ANNUAL REPORT 2015 – 2016

Looking to the past to innovate for the future

The Reserve Bank of New Zealand presents forward thinking backed by experience.

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

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Reserve Bank of New Zealand Annual Report and Financial Statements for the financial year ended 30 June 2016, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2016.

ANNUAL REPORT 2015 – 2016

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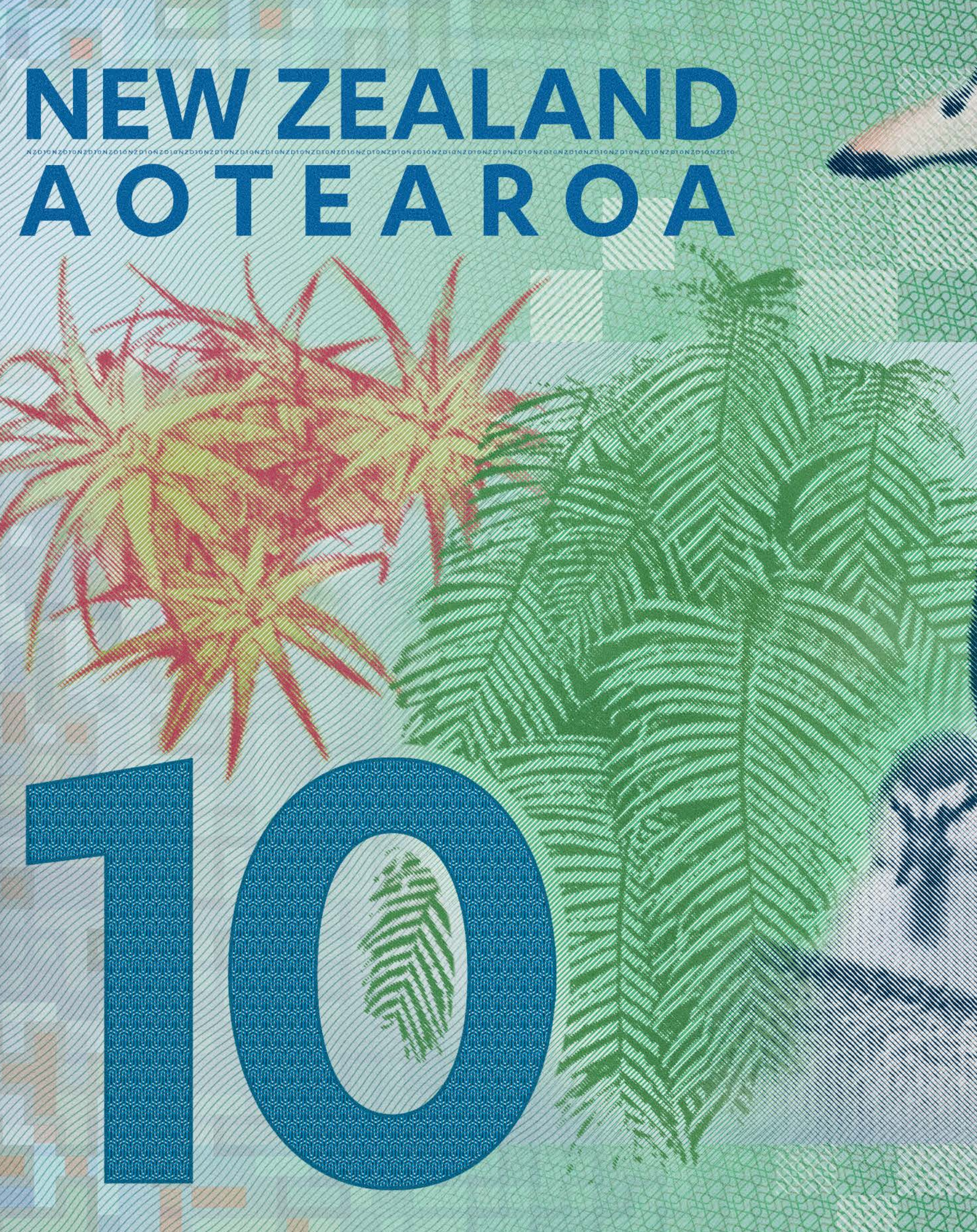
NEW ZEALAND
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10

Innovation to note

BRIGHTER MONEY

The new Series 7 *Brighter Money* banknotes are brighter, bolder and clearer than the Series 6 banknotes, and incorporate world-class security features. They are the same sizes and denominations, and continue to be made of flexible polymer. They feature cutting-edge security features and incorporate world-first design and printing techniques. The themes of the notes remain the same, with the same respected New Zealanders, the Queen and flora and fauna remaining central to the designs. Here is an overview of the designs and details of the key security features and innovations to note.

Holographic window

Check the transparent window and hologram inside – as you tilt the note, colours appear inside the new, larger window. You will see a silver fern, map of New Zealand and the same bird featured on the note. A number is embossed into the bottom of the window.

Colour change

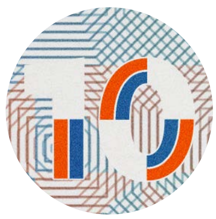
Check the colour-changing bird – as you move the note, the colour inside the bird changes and a bar rolls diagonally across the bird shape.

Raised ink

You can feel raised print on the large numbers and words 'Reserve Bank of New Zealand Te Pūtea Matua' and 'New Zealand Aotearoa'.

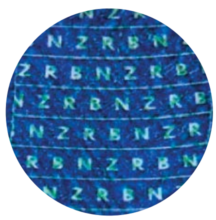
Puzzle number

Holding the note up to the light will make the irregular shapes on the front and the back of the note line up to show the denomination of the note.



Microtext

Using a magnifying glass, look closely around the portrait. You can see the value of the note printed repeatedly. Look at the numeral on the front and back of the banknote. There is microtext saying 'RBNZ' on the front and 'NZD10', or the denomination on the back repeatedly.



Fluorescent feature

There is a fluorescent square on the front of the note that illuminates bright green under ultraviolet light while the rest of the note remains dull in contrast. Shine an ultraviolet light over the front of the note to see the feature.

Issuing, collecting and recycling

The Reserve Bank issues new notes to banks as they order them. We take back old, surplus or worn notes. Old series banknotes are then shredded and recycled.

FORWARD THINKING BACKED BY EXPERIENCE

Over recent decades, the Reserve Bank has placed significant emphasis on innovation to enhance its contribution to the New Zealand economy - taking on board lessons from the past to shape the future. This historical snapshot showcases just how far we have come.

The life of a note

Changing from paper to polymer banknotes in 1999 made our notes more durable.

84

MONTHS

AVERAGE LIFE OF A POLYMER NOTE IN 2016

12

MONTHS

AVERAGE LIFE OF A PAPER NOTE IN 1999

Keeping prices stable

The Reserve Bank sets the Official Cash Rate to keep prices stable and keep our cost of living from fluctuating too much. The Bank works to keep inflation between 1 and 3 percent on average over the medium term, with a focus on the midpoint, 2 percent.

3.2%

THE AVERAGE ANNUAL PRICE INCREASE FOR A KILOGRAM OF SAUSAGES IN 2016

15.5

PERCENT

THE AVERAGE ANNUAL PRICE INCREASE FOR A KILOGRAM OF SAUSAGES IN 1987

Recycling our banknotes

The introduction of a recycling system means the disposal of polymer banknotes notes is now more environmentally friendly.
Old or damaged polymer notes are destroyed by being shredded.
The shredded notes are then recycled into other plastic products instead of being buried or burnt.

22.4

MILLION

NOTES WERE RECYCLED IN THE LAST FINANCIAL YEAR

ZERO

NOTES WERE RECYCLED PRIOR TO 2015

Decimal conversion

We're approaching the 50th anniversary of the conversion from pounds, shillings and pence to decimal currency. The 1967 change from imperial to decimal made it simpler to calculate everyday transactions.

DOLLARS & CENTS

OUR DECIMAL CURRENCY IN 2016

POUNDS AND SHILLINGS

OUR IMPERIAL CURRENCY PRIOR TO 1967

Making money flow

ESAS is the Reserve Bank of New Zealand's Exchange Settlement Account System which is used by banks and other approved financial institutions to settle their obligations on a Real-Time Gross Settlement basis.

SETTLEMENT HAPPENS IN **REAL-TIME** IN 2016 AND CAN'T BE REVERSED

SETTLEMENT TOOK **ONE DAY** IN 1997

Bank to bank

The ESAS systems allows financial institutions to settle accounts with each other. Billions of dollars worth of transactions are processed through ESAS every day, and the number of transactions continues to rise.

3,108,500

AVERAGE ESAS TRANSACTION VOLUME IN 2016

ONE MILLION FOUR HUNDRED THOUSAND

AVERAGE ESAS TRANSACTION VOLUME IN 2006

Computing power

A secure and efficient IT infrastructure is critical in driving innovation at the Bank.

850

COMPUTERS (INCLUDING SERVERS) IN 2016

COMPUTER IN 1964

GOVERNOR'S STATEMENT

The Bank has been active on many fronts. The global economy and financial markets have been challenging for monetary policy, the Bank has an intensive programme of work in respect of prudential oversight and macro-prudential policy; and it also has more major operational projects underway than in recent years.

Nearly 10 years on from the start of the global financial crisis, global economic growth remains disappointingly weak in many regions. Global growth in 2015, at 3 percent, was the weakest since 2008 and well below its long-term average. This was despite unprecedented monetary stimulus and commodity prices that remain well below the levels two years previously. Unfortunately, 2016 has seen further downward revisions of growth forecasts by the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD).

Against a background of large global excess capacity, declining volumes of merchandise trade and rising protectionism in G20 countries during 2016, the New Zealand economy is performing relatively well. The economy is in its eighth year of expansion and annual gross domestic product growth of 3 – 3½ percent is forecast over the next two years. Current economic growth is above trend, employment growth has been strong, labour force participation is high and the unemployment rate continues to decline. Furthermore, real wage growth has been quite strong; until recently, the household savings rate has been rising, and increasing economic growth has not been accompanied by the sharp deterioration in the current account that has characterised previous recoveries. Not least, the cost of living, as measured by the consumers price index (CPI), has been rising slowly.

As with every economy there are also some negative aspects: domestic economic growth has been weaker on a per capita basis; the global dairy market has serious oversupply problems that depress our dairy returns (despite more recent signs of improvement); excessive house price inflation is creating financial stability risks; our exchange rate is too high and affecting the competitiveness of our export and import substitution industries; and headline inflation lies below the target band in the *Policy Targets Agreement.* In addition, the strongest migration cycle in several decades is creating stresses as well as positives for the economy.

