy;

- reflect on insights gained from recent stress-testing exercises and work with banks to reinforce best practice and make incremental improvements to stress-testing frameworks;

- continue to enhance our *FSR*s through research in areas such as household debt and commercial property; and

- fully implement the new bank balance sheet collection, preserving continuity with existing statistics and engaging with users on the new collection.

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.

- An assessment of the soundness and efficiency of the financial system is published twice yearly in the *FSR*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 will contribute to a thorough assessment of the existing framework and make considered recommendations for how the framework can be improved.

Sound and efficient financial system

Prudential supervision

Relationship to strategic priorities

I. Enhancing the Bank's policy frameworks

3. Review key elements of the prudential policy framework to better meet the Bank's soundness and efficiency objective

II. Continuing to strengthen the Bank's internal and external engagement

5. Engage and communicate with stakeholders.

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.

The four major Australian-owned banks comprise a major part of New Zealand's financial system, and we maintain close relationships with Australia's financial regulatory authorities.

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. We also monitor significant policy developments in relevant jurisdictions, such as Australia.

The IMF's FSAP recently provided a comprehensive assessment of the country's financial system, with a particular focus on the quality of financial sector regulation. The FSAP review is providing useful input for the ongoing development of the Reserve Bank's prudential regime. The Bank will continue its consultative approach to developing new policy initiatives.

The Bank continues to develop its structured and systematic approach to insurance supervision. Likewise, the Bank continues to monitor licensed NBDTs in conjunction with the trustee corporations that are responsible for supervising the NBDT sector. As part of the Bank's AML/CFT obligations, the Bank supervises reporting entities within the banking, insurance and NBDT sectors — assessing the risk of money laundering and monitoring these entities for compliance with the legislation.

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

- the findings of the review of New Zealand's financial sector by the IMF under its FSAP, and their implications for the evolution of the Bank's supervisory framework;
- whether capital requirements for banks remain appropriate, taking into account ongoing refinements to international standards;
- whether policy documents such as the Banking Supervision Handbook are as clear and accessible as possible;
- the effectiveness of the registered bank director attestation regime;
- the appropriateness of the current legislative framework for the oversight of systemically important financial market infrastructures;
- continually assessing whether our AML/CFT supervisory approach is optimal; the desired outcome is sustainable compliance of reporting entities with the AML/CFT Act.
- the Bank's capacity to respond to financial crises, including targeted refinements to crisis policies and processes; and
- the risks associated with residential and commercial property markets, challenging conditions in the dairy sector and bank reliance on global funding markets, and the Bank's supervisory ability to respond to these risks.

Initiatives and strategies

To address these issues the Bank will:

- undertake a comprehensive follow-up to the IMF's FSAP review. This will involve developing a work programme for considering and implementing the FSAP recommendations and reporting quarterly to the Minister of Finance on progress, in consultation with other agencies as appropriate;
- conduct a wide-ranging and consultative review of the Reserve Bank's capital requirements for banks;
- continue the work that is under way to improve the grouping and layout of the documents that make up the Reserve Bank's Banking Supervision Handbook;
- work with banks captured by the Bank's outsourcing policy to support them on a path to compliance with revised policy requirements;
- revise the quarterly disclosure statement framework for banks, with a view to introducing a 'dashboard' approach;
- integrate with our frameworks the new statistical returns that resulted from the Balance Sheet project;
- conduct a comprehensive thematic review of the bank director attestation regime;
- implement a new framework for systemically important financial market infrastructures, including crisis management powers, by continuing to draft and consult on proposed legislation;

- continue the review of the Insurance (Prudential Supervision) Act, with further consultation and engagement with interested parties;

- further refine crisis management tools to assist in managing the risks to the Crown balance sheet, and review the case for amendments to the statutory management powers in the Reserve Bank of New Zealand Act to clarify aspects of the legislative framework for the Open Bank Resolution policy;

- 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 maintaining engagement with executives and directors of regulated entities; and

- develop plans to take forward the Bank's regulatory stewardship responsibilities over the coming years.

Success measures

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

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

- In its decisions on whether to grant licences to new applicants, the Bank takes a consistent approach within the legislative framework.