Inflation has remained lower for longer than forecast, primarily because of unforeseen and unforeseeable global events. Inflation in the tradables sector, which accounts for almost half of the CPI regime, has been negative for the past four years. This has been due to the subdued global inflation, falling global commodity prices and the high New Zealand dollar exchange rate. Given the outlook for global inflation and policy interest rates, low tradables inflation appears likely to continue for some time yet. Inflation in the non-tradables sector has averaged 2 percent in the past two years. Reduced government charges, such as the decline in ACC levies, have lowered non-tradables inflation, but we have also seen wage moderation as the surge in net migration since 2012 has increased the labour supply by around 4.5 percent. The Bank's measures of core inflation currently lie within the lower half of the inflation target band.

In response to the low inflation and high exchange rates, the Reserve Bank's Governing Committee, which comprises the Bank's four Governors, lowered the Official Cash Rate six times since June last year. Policy rates are currently at historic lows and this has supported economic growth, and helped to prevent a decline in long-term inflation expectations. However, despite the cuts in the OCR, the trade-weighted exchange rate remains 2½ percent higher than in June last year, and there has been some weakening in short-term inflation expectations. A key rationale for cutting the OCR has been to lower the risk of a further decline in short-term inflation expectations.

At the same time the country is experiencing major imbalances in the housing market. In the past year house prices have increased by 15 percent and house-price-to-income ratios in Auckland, at around 9.5, are among the highest in the world. House-price-to-income ratios average around 5.4 for the rest of the country, but are increasing as annual house price inflation outside Auckland and Christchurch is currently running at 20 percent.

The historic surge in net migration in the past three years, the decline in global interest rates, and policy cuts by the Bank have stimulated housing demand. Even though annual building consents for the country as a whole are at an 11-year high, additional supply is needed. This would be facilitated by addressing issues relating to the costs and delays associated with planning approvals, choices in respect of housing densification within urban limits, and the productivity of the building and construction sector that is linked to scale and other factors.

Our concern is that a severe housing correction would pose substantial risks for financial system stability and the broader economy. The banks are heavily exposed to housing, with mortgages making up around 55 percent of their total assets. Household debt, at 163 percent of household disposable income, is at a record level.

We remain vigilant about financial stability risks arising from imbalances in the housing market. High prices and excessive leverage – both in Auckland and elsewhere – highlight the risk that a major price correction could occur. We deployed macro-prudential policy, in the form of loan-to-value ratio limits, to address some of the financial risks posed by the housing market. These measures have reduced credit risks associated with bank mortgage lending, and in doing so have helped to improve the resilience of bank balance sheets.

Striving to be a high-performing central bank

Innovation is one of the Bank's core values and central to what we do. We continue to invest heavily in initiatives that strengthen our management, knowledge and technical capabilities while improving efficiency.

The *Annual Report* outlines the Bank's vision and strategic direction, our core functions, our 10 strategic priorities and the work programmes that stem from them. As well as outlining the environmental conditions experienced during the year and how the Bank responded, the Report also discusses our success measures and whether we met our goals.

Some of the more significant developments during the year are summarised below.

— We released the first of the Series *7 Brighter Money* banknotes into circulation, and ran a nationwide multi-channel public awareness and education campaign to increase awareness of the new notes and their modern security features. The $5 note was named Banknote of the Year in an international banknote design award.

— The architecture of the Bank's financial management systems was finalised and is being implemented. More modern systems will assist in decision-making and reduce operational and market risks by providing market-standard trade valuation, position and collateral management, and enhanced risk and performance reporting.

— Important progress was made with major projects to replace and improve our payments and settlement systems.

— The Macro-Financial and Prudential Supervision departments have worked closely with banks to develop a comprehensive stress-testing framework to gauge the resilience of the banking system to adverse shocks. Considerable work was undertaken on loan-to-value and debt-to-income instruments.

— The Prudential Supervision department has undertaken a major review of bank prudential regulation with industry collaboration, resulting in consultations on an enhanced disclosure framework, as well as more clarity around the policy-making process. It has issued two consultative documents on bank outsourcing; and consulted on potential revisions to the regulatory framework for financial market infrastructure. The department also extended its engagement with boards and senior executives of banks and large insurers.

— The Bank continued to focus on keeping staff well connected, providing growth opportunities, and recognising performance. We have further developed our high-performance framework and continued to build leadership and management competencies through development programmes for managers and emerging leaders.

— We extended our outreach programme with external stakeholders – by participating in more than 100 speaking engagements around the country, expanding our use of digital channels, and identifying opportunities to help stakeholders better understand and connect with the Bank.

All of the Bank's work has been undertaken within the constraints of a tight five-year funding agreement that provides for annual funding increases of around 1 percent a year. This has involved careful expenditure management, several redundancies last year and a major review of the Bank's space needs. We are currently preparing to lease out an additional three floors of our Wellington building.

The Bank is fortunate to have talented and hardworking staff who are deeply committed to obtaining good outcomes for New Zealand in carrying out their broad range of responsibilities. I wish to thank my Bank colleagues, including the senior management team and my fellow Governors on the Governing Committee for their professionalism and dedication in ensuring that the Bank met high standards in fulfilling its extensive responsibilities.

I wish to pay tribute to the Reserve Bank Board. The Board met 10 times during the year and, under the leadership of Dr Rod Carr, provided strong support and advice while also probing and questioning to ensure that the Bank fully met its responsibilities.

Graeme Wheeler
Governor

26 August 2016

BOARD OF DIRECTORS' REPORT FOR THE YEAR ENDED 30 JUNE 2016

The Board is pleased to report on the performance of the Reserve Bank for the year to 30 June 2016.

The Bank plays a central role in our economy. The Bank's responsibility for monetary policy is designed to ensure low and stable rates of inflation over time. Monetary policy operates through short-term interest rates, which in turn influence saving and borrowing behaviour, the exchange rate and the rate of economic growth. The Bank's responsibility for financial system stability operates through prudential supervision, capital requirements and measures aimed at loan quality. The Reserve Bank oversees New Zealand's electronic payments system, and operates the Exchange Settlement Account System (ESAS) and NZClear payments and settlement systems, which support payments and salaries flowing smoothly through the economy. It also issues our banknotes and coins.

These activities reflect responsibilities that are spelled out in the Reserve Bank of New Zealand Act 1989 (Reserve Bank Act). With these responsibilities comes accountability. Given such an extensive reach into the economy, the Bank's policies and activities are quite appropriately subject to public scrutiny.

The Bank's own account of how it performed its functions in the past financial year, and the wide range of accountability mechanisms to which the Bank is subject, are covered elsewhere in this *Annual Report*.

The Board of Directors is specifically tasked by the Reserve Bank Act with keeping the performance of the Bank and the Governor under constant review, and with publishing its annual assessment within the Bank's *Annual Report*. The Minister of Finance's first Letter of Expectations addressed to the Board, received in November 2015, has been used to provide structure for our report this year.

With the Bank's responsibilities also come expectations. Formally, in the case of its primary function – maintaining stability in the general level of prices – expectations are captured contractually in a *Policy Targets Agreement* (PTA) between the Governor and the Minister of Finance. The PTA is further qualified by the requirement under the Reserve Bank Act for the Bank to formulate and implement monetary policy having regard to the efficiency and soundness of the financial system.

The past year has continued to present challenges for the world's central banks, and New Zealand is no exception. Internationally, responses to persistent and exceptional levels of monetary stimulus (low interest rates and easy access to credit) have not been as expected. In many countries measures of economic growth have been slower and consequently interest rates lower for longer than expected a year ago. New Zealand may be an island nation but it is deeply connected to the world's markets for capital, products and services. The performance of the Bank must be assessed in this context, recognising the tools it has as well as the constraints under which it operates in meeting wide-ranging performance objectives. The Board's overall assessment is that the Bank continues to perform its functions to a high standard, is held in high regard by its international peers and contributes to New Zealand's stability and prosperity.

Monitoring the performance of monetary policy with respect to the Policy Targets Agreement

The PTA requires the Bank to maintain a price stability target defined as "keeping future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint."

The PTA recognises that the apparent pinpoint precision of the inflation target belies the challenge of manoeuvring monetary policy through many factors beyond the Bank's control or influence and the need to consider a wider set of implications of its policies. Hence the PTA also recognises circumstances in which pursuing the numerical target may not be achieved for a period of time.

The Bank is operating in an extraordinary global environment. Global economic growth remains significantly below trend, despite unprecedented monetary stimulus. Central banks are faced with the challenges of historically low, and in some cases negative, interest rates. Quantitative easing by central banks is expected to reach record levels in 2016 and is fuelling high asset valuations that are presenting risks to financial stability in many economies.

New Zealand is relatively well placed to cope with this environment, but the future is not without its risks. While tradables sector activity has been dampened by weak global demand and world trade, low prices for commodities such as dairy products, and a strong exchange rate, the New Zealand economy grew by 2.8 percent in the year to March 2016, driven principally by the construction and tourism sectors. Record high net immigration was an important contributor to domestic demand and labour force growth.

CPI outcomes have been below the lower bound of the target, but in every case the projected medium-term inflation outcomes have been consistent with the target on the basis of the information available at the time. The lower CPI inflation results from significant falls in the price of oil, and ongoing weakness in the price of other imports, which, combined with the strength of the New Zealand dollar, have resulted in a sustained period of negative tradable inflation. At the same time, the impact of high net immigration is moderating nominal wage outcomes and reductions in government charges are lowering non-tradable inflation from what it otherwise would have been. With long-term inflation expectations anchored and the output gap estimated to be close to zero, non-tradable inflation has remained close to 2 percent per annum.

During the year the Board regularly monitored the Bank's thinking on the balance of risks and the judgements the Bank made in setting monetary policy and publishing the projections contained in the *Monetary Policy Statement* (MPS). It also monitored market and media reaction to the Bank's announcements.

The Board undertook an *ex post* review of each MPS and Official Cash Rate (OCR) review, with access to all background papers, including the written advice to the Governor from each member of the Bank's Monetary Policy Committee.

Papers were made available to the Board summarising the outcome of the Bank's internal committee discussions, and setting out the Bank's research on the factors that have resulted in measured CPI inflation being below the target range. This research has improved the Bank's and the Board's understanding of the monetary policy implications of low inflation expectations, the recent high levels of immigration, weak global demand, the high exchange rate, and falling import prices for measured inflation in New Zealand. The Board noted that the Bank is incorporating the key aspects of its research into its modelling framework.

At its meetings the Board discussed papers outlining the Bank's thinking on the potential impact of different OCR paths and the trade-offs involved with a potentially faster return to the mid-point of the target band. These discussions have highlighted the risks and uncertainties that the Bank is endeavouring to balance, and the judgement that is required in choosing between a number of policy actions that might be consistent with the PTA. Directors also discussed issues raised in the Bank's recent on-the-record speeches, Bulletin articles and *Analytical Notes* on current monetary policy developments.

On the basis of the information and advice available to the Governor at the time of his decisions, the Board assessed that the four MPSs and the intervening OCR reviews met the requirements laid out in section 15 of the Reserve Bank Act.

Directors were assisted in their quarterly assessments of MPSs by a written commentary by director Professor Quigley.

Assessing the performance of the Bank in promoting the maintenance of a sound and efficient financial system

The Board reviewed the November 2015 and May 2016 *Financial Stability Reports* and the Bank's findings that while the financial system is generally sound, effective and resilient, financial stability risks relating to house prices and household debt have increased, and the dairy sector still faces headwinds.

Directors extensively discussed the housing market and reviewed the Bank's introduction of tighter loan-to-value ratio (LVR) restrictions on investor-related lending from 1 November 2015. The Board noted the Bank's evidence that the LVR restrictions overall had the desired effect of lowering the proportion of highly leveraged lending in bank loan portfolios and hence the level of lending risk. It noted that the restrictions had produced results consistent with the Bank's modelling, although the Bank expected the impact of the measures would diminish over time.

Directors were apprised of the potential need for further macro-prudential intervention, including a debt-to-income-based policy instrument. The Board is being kept informed on the further work required in this regard.

The Board also spent considerable time discussing the global dairy market and the implications of a protracted period of low dairy prices for farm incomes, debt and land prices, as well as for the dairy loan portfolio of the domestic banking system. These discussions covered the Bank's analysis of break-even pricing and stress-testing of bank balance sheets. The Board noted the Bank's encouragement to banks to take a medium-term view of farm viability but a conservative approach to collective provisions (i.e. for loans assessed in pools of similar assets with similar risk characteristics).

The Bank has kept directors informed of other regulatory developments, including increased oversight of financial market infrastructures, the regulatory stocktake, the review of outsourcing policy, and the review of bank capital requirements, as well as the upcoming International Monetary Fund (IMF) Financial Sector Assessment Programme (FSAP) in 2016.

The Board agreed that the November 2015 and May 2016 *Financial Stability Reports* met the requirements contained in section 165A (2)(a) and (b) of the Reserve Bank Act, and met the reporting and accountability requirements of the Memorandum of Understanding on Macro-Prudential Policy and Operating Guidelines [May 2013].

Directors were assisted in their assessment by a written commentary by director Ms Vautier.

In the course of the year, the Board has initiated work to develop a framework to refine and enhance its monitoring of the Bank's responsibility to maintain a sound and efficient financial system.

The Bank explained its outreach programme, which was devoted to the key messages in the FSR to stakeholders who included legal, accounting and general business audiences, analysts, Treasury, and the Financial Markets Authority.

With the Governors present, the Board met three of the chairs and a deputy chair of the four major banks for discussions on two key issues: the governance of New Zealand subsidiaries of the large Australian banks; and regulatory issues that are currently front-of-mind for New Zealand bank boards. The banks discussed risks in the dairy and housing sectors and the impact of LVR limits on balance sheet risks. The banks also discussed the review of the Bank's outsourcing policy and risks associated with possible cyber threats.

Monitoring the Bank's regulatory policy processes

The Board considered a report on the Bank's regulatory stocktake, including the response to submissions on the Bank's public consultation. The stocktake reviewed the effectiveness and compliance costs associated with different regulatory policies. Directors were briefed on the design of a proposed dashboard that would replace banks' off-quarter general disclosure statements and be published on the Reserve Bank's website.

Preparations for the upcoming IMF FSAP were reviewed and the Board looks forward to meeting with the IMF review team later this year.

Directors were informed of the Bank's new six-monthly review of its planned regulatory policy work programme, which forms part of the Bank's commitment to the Minister for transparency in regulation. The present work programme covers outsourcing, the FSAP review, the development of a 'dashboard' approach to quarterly disclosure by banks, bank crisis management, issues relating to the implementation of Open Bank Resolution, reviews of bank capital and liquidity requirements, stress-testing of bank balance sheets, and a review of the insurance prudential supervision regime. In each case the Bank is engaged in ongoing consultation with directly affected organisations. Final policy positions have yet to be reached and in a number of cases other Government agencies will contribute advice before final decisions are reached.

The Board has initiated work on a framework to refine and enhance its monitoring of the Bank's regulatory policy processes.

Monitoring the Bank's relationships

The Board has also developed a framework for meeting the Minister's expectation of monitoring the Bank's relationships. The framework was adopted in June 2016 and enables the Board to increase its consideration of how key Bank relationships are operating in practice.

The key relationships to be monitored are those identified in the Minister's Letter of Expectations – the Minister, the Treasury, regulated entities and other agencies – while acknowledging the importance of other relationships with financial markets, businesses, the media and educators. It was noted that the relationship between the Governor and the Minister is defined in the Reserve Bank Act; where the Minister acts as a principal in that relationship the Board's role as the Minister's agent is limited.

The Board meets with important stakeholders, often on an issues basis, e.g. housing, and with other organisations over lunch and at outreach functions. It also takes account of the Bank's speech programme and a comprehensive review undertaken in 2014 of key stakeholder engagements.

During the year the Board hosted meetings with external parties, including the Financial Markets Authority, the four major banks, Wellington high-tech firms, and Canterbury and Waikato business sector leaders, as well as the Bank's managers.

The Board was briefed by the Governor on the outcome of an investigation by Deloitte relating to a leak of the March OCR release and endorsed the decision taken by the Governor to cease pre-announcement media lock-ups.

The Governor has kept the Board informed of the Bank's six-monthly briefings of Parliamentary caucuses.

Monitoring of operational functions

In addition to the Board's monthly review of key indicators of operational performance, the Board's monitoring includes a six-monthly review of the Bank's Human Resources function. The Board noted that the Bank's annual staff engagement survey showed continuing positive trends, despite substantial organisational change in the previous 12 months.

The Board reviewed the Bank's health and safety policies in the context of the new legislation and advised that these should be reviewed annually and be externally audited.

Directors monitored planning of the arrangements being put in place by the Bank to lease out three more floors of its Wellington building in order to generate income to help meet the Bank's obligations under the Funding Agreement.

Organisational strategy and financial management

The Board provided input to the drafting of the Bank's Strategic Priorities for 2016–2017 and is monitoring progress against the Bank's stated intentions.

The Audit Committee reviewed recent cyber security testing that the Bank had undertaken, one example of a significant and emerging global focus. The Committee also considered the Bank's replacement for ESAS, the evaluation of the possible sale of NZClear, which was ultimately not proceeded with, changes to the treasury system architecture, and the banknote upgrade.

The monthly Chief Executive's Report and Balanced Scorecard provided directors with detailed information on the Bank's risk and financial indicators.

The Board was kept informed of the Bank's progress against its budget during the year. It noted that underspending in the 2015–16 financial year had been anticipated in the first year of the five-year Funding Agreement due to one-off factors, with several project costs being capitalised, affecting future depreciation charges and overall expenditure in future years.

The Board monitored progress on several major projects: the launch and delivery of the Series 7 banknotes; the selection of the provider of a central securities depository as part of the NZClear upgrade; the trade valuation system implementation project; and work on the building occupancy project.

The Board also conducted a self-evaluation in relation to its own performance, consistent with shareholding Ministers' expectations of Crown-owned entities.

On behalf of the Board, we would like to thank the Governors and all the staff of the Bank for their professionalism, commitment and individual contributions during the past year.

On behalf of the Board of Directors:

Rod Carr
Chair
26 August 2016

Keith Taylor
Deputy Chair
26 August 2016

Role

The Reserve Bank's Board of Directors is responsible for keeping the performance of the Bank and of the Governor under constant review across all Bank functions. The Board is a unique governance body in the government sector, having limited decision-making power, but provides advice and monitors the performance of a key agency in the New Zealand economy. Directors bring expertise from a wide range of backgrounds, and apply this to evaluate, on behalf of the Minister of Finance, whether the Bank meets its obligations under the Reserve Bank Act.

The Board has a major role to play in the appointment of the Governor and Deputy Governors, and in ensuring that the Governor and the Bank carry out their mandated functions and powers to a high standard. This includes assessing whether the Governor has met the obligations contained within the PTA.

At least once a year, the Board meets with the Minister of Finance, without executives, to discuss the Bank's performance. The Chair meets with the Minister from time to time as required. The Board's formal review of the Bank's performance is included in the Bank's *Annual Report*.

Membership

The current membership consists of seven non-executive members (details are on page 20) and the Governor as an executive member. The Board annually elects its own Chair, who appoints a Deputy Chair from its number for a one-year term, on advice from fellow Directors. There were no changes to the Board during the year.

Meetings

The Board may meet as often as necessary, but must meet at least six times each financial year. In 2015-16, the Board held 10 meetings, seven of these meetings being in Wellington, and the remainder in Christchurch, Hamilton and Auckland.

With most Board meetings the Board hosts a small lunch with key business, community or government leaders. When meeting outside Wellington, and with one Wellington meeting, the Board also hosts a larger evening function to engage with representatives of many local businesses and organisations.

At these functions, the Governors give a brief off-the-record presentation on the economy consistent with the latest MPS or OCR review, and open the floor to questions. This outreach is a longstanding practice of the Board to ensure visibility of its role among the wider community, and to facilitate directors' understanding of local economic developments and the wider public's understanding of the Bank's policies.

Committees

The Board takes special interest in the Bank's risk management policies and practices. The Board's sole committee is its Audit Committee. This met four times and held a teleconference during the year to review the Bank's financial statements and internal and external audit activity, and reported back to the Board.

Keith Taylor chairs this committee, which includes Kerrin Vautier and Bridget Coates. The Bank seeks the Board's agreement to its recommendation of a dividend to the Government. This recommendation is first reviewed by the Audit Committee.

WHAT WE DO

Governance

The Reserve Bank of New Zealand is the nation's central bank. A Crown agency, the Bank performs functions across the financial sector derived from several pieces of legislation:

- the Reserve Bank of New Zealand Act 1989 (RBNZ Act), which specifies the Reserve Bank's and the Governor's capacity, functions and powers, as well as its monetary policy and banking supervision functions;
- the Insurance (Prudential Supervision) Act 2010 (IPSA), which provides for the Bank's role as prudential supervisor of the insurance sector;
- the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, which confers responsibility on the Bank as a AML/CFT supervisor; and
- the Non-bank Deposit Takers Act 2013 (NBDT Act), which establishes the Bank as prudential regulatory and licensing authority for non-bank deposit takers (NBDTs).

These Acts, and regulations made under these Acts, can be viewed electronically on the New Zealand Legislation website.

Under the RBNZ Act, the Bank exercises its authority through the Governor and subject to the:

- Policy Targets Agreement, a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve (RBNZ Act section 9);
- Bank's funding agreement, a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs (RBNZ Act sections 159–161);
- Memorandum of Understanding with the Minister of Finance in respect of macro-prudential responsibilities.

The Bank also receives an annual letter of expectations from the Minister of Finance setting out expectations of engagement with the Minister through the year.

The RBNZ Act confers considerable day-to-day operational autonomy on 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 formal roles. The Bank publishes a range of accountability documents including an *Annual Report, Statement of Intent* (SOI) and *Financial Stability Report* (FSR). The Bank's activities are scrutinised by Parliament's Finance and Expenditure Committee. Typically, hearings are held covering the quarterly *Monetary Policy Statements* (MPSs), the six-monthly FSRs and the Bank's annual financial performance.