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

Sound and efficient financial system

Settlement services

Relationship to strategic priorities

III. Improving infrastructure and reducing enterprise risk

6. Implement the payment systems review

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 to improve system resilience and security, and support developments in the payments industry. A work programme has been initiated to ensure that systems and infrastructures are updated or replaced to meet evolving requirements.

Initiatives and strategies

To address this issue the Bank will progress 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.

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.

Legal tender that meets the currency needs of the public

Currency operations

Relationship to strategic priorities

III. Improving infrastructure and reducing enterprise risk

8. *Develop a plan for the future custody of and distribution arrangements for currency*

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

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

- mitigate counterfeiting risks. The rapid innovation in copying and printing techniques heightens the need for counterfeit awareness and resilience. Our new brighter, more secure Series 7 Brighter Money banknotes have now been rolled out, but the majority of banknotes in circulation are still of the previous polymer series introduced 17 years ago;
- 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;
- review the levels and locations of contingency reserves; and
- ensure appropriate domestic, long-term, secure premises for the Bank's operational currency holdings.

Initiatives and strategies

To address these issues, the Bank will:

- review and implement appropriate changes to the levels and locations of operational and contingency currency reserves; and
- develop a plan for the custody and distribution arrangements for currency, which takes advantage of technological advancements and improves efficiencies across the cash life cycle.

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

Relationship to strategic priorities

II. Continuing to strengthen the Bank's internal and external engagement

4. Embed the Bank's high performance culture

5. Engage and communicate with stakeholders

Embed the Bank's high-performance culture

The Bank has largely established its high-performance frameworks. The priority now is to deliver stronger management performance and greater staff engagement. This will be achieved through the greater empowerment and skill development of staff, and accountability for results by managers. High performance and engagement will be underpinned by the Bank's values of integrity, innovation and inclusion, and will support a talented, diverse workforce. The Bank will measure continual improvement in efficiency and business results.

People and culture

The Bank's high-performance framework for managers is underpinned by key accountabilities for people leadership and capability building. Managers are expected to align team visions with the Bank's vision, and to provide clear direction and stretch objectives so that their colleagues can better contribute to the Bank's success, and grow and develop in their jobs. The Bank is realigning its Human Resources business partnership model to support managers to perform to expectations and own the high-performance accountabilities. This will involve the development of appropriate metrics to assist managers to measure their success. Managers' performance on leadership and capability building will be more closely linked to their remuneration and reward outcomes.

A high level of staff engagement is a key indicator of a high-performing organisation. The Bank measures engagement annually and results are improving each year. Actions taken to improve engagement are recommended by staff, and focus on the principles of continual improvement, collaboration, inclusion and contribution. Business results, staff engagement and financial performance measures remain positive and the Bank is committed to continuing to improve and measure its performance culture.

Providing and maintaining a healthy and safe workplace in accordance with the Health and Safety at Work Act 2015 is a priority for the Bank. The focus is on keeping employees and other people at the Bank safe, as well as improving safety awareness and encouraging involvement in health, safety and wellness.

Communications

Relationship to strategic priorities

II. Continuing to strengthen the Bank's internal and external engagement

5. Engage and communicate with stakeholders

The Bank will continue to broaden its communications programme and deepen engagement with a range of stakeholders.

The Bank will continue to communicate the reasoning for and impacts of its activities through its extensive on- and off-the-record speech programme, briefings for a diverse range of audiences, media engagements, videos, audio presentations, animated media, appropriate social media and traditional mainstream media, online channels, publications and the Bank's Museum & Education Centre. We will measure the effectiveness of our communications engagements, and identify new ways to reach and relate to stakeholders by undertaking another External Stakeholder Engagement survey in 2018.

Within the Bank, Communications will support deeper engagement and motivation by better connecting colleagues' activities to the Bank's vision, and supporting initiatives to improve our performance culture. The outcomes of key Bank-wide projects will be clearly communicated to Bank colleagues.

Knowledge Services

Relationship to strategic priorities

II. Continuing to strengthen the Bank's internal and external engagement

5. Engage and communicate with stakeholders

III. Improving infrastructure and reducing enterprise risk

7. Implement the roadmap for best-practice central bank balance sheet and financial management

9. Improve the resilience of the Bank's operations

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

Key initiatives for the Knowledge Services department this year will be to:

- continue with the implementation of the Trade Valuation Solution project for the Bank's financial management;
- continue to support the implementation of replacement payment systems used to provide real-time gross settlement services (ESAS) and securities settlement and depository services (NZClear);

- review the efficacy of information security controls in IT systems and across the Bank in line with the Protective Security Framework, and build capability;
- refresh the Bank's Enterprise Architecture (EA) to ensure that IT strategy and technology roadmaps are aligned to the Bank's business intent and build on our internal EA capability; and
- strengthen our internal IT service management practices through improved controls and reporting.