The Minister

The Minister of Finance has the following functions and powers under the RBNZ Act, IPSA and the NBDT Act:

- appointing a Governor on the recommendation of the Board
- advising the Governor-General to remove a Governor, either on the recommendation of the Board or because statutory criteria for removal are made out;
- agreeing with the Governor the *Policy Targets Agreement and any variation to it;*
- agreeing with the Governor a five-year funding agreement and any variations to it; and
- various powers under Part 5 of the RBNZ Act, such as consent to the deregistration of, or a direction to a registered bank, and advising the Governor-General to place a registered Bank into statutory management.

Subject to procedures intended to ensure transparency, the Minister of Finance can also:

- put in place alternative monetary policy targets;
- direct the Bank to intervene in the foreign exchange market or dealing in foreign exchange within fixed exchange rate bands; and
- direct the Bank to have regard to government policies relating to the Bank's prudential functions under the RBNZ Act, IPSA and the NBDT Act.

Board of Directors

Section 53 of the RBNZ Act specifies the duties of the Board, among other things, as being to:

a. keep under constant review the performance of the Bank in carrying out —
    i. its primary function [monetary policy]; and
    ii. its functions relating to promoting the maintenance of a sound and efficient financial system; and
    iii. its other functions under this Act or any other enactment:
b. keep under constant review the performance of the Governor in discharging the responsibilities of that office:
c. keep under constant review the performance of the Governor in ensuring that the Bank achieves the policy targets agreed to with the Minister [the *Policy Targets Agreement*]:
d. determine whether policy statements made pursuant to section 15 [MPSs] are consistent with the Bank's primary function and the policy targets agreed to with the Minister:
e. keep under constant review the use of the Bank's resources.

Section 53 also specifies that the Board may provide advice to the Governor on any matter relating to the performance of the Bank's functions and the exercise of its powers.

In November 2015, the Board received a letter of expectations from the Minister for the first time, setting out the Minister's expectations of the Board's role.

The Board's Audit Committee reviews the Bank's financial statements and internal and external audit activities. Each year, the Board writes an assessment of the Bank's and the Governor's performance, which is provided as advice to the Minister of Finance and made public later in the Bank's *Annual Report*.

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 the Board believes that the Governor's performance or conduct has been inadequate or inappropriate. The Board appoints the Deputy Governors on the Governor's recommendation.

The Board typically meets nine times a year, with provision for additional meetings. In the 2015–16 year the Board had seven non-executive directors (see details on page 20). Board members are appointed for five-year terms and are eligible for reappointment.

Conflicts of interest

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank personnel, including Governors and directors. The policy requires that all personnel act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that personnel must avoid situations where their integrity might be questioned, and that their best protection is full disclosure of any potential conflicts.

Governors and departmental managers are required to give the Bank quarterly updates about their personal interests so that any potential conflict of interest is recorded. If any other personnel have a particular concern, they can also record their interests in the same way.

Personnel must not be involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. Bank staff cannot own or control shares in entities (or their parent companies) that the Reserve Bank regulates, or use inside information to benefit when depositing or withdrawing funds from financial institutions, or purchasing or selling bonds or shares, or when changing between fixed and floating rates for a loan. It is unacceptable to use inside information whether to avoid losses or to make gains.

Under sections 56 and 61 of the Reserve Bank Act, the Minister must have regard to the likelihood of conflict of interest in appointing a director to the Board, and directors must disclose their interests in any contract with the Bank. On appointment to the Board, directors sign a declaration that they will observe confidentiality in relation to the affairs of the Bank and will not make use of any confidential information they may acquire regarding Bank operations. They also disclose any other directorships and significant interests to enable the Board Chair and the Governor to manage any conflicts. These interests are updated on a regular basis.

Financial disclosure of the Governor

As the Bank has extensive responsibilities, and in the interests of promoting sound organisational governance and transparency, there is merit in reporting the Governor's financial disclosure. This is reported in each *Annual Report* and any changes made during the previous 12 months are highlighted.

Reserve Bank Governor financial disclosure as at 10 August 2016[1]

1. Marketable securities, real estate, rights, proprietary and other interests, business and other assets owned during 2015-16 and valued above NZD10,000.

   Real property[2]:

   — Family home, Wellington[3]

   — Holiday home, Coromandel Peninsula[3]

   — Section, Coromandel Peninsula[3]

   Deposits and marketable securities:

   — Deposit at Bank-Fund Staff Federal Credit Union (Washington DC)

   — Deposit at Westpac Bank

   — KiwiSaver employee and employer contribution

2. Sources of non-Bank income over NZD5000 during 2015-16 (other than from listed investments)

   — World Bank Group Pension

3. Liabilities over NZD50,000 owed during 2015-16[2]

   — None

4. Trading in foreign currency or in financial instruments

   — None

5. Positions held outside RBNZ

   — None.

1. All assets and liabilities are jointly owned with spouse.
2. Disclosure has changed from previous year.
3. Purchased prior to joining the Reserve Bank.

Financial management overview

The Bank receives no direct funding through the Parliamentary appropriation 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. Currency in circulation is a liability on which no interest expense is incurred. The funds received from registered banks when currency is issued to them are invested and earn interest income, which is known as seigniorage[4].

The nature and extent of the Bank's principal activities that affect its balance sheet are described in the financial statements on page 53.

Foreign reserves management, New Zealand dollar liquidity management, and currency operations materially affect the size and structure of the Bank's balance sheet. The Bank's financial performance is also influenced by: changes in both foreign exchange rates and interest rates; the extent of available funds in the form of equity; and currency in circulation. The Bank's reported net income will fluctuate from year to year, primarily because the Bank's unhedged foreign currency reserves will generate profits and losses as foreign exchange rates change.

Under the Reserve Bank Act, the Minister of Finance and the Governor shall enter into a five-year funding agreement which may specify the amount of the Bank's income that may be used to meet operating expenses in each of those years. Capital expenditure is funded by the Bank, with depreciation of fixed assets included in annual operating expenses.

In 2015, the Governor and the Minister signed a funding agreement for the five years from 1 July 2015 to 30 June 2020.

Annual distributions paid by the Bank

Under the Reserve Bank Act, the Bank must publish in its *SOI* the principles upon which its annual dividend is recommended to the Minister. The following principles have applied:

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 its Audit Committee and any other relevant matters.

4. No interest is paid on currency in circulation. When notes and coins are issued to a registered bank, the registered bank will pay for the currency that is issued by paying funds to the Reserve Bank from that bank's exchange settlement account with the Reserve Bank. The Reserve Bank invests the proceeds it receives, and the earnings on those investments are known as 'seigniorage'.

MANAGEMENT STRUCTURE

Governor
Graeme Wheeler

Assistant Governor Head of Economics
Dr John McDermott

Deputy Governor Head of Financial Stability
Grant Spencer

Deputy Governor Head of Operations
Geoff Bascand

Head of Prudential Supervision
Toby Fiennes

Head of Risk Assessment & Assurance
Steve Gordon*

Head of Macro-Financial Stability
Bernard Hodgetts

Head of Communications Board Secretary
Mike Hannah

Head of Financial Markets
Mark Perry

Chief Information Officer
Tanya Harris**

Head of Currency, Property & Security
Steve Gordon,
Brian Hayr***

Head of Human Resources
Lindsay Jenkin

Chief Financial Officer
Mike Wolyncewicz

* Head of Risk Assessment & Assurance
Position currently vacant, following Steve Gordon's appointment as Head of Currency, Property & Security on 29 March 2016.

** To 30 June 2016

*** Steve Gordon replaced Brian Hayr as Head of Currency, Property & Security on 29 March 2016.

OUR BOARD

Dr Rod Carr

- Chair, Reserve Bank of New Zealand Board of Directors
- Vice-Chancellor, University of Canterbury

Non-Executive

Corporate interests:

- Joint Research Consultants (NZ) Limited/Director
- Canterprise Limited/Director
- Lyttelton Port Company Limited/Director
- Waingawa Forest Corporation Limited/Director

Other interests:

- Canterbury Employers' Chamber of Commerce/Director
- Christchurch Earthquake Appeal Trust/Trustee
- University of Canterbury Trust Funds/Vice-Chancellor
- UC International College/Director
- University of Canterbury Foundation/Trustee
- Quake Centre for Research Excellence/Member

First appointed 16 July 2012 – current term expires 15 July 2017

Keith Taylor

- Deputy Chair, Reserve Bank of New Zealand Board of Directors — from 19 June 2014
- Chair, Reserve Bank of New Zealand Board of Directors' Audit Committee
- Company director

Non-Executive

Corporate interests:

- Butland Management Services Limited/Director
- Gough Gough & Hamer Limited/Chair
- Port Marlborough Limited/Director
- Auckland Council Investments Limited/Chair

Other interests:

- Annuitas Management Limited/Chair
- Earthquake Commission/Deputy Chair
- Government Superannuation Fund Authority/Chair
- Reserve Bank Superannuation Fund/Trustee
- Southern Cross Medical Care Society/Director
- Southern Cross Health Trust/Trustee (parent of Southern Cross Benefits Limited)

First appointed 1 July 2009 – current term expires 30 June 2019

Professor Neil Quigley

- Vice-Chancellor, University of Waikato

Non-Executive

Other interests:

- New Zealand Qualifications Authority/Board Member

First appointed 1 February 2010 – current term expires 31 January 2020

Kerrin Vautier CMG

- Consulting research economist

Non-Executive

Other interests:

- High Court/Lay member under the Commerce Act 1986

First appointed 9 February 2010 – current term expires 8 February 2020

Jonathan Ross

- Barrister and solicitor

Non-Executive

Corporate interests:

- Marlborough Lines Limited/Director

Other interests:

- Panel of Recognized International Market Experts in Finance (The Hague)/Panel of experts' member
- Rhodes Scholarships for New Zealand/Director

First appointed 12 August 2013 – term expires 11 August 2018

Bridget Coates

- Company director

Non-Executive

Corporate interests:

- White Cloud Dairy Innovation Limited/Chair and CEO

Other interests:

- Fahrenheit Partners New Zealand Limited/Director
- 212 Equity LLC (United States private equity investment)/Director
- Arc-Angels (angel investment network)/Chair
- BRAC USA (global non-profit)/Director
- University of Auckland Business School Advisory Board/Board member

First appointed 1 October 2013 – term expires 30 September 2018

Tania Simpson

- Company director

Non-Executive

Corporate interests:

- AgResearch Limited/Director
- Tainui Group Holdings Limited/Director
- Kowhai Consulting Limited/Director

Other interests:

- Global Women/Board member
- King Tuheitia's Council/Member
- Radio Maniapoto/Trustee
- Tui Trust/Trustee
- Waitangi Tribunal/Member

First appointed 16 June 2014 – term expires 15 June 2019

Graeme Wheeler

- Governor

Executive

First appointed 26 September 2012

Mike Hannah

- Board secretary

Secretariat

VISION & VALUES

Vision

The Reserve Bank's vision is to promote a sound and dynamic monetary and financial system.

Values

It endeavours to achieve this vision by being a high-performing small central bank, with values of:

Integrity

— Being professional and exercising sound judgement

Innovation

— Actively improving what we do

Inclusion

— Working together for a more effective Bank.

Outcomes

The Bank contributes to the Government's goal of improving New Zealand's economic performance by targeting three outcomes.

These are 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.

Functions

To achieve these outcomes, the Bank's functions cover:

— monetary policy formulation;

— financial market operations;

— macro-financial stability;

— prudential supervision;

— settlement services; and

— currency operations.

These functions, the links between them through the outcomes targeted, and the measures used to evaluate performance are shown in the following pages.

RESERVE BANK GOAL AND OUTCOMES 2015-16

Goal

Improved economic performance.

Outcomes

— Price stability maintained
— Sound and efficient financial system maintained
— Currency needs of the public are met.

Functions

Monetary policy formulation

Stability in the general level of prices.

Success measures

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

Financial market operations

— Adequate banking system liquidity
— Short-term interest rates consistent with monetary policy
— Confidence in the efficient functioning of New Zealand financial markets
— Foreign reserves available for efficient foreign exchange intervention and crisis management.

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.
— Over the medium term, domestic market operations generate a positive return.
— Foreign reserves are maintained at target levels, with liquidity and credit standards met throughout.
— The Foreign Reserves Management portfolio yields a net return on assets that meets or exceeds the benchmark portfolio.
— The foreign exchange open position is managed such that:
  a. the bulk of active foreign exchange purchases (sales) are undertaken around peaks (troughs) in the exchange rate cycle; and
  b. the net return on the non-core open foreign exchange position is positive over the cycle.

Macro-financial stability

A sound and efficient financial system that supports the functioning of the economy.

Financial stability, promoted by:

- Increased resilience of the domestic financial system during periods of extreme credit growth and rising leverage or abundant liquidity; and
- Dampening of excessive growth in credit and asset prices.

Success measures

- Significant risks to domestic financial systems 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.
- An assessment of the soundness and efficiency of the financial system is published twice yearly in the *Financial Stability Report*, including the reasons for, and the impact of, any use by the Bank of macro-prudential policy instruments.
- Information on the risk assessment framework, including the macro-prudential indicators that are used to guide policy settings, is published in a manner that assists the assessment of financial stability.
- Statistics are collected 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 Efficient Statistics System.

Prudential supervision

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

Success measures

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

Settlement services

An efficient, reliable and secure payments system that supports the smooth functioning of the economy.

Success measures

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

Currency operations

Legal tender that meets the currency needs of the public.

Success measures

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

STRATEGIC PRIORITIES AND OUTCOMES

1. Continuing to strengthen the Bank's performance

1

Leading change and business improvement

Priority

The new five-year funding agreement required the Bank to find substantial efficiency savings. A number of staffing and business process efficiencies were implemented this year, and further savings will be made in the remaining years of the funding agreement. All business areas were reviewed thoroughly. A change management programme was adopted with a focus on working adaptively. Staff were engaged in seeking continual improvement in business processes.

Outcome

The Bank continues to work towards building a high-performance workplace, maintaining a focus on improving efficiency and business results. Financial outcomes and efficiency initiatives have been reviewed regularly. A building occupancy programme directed at enhancing our utilisation of floor space, strengthening collaboration between colleagues and raising revenue from tenanting additional floors has been instituted and will be implemented in 2016–17. Business transformation is being delivered through substantial investment projects in treasury and payment systems.

2

Continuing to improve performance culture

Priority

The Bank's senior management places considerable emphasis on and resources behind developing managers' leadership capabilities and performance. Managers will use the Bank's competency framework, and performance and development process, to lead and develop staff and connect staff objectives and team visions to the Bank's aspirational goal of being the Best Small Central Bank. Remuneration and performance links will continue to be strengthened and the annual staff engagement survey will help to shape the Bank's approach to being a high-performing workplace. The Bank will develop a consistent framework to measure performance benchmarks for business plans, so that senior management can improve the way they monitor and manage resources.

Outcome

After a period of organisational change, the Bank further engaged with staff and managers in identifying and promoting continual improvement initiatives that would help to transform the business to be more cost-effective and innovative. Enhancements to the process for discussions on forecasting and to some IT practices were among the results. The emphasis on staff engagement, innovation, leadership and staff development had a positive impact on the level of staff engagement. The third annual staff engagement survey showed that the Bank's overall engagement index was stable to slightly improving, in a year in which the Bank restructured and downsized. The survey provided management with further insights into what keeps staff engaged and an action plan was developed with staff, focused on keeping staff well connected, providing growth opportunities, and recognising performance and contribution. The Bank implemented a high-performance framework that provides managers and staff with more guidance on desired results and behaviours. The framework has been well-received and will continue to advance the Bank's performance culture.

3

Engaging and communicating with stakeholders

Priority

The Bank will extend its engagement, accessibility, relevance and dialogue with stakeholders to enhance mutual understanding. Its approach will be guided by feedback, especially its external stakeholder engagement surveys. The Bank will communicate broadly on its policies, its reasoning, and the impact of its activities through its proactive on- and off-the-record speech programme, briefings, media engagements and online channels. The production and release of a new series of banknotes will be supported by clear, effective and proactive communication.

Outcome

The Bank continued its extensive outreach programme while monitoring stakeholder relationships and opportunities to help stakeholders better understand and connect with the Bank. As well as a nationwide speech programme of 118 engagements, the Bank extended its media and stakeholder briefings, and publications.

The wide-reaching public awareness campaign to support the release of the Series 7 *Brighter Money* banknotes was well received through a wide range of traditional, digital and social media channels.

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

4

Exploring macro-prudential policy options to manage the financial stability implications of housing cycles.

Priority

The Bank will explore macro-prudential policy options for managing the financial stability implications of housing market cycles. It will continue to investigate the interactions between monetary policy, prudential policy and the objectives of price and financial stability. The Macro-Financial department will lead work through the Macro-Financial Committee and Governing Committee, with support from the Economics and Prudential Supervision departments.

Outcome

The Bank implemented new macro-prudential restrictions on lending to Auckland property investors in November 2015, requiring most to have deposits of at least 30 percent. This requirement was implemented in response to financial stability risks stemming from rising imbalances in the Auckland housing market. Housing market pressures subsequently re-emerged in Auckland and spread to the rest of the country, prompting the Bank to consider further tightening these restrictions. Work is under way to understand better the nature of the risks from high debt-to-income lending, and to consider the implications of any policy action to address these risks.

Analysis based on new data on the debt-to-income ratios of new lending was published in the November 2015 FSR.

5

Updating the prudential policy and supervision frameworks

Priority

The Bank will implement changes arising from the regulatory stocktake and will review other key policy settings. These will include banks' outsourcing requirements, and capital and liquidity settings in light of the revised Basel standards.

Outcome

In December 2015 the Bank announced the recommendations of its regulatory stocktake of prudential regulations for banks and NBDTs, following a series of workshops with banks and the release of a public consultation paper. One of the recommendations from the regulatory stocktake was to carry out further work on the dashboard model for quarterly disclosure. Under this model, information drawn from banks' public and private reporting would be published on the Bank's website. We consider that the dashboard could support market discipline by enhancing the usefulness and comparability of banks' disclosures. We also concluded that the *Banking Supervision Handbook* should be reorganised, and that various measures should be adopted to enhance the transparency of the Bank's policy-making process — for example, by publishing a document on the Bank's policy-making process. Work is under way on the implementation of these measures, and is expected to be completed within the next 12–18 months.

The Bank has initiated reviews of its liquidity and capital adequacy policy frameworks. These reviews are being undertaken in the context of evolving international standards, which are set out by the Basel Committee on Banking Supervision. The nature and timing of these international developments will have a bearing on any changes to the Bank's capital framework. The liquidity policy review will focus on whether it would be appropriate to harmonise the Bank's existing policy framework with the finalised international standards, and assess the merits of extending liquidity disclosure requirements to overseas-incorporated banks. The Bank will consult on any proposed changes to its frameworks arising from these reviews.

6

Developing a comprehensive stress-testing framework for the New Zealand banking system

Priority

The Macro-Financial and Prudential Supervision departments are developing a comprehensive stress-testing framework to gauge the resilience of the banking system to adverse shocks. The Reserve Bank will work with the banks to identify and implement improvements to the banks' technical stress-testing frameworks and processes. In addition, the Bank will ensure that stress tests become the centrepiece of banks' internal risk management and are regularly scrutinised by senior management and boards.

Outcome

The Bank worked with the banking system during the year to improve stress-testing practices. A discussion document was released in May, setting out key principles to which banks are expected to adhere as part of their stress-testing frameworks. The Bank also completed two stress tests of the banking system in 2015. The five largest dairy lenders were asked to complete stress tests of their dairy exposures in response to cash-flow pressure emerging in that sector. The results of this exercise were published in a *Bulletin* article in March 2016. In addition, in conjunction with the Australian Prudential Regulation Authority, we supplied a scenario to the four largest New Zealand banks to use in their internal stress-testing. We analysed the results of this exercise and provided feedback to banks. The results of this exercise were published in the May 2016 FSR.

3. Improving infrastructure and reducing enterprise risk

7

Implementing the payments system review

Priority

The Bank will select a replacement for the Exchange Settlement Account System (ESAS)/Real Time Gross Settlement (RTGS) technology system and begin implementation. The Bank will decide whether to continue to provide securities settlement (NZClear) services. If the decision is made to exit the business, the Bank will ensure a smooth transition to an alternative provider, and will reshape the way it provides remaining services. If the Bank decides to continue providing securities settlement services, it will begin the selection and implementation of a replacement securities system.

Outcome

Significant progress was made on the RTGS and infrastructure work streams to develop a replacement for ESAS and replacement infrastructure.

In March 2016 the Bank decided to retain the NZClear business. Following an earlier strategic review, the Bank sought interest from potential operators of securities settlement services but concluded the search without attracting suitable bids that met the Bank's service requirements and commercial terms. The Bank will invest in a new platform to provide this service. The Bank is advanced in its evaluation of a potential solution and members will be consulted before a system is procured.

8

Finalising and implementing the roadmap and architecture for the Bank's financial management

Priority

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 needs to update key functionality.

Outcome

In early 2016 the Bank selected Numerix as the business partner to modernise the Treasury systems. The Numerix system is regarded as providing best-of-breed financial markets valuation methodology and risk management instruments. Phase one of the modernisation programme is under way and will involve the implementation of a best-practice market valuation methodology and industry-leading cross-asset analytic functionality. Phase one will deliver integration with the Bank's existing back-office accounting and settlement systems. Phase two will provide enhanced position, performance and collateral management and the addition of a modern user interface for risk management. Phase two is currently in the business requirement specification phase and is scheduled for delivery in 2017.