Internal financial services

Relationship to strategic priorities

II. Continuing to strengthen the Bank's internal and external engagement

4. Embed the Bank's high performance culture

III. Improving infrastructure and reducing enterprise risk

7. Implement the roadmap for best-practice central bank balance sheet and financial management

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 continue to implement the roadmap it developed for the design and architecture of its treasury systems, collaborating with financial market operations to meet changing business needs.

Risk assessment and assurance

Relationship to strategic priorities

III. Improving infrastructure and reducing enterprise risk

6. Implement the payment systems review

7. Implement the roadmap for best central bank balance sheet and financial management

8. Develop a plan for the future custody of and distribution arrangements for currency

9. Improve the resilience of the Bank's operations

The Bank faces a wide range of risks, some general and others unique to central banks. The identification, management and monitoring of these risks is an integral part of the Bank's activities in maintaining a sound and dynamic monetary and financial system.

The Bank's objective for enterprise risk management is to ensure that risks to its objectives are systematically identified and managed effectively and efficiently. The Risk Assessment and Assurance department facilitates regular reviews of the Bank's risk profile from the pursuit of its strategic priorities and performance of its functions. It will support and be involved in the development and implementation of key projects as identified in the Bank's strategic priorities, and will focus on coordinating and refining processes to improve the resilience of the Bank's operations. Two areas of focus will be the business continuity role of the Auckland office to provide effective back up to the Bank's operations, and the Bank's ability to manage cyber-security threats.

The internal audit function will provide assurance about the design and effectiveness of operational controls in the Bank's activities, through the implementation of a risk-based annual audit plan. The legal function oversees the broad range of legal risks facing the Bank from both prudential and operational perspectives, and supports the operational functions of the Bank through legal advice and support.

Property and security

Relationship to strategic priorities

III. Improving infrastructure and reducing enterprise risk

8. *Develop a plan for the future custody of and distribution arrangements for currency*

9. *Improve the resilience of the Bank's operations*

The Bank continually assesses its security access and control systems to ensure that they are robust. The Bank will continue to maintain and extend energy-saving and recycling programmes, such as incorporating new LED lighting, and continuing to recycle polymer banknotes into plastic goods.

The Bank owns its premises at 2 The Terrace, Wellington, and is optimising office space efficiency and effectiveness through the Building Occupancy project. This will free three additional floors for lease to external tenants, generating additional lease revenue.

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 2015–2016* (pages 69–70). 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 $69.5 million for 2016–17 and $66.3 million for 2017–18.

Annual distributions paid by the Bank

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

Statement of dividend principles

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

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

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

Accounting standards

The Bank applies Public Benefit Entity accounting standards based on International Public Sector Accounting Standards. The Bank's accounting policies are described on pages 63–70 of the *Annual Report 2015–2016*.

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 2017, currency in circulation was $6.0 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 more 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 over the exchange rate cycle. Holding unhedged foreign reserves means that the Bank's net equity will fluctuate with changes in the exchange rate; foreign 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 volatility in the Bank's financial performance and financial position. At 30 April 2017, the Bank held an open foreign exchange position of SDR1.5 billion (NZ$3.0 billion). At 30 June 2016, the open foreign exchange position was SDR1.5 billion (NZ$3.0 billion);

- *interest rates earned on the Bank's investment in government securities and other securities*: the Bank's holdings of New Zealand government securities are valued at market value, with unrealised gains and losses on those holdings booked to equity.[1] Interest income and realised gains and losses on the disposal of New Zealand government securities are booked to the Bank's Income Statement;

- *the size and performance of the Bank's foreign reserve management and market operations functions*: the Bank holds foreign reserves that can be liquidated at short notice to support its functions, including monetary policy objectives and the maintenance of orderly markets. Foreign reserves are valued at market value. Changes to foreign exchange rates and international interest rates will affect the market value of those reserves, and valuation changes are booked to the Bank's Income Statement. At 30 April 2017, the Bank had a foreign exchange intervention capacity of SDR5.3 billion (NZ$10.5 billion);