9

Delivering New Zealand's new banknotes

Priority

The release of the Series 7 *Brighter Money* banknotes was scheduled for the end of 2015 and in 2016. The successful release will require continued extensive interactions with the Canadian Bank Note Company and increased engagement with the public, the financial services industry and other key stakeholders.

Outcome

The $5 and $10 banknotes were released in October 2015, with the $20, $50 and $100 banknotes released in May 2016. A public awareness and education campaign accompanied each release utilising print, radio, social and online media. This informed New Zealanders about the release of the Series 7 *Brighter Money* banknotes and the overt security features incorporated within the note designs.

The banknote-handling industry was consulted in advance of the release of each denomination to ensure that it was adequately prepared for the release. This consultation included hosting industry stakeholder meetings as well as supporting and overseeing extensive equipment calibration, testing and deployment activities.

The *Brighter Money* banknotes will continue to be issued as Series 6 banknotes are withdrawn from circulation.

10

Developing a plan for future custody and distribution arrangements for currency

Priority

The Bank will review 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 and identify options for the custody and distribution of currency. The Bank will consult and collaborate with key stakeholders during 2015–16 to ensure that the review's recommendations are understood and supported.

Outcome

An extensive review was conducted and options were identified. Key stakeholder consultation was rescheduled to allow for a dedicated focus on the *Brighter Money* banknotes release during 2015–16. The Bank will consult and collaborate with stakeholders during 2016–17 to ensure that the review's recommendations are understood and supported.

The year in review

OUR ENVIRONMENT

The New Zealand economy grew by 2.8 percent in the year to March 2016.

Growth was concentrated in construction and the services sector, which benefitted from strong tourism. Net immigration, which reached a new record high, was an important contributor to domestic demand and growth in the labour force. Tradables sector activity continued to be dampened by weak global demand and world trade, low prices for commodities such as dairy products, and a strong exchange rate.

Global growth remained moderate despite very stimulatory monetary policy internationally.

Central banks in most of the developed economies had policy interest rates close to zero, and many major central banks relied on unconventional measures to support demand. This has seen long-term interest rates falling to record lows. At the end of June 2016, Japan, Germany, Switzerland, Denmark and the Netherlands, amongst others, were all experiencing negative 10-year government bond rates.

Slowing growth in China fuelled concerns about the global outlook. Financial risks in China, built up over many years, were highlighted in August 2015 when the Chinese sharemarket collapsed by 35 percent. The Chinese authorities implemented a range of measures to stabilise the sharemarket. Nonetheless, there were further abrupt declines in share prices in early 2016, which significantly destabilised global sharemarkets.

In the United States, where economic activity had been improving, the Federal Reserve was expected to raise policy rates for the first time in six years. In undertook only one interest rate increase, in December 2015, and forestalled further increases. In Japan the monetary authorities introduced negative policy rates in February 2016, while in Europe the European Central Bank introduced a broad package of stimulatory measures in March 2016.

Concerns about the world outlook and excess supply in specific commodity markets saw global commodity prices decline significantly in 2015.

Oil prices reached their lowest levels since 2003, sinking from over USD100 per barrel in mid-2014 to just USD25 per barrel. Dairy prices also declined significantly with dairy production increasing in most of the world's dairy-producing regions. Since February 2016, some commodity prices have recovered modestly.

New Zealand financial markets have responded to these global trends.

New Zealand's relatively sound economic activity levels, stable political environment, and yields proved attractive to international capital. Consequently, the New Zealand dollar has proved resilient in the face of global volatility, with the trade weighted index about 6 percent higher at the end of June 2016 compared to a year earlier. This has occurred despite the Bank reducing the Official Cash Rate from 3.5 percent to 2.25 percent during the 2015-16 financial year. New Zealand's relatively higher yields proved attractive, and 10-year government bond yields fell from over 3.5 percent in June 2015 to a record low of 2.4 percent. Despite periods of heightened global volatility, including in June, after the United Kingdom referendum vote to end membership of the European Union, domestic capital markets operated in an orderly fashion.

Financial stability risks increased due housing market imbalances and weak dairy sector cash flows.

The low global interest rate environment, very strong rates of inward migration and tight supply constraints have contributed to continued house price pressures, particularly in Auckland. Nationwide house price inflation strengthened through 2015 and there was a broadening in house price pressures to most regions across New Zealand. A subsequent correction in the housing market could cause significant loan defaults and risk a severe credit contraction. This risk has been accentuated by a rising share of lending to investors and lending at high debt-to-income ratios.

Lower dairy prices have generated difficult challenges for New Zealand dairy farmers and associated industries. With dairy prices low, many farms have faced cash losses and have been heavily reliant on working capital from banks. The dairy industry is highly indebted, accounting for around 10 percent of bank lending, and levels of problem loans to the sector have begun to rise due to cashflow weakness.

In the face of these challenges, the New Zealand banking system remains sound and well capitalised.

Capital and liquidity buffers for banks are in excess of minimum requirements and stress tests of the banking system suggest that banks will remain solvent in the event of a severe macroeconomic downturn, albeit with a tightening in the supply of credit. Bank capital ratios increased and were comfortably above regulatory requirements. Bank profitability remained strong, although reduced margins and increased provisions for dairy loans affected some banks. Bank lending grew moderately and lending growth was higher than deposit growth.

To mitigate risks to financial stability from an overheated housing market, the Bank adjusted high loan-to-value (LVR) residential mortgage lending speed limits from 1 November 2015. Banks complied with the 10 percent high-LVR residential speed limit that applied prior to November and the new speed limits throughout the remainder of the year.

The non-bank and insurance sectors remain stable and New Zealand's financial market infrastructures have continued to operate effectively during the year with no disruptions to the processing of transactions.

As of 30 June 2016 there were 31 entities licensed under the NBDT Act 2013. This sector remained stable during the year, with no cancellations or new issues of NBDT licences. None of the regulatory compliance or prudential matters relating to the NBDT sector triggered enforcement action. Meanwhile, all NBDTs have been preparing to comply with the Financial Markets Conduct Act 2013.

The Bank continues to actively supervise licensed insurers. An emphasis has been placed on reinforcing insurers' self-discipline to meet the purposes set out in IPSA. There are indications that the insurance sector's overall solvency and risk governance has strengthened since the conclusion of full licensing in 2013. Competition, distribution channels and settlement of Canterbury earthquake claims are the key areas of focus for general insurers. Challenges around replacement business, adviser remuneration and a low-interest-rate environment dominate our discussions with life insurers.

New Zealand's currency needs continue to be met as the demand for cash increases.

The Bank meets the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand banknotes and coins, as well as maintaining the quality, and verifying the authenticity, of currency in circulation. The Bank released the new Series 7 *Brighter Money* banknotes into circulation during the year. Cash remains an important means of undertaking transactions in New Zealand, and continues to grow at a rate in excess of nominal GDP. The value of currency in circulation grew by 7.2 percent to $5.63 billion in the year to 30 June 2016. In the 10 years to June 2016, currency in the hands of the public rose by 76.2 percent.

MONETARY POLICY FORMULATION

The objective of the monetary policy formulation function is:

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 inflation outcomes between 1 and 3 percent on average over the medium term, with a focus on keeping future average inflation near the 2 percent target midpoint"*. It also requires that, *"In pursuing its price stability objective, the Bank shall ... seek to avoid unnecessary instability in output, interest rates and the exchange rate"*.

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcome

Stability in the general level of prices.

Initiatives and strategies

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

Our performance would be measured by:

Success measures

— Reserve Bank forecasts of annual CPI inflation should be comfortably within the target range in the second half of the forecast horizon, and near the 2 percent target midpoint.

— Measures of underlying inflation should generally remain within the target range.

— Unnecessary instability in output, interest rates and the exchange rate should be avoided.

— MPSs are informative and accurately assess the Bank's performance in meeting the objectives of the *Policy Targets Agreement*

What we did — success measures

The Bank's quarterly MPS is the key accountability document for our monetary policy performance, as required by the RBNZ Act. The Bank's assessment of economic conditions and the level of inflationary pressures, and the rationale for OCR decisions, are explained in the MPS.

Headline CPI inflation was 0.4 percent in the year to June 2016. Declines in international oil prices contributed to a large decline in domestic fuel prices. The elevated exchange rate and low global inflation also dampened tradables inflation.

Non-tradables inflation weakened during 2015 despite economic growth being around average and the unemployment rate trending lower. In part, the fall in non-tradables inflation was due to temporary factors. However, survey measures of inflation expectations fell, with short-term inflation expectations falling below the 2 percent target midpoint. The decline in inflation expectations contributed to a slowing in wage inflation and non-tradables inflation. Nevertheless, long-term inflation expectations remain well-anchored around the target mid-point.

In response to continued global uncertainty, falling commodity prices, the elevated exchange rate and weak inflationary pressures, the Bank moved from a neutral policy stance to an easing stance in the June 2015 MPS. The Bank reduced the OCR by 125 basis points from the start of 2015 and this reduction contributed to declines in floating and fixed mortgage rates. In June 2016 the Bank maintained the OCR at 2.25 percent, but signalled that it was likely to lower the OCR further.

The June MPS projects CPI inflation to return to the target range in late 2016, and to reach the 2 percent midpoint by 2018. The elevated exchange rate is expected to continue to depress tradables inflation, while low interest rates will support economic growth and contribute to an increase in non-tradables inflation in the medium term.

What we did — initiatives and strategies

The Bank conducted research on a range of topics and progressed initiatives to support monetary policy formulation.

We devoted considerable attention to enhancing our understanding of price and wage-setting behaviours by firms. The Bank developed new tools for understanding inflation expectations and labour market capacity. Our findings, which supported decision-makers in their deliberations on and communication of monetary policy, were disseminated in research papers, speeches and the *MPS*.

We continued our research into the interaction between monetary policy and macro-prudential policies. The Bank's research programme also focused on open economy macroeconomics, which examined issues related to the exchange rate, commodity prices, migration and interest rates.

The Bank changed the MPS publication schedule — which takes effect from August 2016 — to better align with the publication of key economic data. The Bank communicated the new release schedule in August 2015 to give the financial market plenty of time to adjust to this change.

The Bank continued to publish a range of on-the-record speeches relating to monetary policy. Bank research staff presented their research at conferences in New Zealand and overseas, and the Bank hosted presentations by visiting international researchers. In December 2015, the Bank hosted workshops on macroeconomic and macro-econometric modelling.

Chart 1
Consumer price inflation
Annual % change, excluding GST

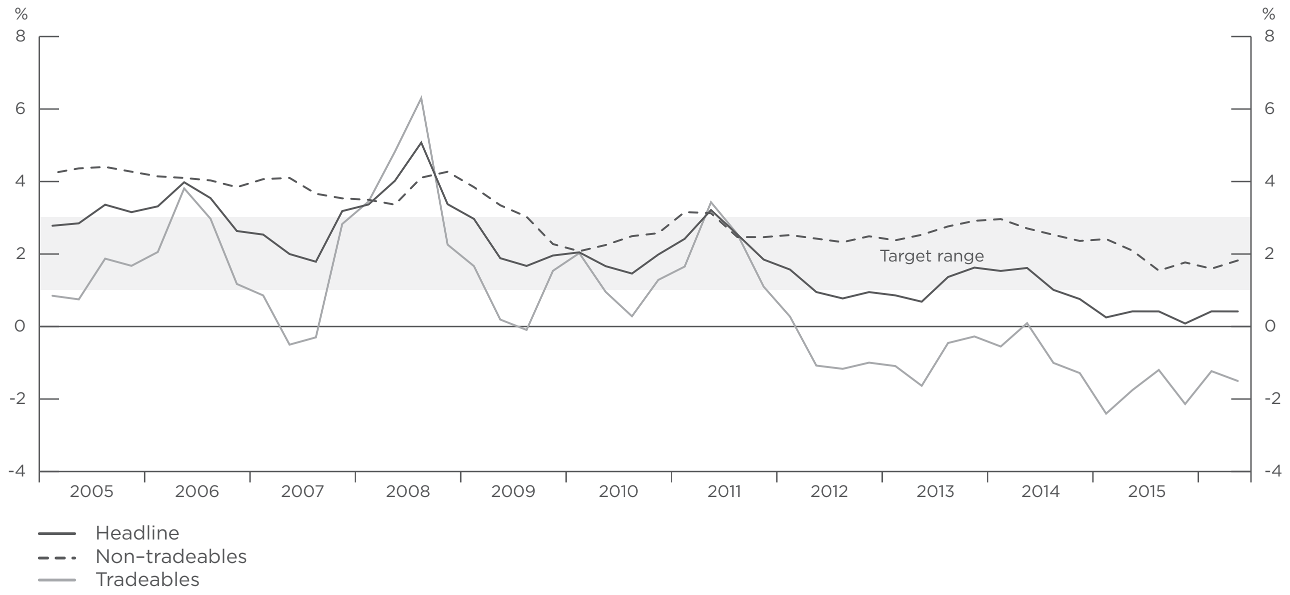
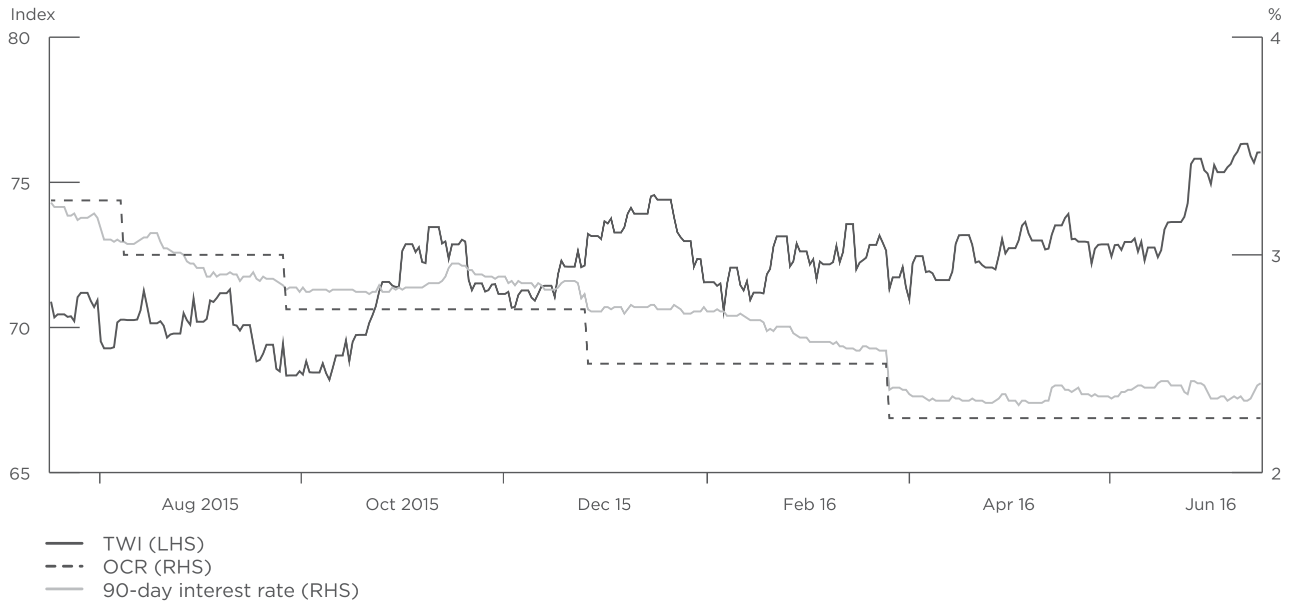


Chart 2
OCR, 90-day rate, TWI



FINANCIAL MARKET OPERATIONS

The objectives of the financial markets function are:

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.

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcomes

- Adequate banking system liquidity.
- Short-term interest rates consistent with monetary policy.
- Confidence in the efficient functioning of New Zealand's financial markets.
- Foreign reserves available for efficient foreign exchange intervention and crisis management.

Initiatives and strategies

- Supporting two key policy functions, foreign reserves management (including currency intervention) and the implementation of monetary policy (liquidity management), treasury system requirements have evolved significantly since the global financial crisis, and the Bank is required to update key functionality gaps.
- Finalising and implementing an agreed Treasury Systems (Roadmap) Strategy to provide market-standard trade valuation, position and collateral management, alongside enhanced risk and performance reporting, will aid effective decision-making and reduce key operational and market risks.
- Performance improvements in financial markets research will be achieved through an expanded and refocused market intelligence function (with increased emphasis on offshore New Zealand dollar [NZD] activity), adding research capabilities in international markets, and increasing connectivity and policy collaboration between wider Bank policy teams.
- Develop and implement further financial tools and instruments to improve the management of the financial risks to which the Bank is exposed, with specific consideration of whether to set up a stand-alone collateral management desk.

Our performance would be measured by:

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) are undertaken around peaks (troughs) in the exchange rate cycle; and
  b. the net return on the non-core open foreign exchange position is positive over the cycle.

What we did — success measures

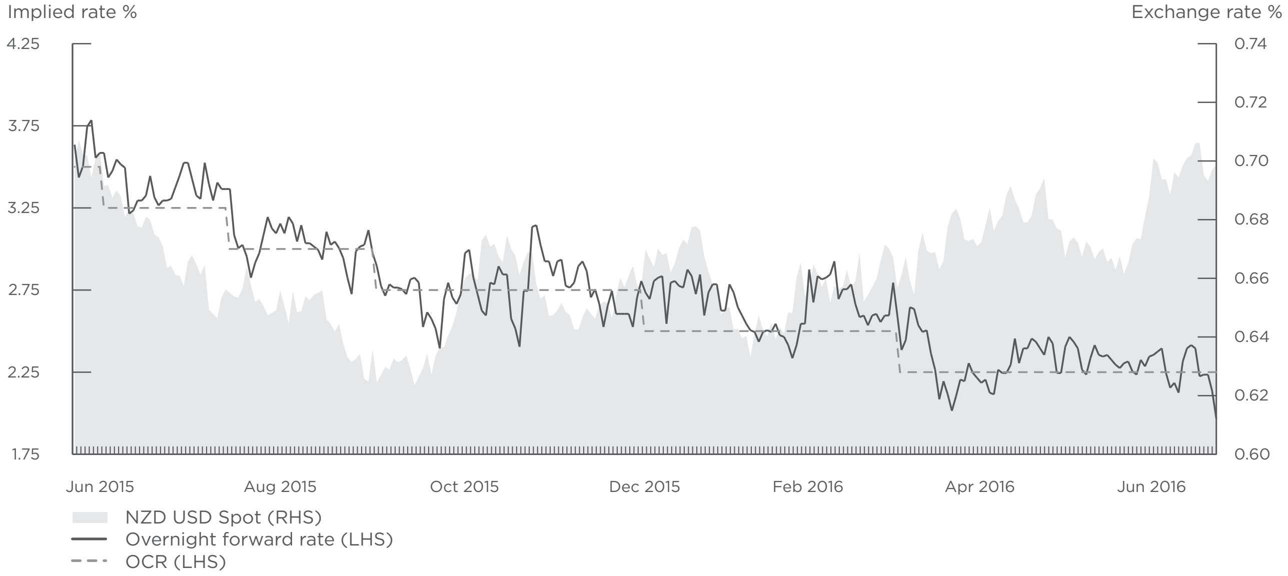
Domestic markets

The Domestic Markets team seeks to maintain short-term wholesale interest rates at levels close to the OCR.

Short-term interest rate markets remained reasonably stable throughout the financial year, although some volatility was evident at quarter ends, in trading outside the New Zealand time-zone and around some central bank rate announcements. The Reserve Bank continued to see declining market liquidity, caused by a reduced risk appetite and the evolving global regulatory landscape. As a result, Domestic Markets assumed a greater intermediating role during times of market volatility, and used FX swaps, repurchase agreements (repos) and Reserve Bank bills to manage this volatility with reasonable success.

Domestic Markets recorded revenue of $14.7 million before operating expenses from its operations for the year, primarily through increased market intermediation activity.

Chart 3
Financial Markets



Foreign reserves management

A recurring theme during 2015–16 was the synchronised decline in global bond yields, to new records lows for some, and an increasing move into negative yield territory for several major economies. This placed pressure on returns around the globe and drove many investors into various asset and credit markets in search of yield.

While returns are important, the Bank's highest priority in managing its foreign reserves is to preserve capital and liquidity to support its foreign exchange intervention mandate. This was achieved by maintaining our current structure of holding a mixture of hedged and unhedged reserves in the world's major currencies (USD, EUR, JPY, GBP, CAD and AUD) and in high-quality government or near-government liquid assets.

Our hedged reserves portfolio seeks to minimise interest rate risk and exchange rate risk and is funded by borrowing foreign currency. The assets in this portfolio are held in short-term instruments of the United States, Europe and Japan. Despite the low yields in these countries, especially in Europe and Japan where interest rates are negative, the hedged reserves portfolio achieved positive returns through the use of cross currency basis swaps. For example, by switching some of our USD assets into JPY we were able to generate excess returns in USD compared with an equivalent return on United States Treasury bills. As of 30 June 2016, 52 percent of hedged reserves were held in USD, 30 percent in EUR and 18 percent in JPY.

Unhedged reserves, which are funded via the sale of NZD, are mostly invested in government bonds of the above-mentioned six major currencies and are benchmarked against an international one- to three-year bond index. The benchmark has an average duration of two years and achieved a return of 1.26 percent. Active management against benchmark underperformed by six basis points largely reflecting positions held in the USD bond portfolio in anticipation that the Federal Reserve would increase United States rates more than once.