- *New Zealand government deposits held at the Bank*: the Bank provides a settlement account facility to the Crown. The size of New Zealand government deposits held in the Crown Settlement Account is a big driver of the Bank's balance sheet. Larger deposits are swapped into foreign currency and invested by the Bank

1 The Bank's investment in New Zealand government securities is classified as 'available for sale securities'. These assets are intended to be held either to maturity or for an indefinite period of time, and may be sold in the normal course of the Bank's operations. Unrealised gains on securities that are classified within the 'available for sale' category are booked to equity rather than to the Statement of Financial Performance.

overseas. However, net earnings are not affected materially by this activity. At 30 April 2017, the Bank held New Zealand government deposits of NZ$4.5 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 2015–16 year was $140 million, and the reported equity at 30 April 2017 was $2.9 billion.

Principal financial risk management considerations

With more than $25 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 82–93 of the *Annual Report 2015–2016*.

Financial projections

The following table outlines the Bank's budgeted income and expenditure for 2017–18. The key assumptions underlying the budget for the year ended 30 June 2018 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 2017 and 30 June 2018;

- projected interest and exchange rates are those advised by the Treasury for the purposes of preparing the Government's Budget for 2017-18;

- 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 2017–2018

For the year ending 30 June	Budget 2017–18 $m
Operating income:	
Net investment income	255.0
Other income	12.5
Total operating income	**267.5**
Operating expenses	
Bank operations:	
Personnel	31.5
Asset management	7.1
Professional and contract services	7.5
Other	13.1
Total operating expenses, bank operations	**59.2**
Direct currency issue expenses:[2]	
Net currency issued	11.6
Delivery expenses	0.5
Series 7 banknote transition expenses	0.5
Total direct currency issue expenses	**12.6**
Operating surplus	**195.7**

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 2017, a 10 percent appreciation in the value of the New Zealand dollar would reduce the Bank's comprehensive income by $277.7 million, and conversely a 10 percent depreciation in the value of the New Zealand dollar would add $339.4 million to comprehensive income. A 1 percent across-the-board increase in interest rates would reduce comprehensive income by about $30.7 million, and a 1 percent across-the-board reduction in interest rates would increase comprehensive income by about $31.4 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 is booked to the Income Statement, whereas the majority of the interest rate sensitivity arises on the Bank's portfolio of New Zealand government securities and is booked directly to equity. Refer to page 87 of the Bank's *Annual Report 2015–2016* for a detailed sensitivity analysis as at 30 June 2016.

Net expenditure[4] budget 2017–2018

For the year ending 30 June	Net expenditure Budget 2017–18 $000s
Monetary policy formulation	9,723
Domestic market operations	4,898
Macro-financial stability	8,077
Prudential supervision	13,722
Foreign reserves management	5,504
Settlement services	(2,106)
Net operating expenditure before currency operations	**39,818**
Currency operations	19,467
Net operating expenditure	**59,285**

The budgeted net operating expenditure for 2017–18 is $59.3 million. The budget includes a provision for the costs associated with significant changes in the critical systems and processes that are needed in order to achieve the Bank's strategic priorities. These priorities include the continuing delivery of the series 7 Brighter Money banknotes, developing a plan for the future custody of and distribution arrangements for currency, progressing the implementation of the payment systems review and implementing systems to enhance the Bank's balance sheet and financial management.

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

While the Bank anticipates under-spending of the Funding Agreement in its first three years, aggregate expenditure in the full five-year period is being managed to be in line with the aggregate funding provided for in the agreement. The under-spending reflects staff costs related to the construction of new systems, which will be capitalised and amortised over several years, resulting in a timing of recognition that differs from that provided in the Funding Agreement.

Funding agreement

	Net expenditure Budget 2017–18 $000s	Funding agreement 2017–18 $000s	Funding agreement under-expenditure $000s
Net operating expenditure excluding direct net currency issue expenses	46,661	50,300	3,639
Direct net currency issue expenses[5]	12,624	16,000	3,376
Total net operating expenditure under funding agreement	**59,285**	**66,300**	**7,015**

5 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.