The Bank's unhedged foreign exchange position was reduced by approximately SDR200m to SDR1,400 million, between July and September, when the NZD/TWI exchange rate eased to its lowest level since June 2012. During the financial year the NZD/TWI appreciated by 6.6 percent despite our OCR being reduced by 1 per cent during the period as monetary policy responded to lower inflation outcomes and expectations. New Zealand's favourable interest rate differential and economic performance continues to be a major driver in supporting the NZD against the global backdrop of declining yields and a search for diversified assets. The rise in the NZD, however, has seen the unhedged foreign exchange position take a revaluation loss of NZD201 million.

What we did — initiatives and strategies

The Financial Markets department is in the process of implementing a new treasury valuation system, partnering with Numerix. This initiative will produce a step change in balance sheet management, enhancing the Bank's pricing, structuring, modelling and valuations of derivative instruments and portfolios. It will also enable improved performance reporting and analyses of future derivatives risks with speed and accuracy.

Within this project scope, incremental improvements were also made during the year to collateral management and foreign reserves and domestic markets' operating and risk management structures. These changes will help facilitate the new treasury system implementation, working within a more streamlined business configuration.

Ongoing improvements were made to the department's international economic and financial market research capabilities. We added resources to and improved coverage in market intelligence to deliver greater value-add research and continue to improve policy collaboration within the Bank.

In June the Bank completed its two-year commitment as Chair of the EMEAP Working Group on Financial Markets (EMEAP is the Executives' Meeting of East Asia-Pacific Central Banks, a cooperative organisation of central banks and monetary authorities). Achievements during the two years included closing the legacy US dollar Asian Bond Fund (ABF1) and successfully reinvesting those funds into a more appropriate local currency bond fund (ABF2). The Working Group also carried out a survey of derivatives market participants, reviewed the impacts of liquidity regulations on EMEAP markets and commissioned the Bank for International Settlements to produce a report on enhancing Asian corporate bond markets.

MACRO-FINANCIAL STABILITY

The objectives of the macro-financial stability function are:

To promote a sound and efficient financial system that facilitates the effective performance of the economy; to increase the resilience of the domestic financial system and counter instability in the domestic financial system arising from credit, asset price or liquidity shocks; and to analyse and report on the soundness and efficiency of the financial system.

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcomes

— A sound and efficient financial system that supports the functioning of the economy.

— Financial stability, promoted by increased resilience of the domestic financial system and countering instability arising from credit asset price or liquidity conditions, and dampening excessive growth in credit and asset prices.

Initiatives and strategies

— Explore additional macro-prudential policy options for managing the financial stability implications of housing market cycles.

— Work with banks to ensure that stress-testing models and processes are robust and central to the banks' internal risk management.

— Continue to assess the linkages between monetary and macro-prudential policy to ensure that complementary or opposing effects between the two policy areas are properly taken into account.

— Continue to enhance the reporting of financial system stability and efficiency, and policy assessments, contained in the FSR and other reports.

— Review the current suite of financial statistics in consultation with stakeholders to ensure they remain fit for purpose.

— Complete the implementation of a new data collection for the insurance sector, a new balance sheet data collection for the banking sector, and a new New Zealand securities database.

Our performance would be measured by:

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.

— An assessment of the soundness and efficiency of the financial system is published twice yearly in the FSR, including the reasons for, and the impacts of, any use by the Bank of macro-prudential policy instruments.

— Information on the risk assessment framework, including the macro-prudential indicators that are used to guide policy settings, is published in a manner that assists the assessment of financial stability.

— Statistics are collected 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.

What we did — success measures

The Bank has regularly communicated evolving risks in the housing market and dairy sector. The November 2015 FSR discussed the banking system's progress towards meeting tighter LVR restrictions that were imposed on 1 November. The FSR also provided an analysis of the risks to bank dairy exposures, with a March 2016 Bulletin article providing further information on a stress-test exercise conducted with banks. The May 2016 FSR noted a further re-emergence of housing risks and that the Bank was considering whether further financial policy measures would be necessary to address these risks.

The Bank reviewed the risk indicators used to guide macro-prudential policy decisions, and has been publishing a revised set of these indicators since October 2015. These indicators have been further augmented by new data collections that have been implemented on the debt-to-income ratios of new borrowers and interest-only lending.

The Bank produces and publishes comprehensive statistics on the soundness and efficiency of the financial system. The Bank released several new statistics during the year, providing insights into residential mortgage lending trends and compliance with the LVR restrictions.

What we did — initiatives and strategies

In November 2015 the Bank implemented tighter LVR restrictions for Auckland property investors. The policy improved the resilience of the banking system to a housing downturn by significantly reducing the share of highly leveraged investor loans on their balance sheets. The policy also acted to slow the Auckland housing market temporarily.

The Bank conducted two stress tests of the banking system. The first, in conjunction with the Australian Prudential Regulation Authority, provided the four largest banks with a common scenario to apply in their own internal stress tests. The results of this exercise were published in the May 2016 FSR. The second exercise focused on a specific stress to the dairy sector, and was published in a March 2016 Bulletin article. In addition, the Bank worked with the industry to improve stress-testing practices and published a discussion document on stress-testing methodology in May.

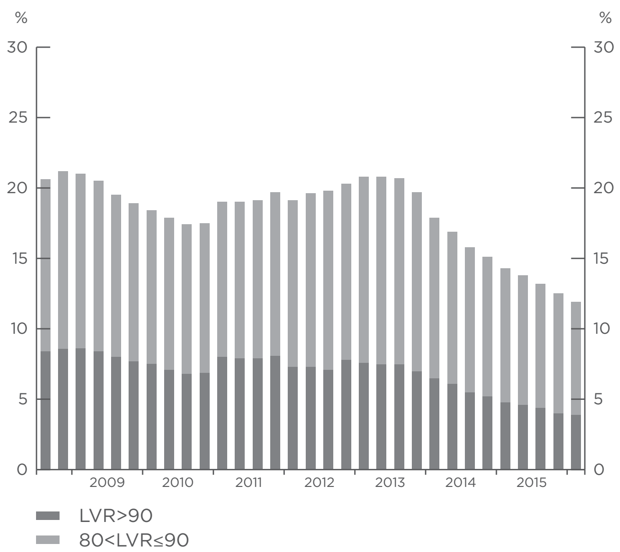
The Bank continues to enhance its reporting on financial system stability. In collaboration with industry we implemented new data collections to improve the understanding of financial system trends:

— We are quality assuring a comprehensive collection of insurance sector data. A regular publication of insurance sector statistics is expected to commence in 2016–17.

— We completed the development of a securities database that collates information on all the debt and equity securities issued in the New Zealand market, and statistics will be published from this database in August 2016.

— We began the final stage of our redevelopment of the banking sector data collection, including bank trials of a draft statistical template. The new collection will focus on improved coverage of bank balance sheet information and enable us to better monitor and report on the health of the banking sector.

Chart 4
Share of bank mortgage loans at high LVRs



PRUDENTIAL SUPERVISION

The objectives of the prudential supervision function are:

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

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcomes

- A sound and efficient financial system that supports the functioning of the economy.
- International and local confidence in New Zealand's financial system.

Initiatives and strategies

- Publish a stress-testing guide with a view to improving the stress-testing practices of New Zealand banks, and continue to develop a comprehensive stress-testing framework for New Zealand banks — a joint initiative with the Macro-Financial department.
- Complete the regulatory stocktake by consulting on and implementing initial enhancements to improve the efficiency, clarity and targeting of prudential standards for banks and NBDTs, and identifying separate areas for further work.
- Maintain supervisory engagement with executives and directors of regulated banks.
- Complete a review of, and consult on, the outsourcing arrangements that currently apply to 'large banks'.
- Work closely with banks to ensure timely compliance with new outsourcing requirements.
- Review the Bank's existing liquidity policy against finalised international liquidity standards.
- Review the Bank's broad suite of capital requirements.
- Consult on a range of amendments to the statutory management powers in the RBNZ Act to clarify aspects of the legislative framework for the Open Bank Resolution policy.
- Promote legislative changes recommended by the review of the prudential regime for NBDTs that was completed in 2013.
- Finalise policy to strengthen the Bank's oversight of financial market infrastructures.
- Implement the business-as-usual supervisory framework for licensed insurers.

Our performance would be measured by:

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 analysis.
- 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 the Government.
- The Bank demonstrates a consultative and transparent approach to its policy development, supported by robust analysis that is understood by regulated institutions and stakeholders.
- In its decisions on whether to grant licences to new applicants, the Bank takes a consistent approach within the legislative framework, without successful challenges.
- The Bank's Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) supervisory activities demonstrate an appropriate risk-based approach to supervision of reporting entities within the Bank's sector.

What we did — success measures

The prudential oversight of banks, NBDTs, insurance companies and payment systems provides the Bank with early warning indicators of emerging financial distress. During the year, the Bank actively engaged with supervised entities to identify and respond to any emerging stresses.

The Bank continues to supervise entities for Anti-Money Laundering and Countering Financing of Terrorism purposes using a risk-based approach. The entities that represented the highest risk of money laundering and financing of terrorism received closer attention through quarterly meetings and more frequent on-site inspections.

The Bank has been transparent about its policy-making process and has valued stakeholder consultation. As a result of the regulatory stocktake the Bank has committed to consultation periods of 6–10 weeks unless circumstances dictate otherwise. The Reserve Bank will also publish a document to explain its policy-making process in detail.

During the year the Bank issued five new insurance licences and cancelled seven. The total number of licensed insurers reduced to 94 at 30 June 2016. Three out of the 94 insurers remain on provisional licences.

What we did — initiatives and strategies

The Bank maintained a high degree of engagement with the executives and directors of registered banks throughout the year. We will continue to hold regular supervisor engagement meetings at various levels in the banks. These meetings form an important aspect of the Bank's approach to the supervision of banks.

The Bank completed the regulatory stocktake project. We are now conducting a series of follow-on consultations and are implementing a number of recommendations from the stocktake, to improve the efficiency, clarity and consistency of prudential regimes for banks and NBDTs. One of the key follow-on initiatives is the redevelopment of the Banking Supervision Handbook, which is a collection of documents that describes the regulatory requirements that are applied to registered banks. This will involve drafting a comprehensive 'Statement of Approach to Policy-Making' that describes the principles behind our approach. To enhance the efficiency of our disclosure regime we will also consult on the 'dashboard' approach to disclosure.

During the third quarter of 2015 we consulted on the recommended legislative changes from the review of the prudential regime for NBDTs. We will continue to work on implementing these legislative changes.

Following two rounds of public consultation, the Bank published a consultation document on the proposed crisis management framework for systemically important financial market infrastructures (SIFMIs). In 2016-17 the Bank will publish the summary of submissions for this proposal, and will seek Cabinet decisions on the proposed new oversight framework for SIFMIs.

The Bank initiated a review of the outsourcing policy that applies to 'large banks' (defined as those banks whose New Zealand liabilities, net of amounts due to related parties, exceed $10 billion) following the stocktake of major banks' outsourcing arrangements. The Bank released a consultation paper on possible revisions to the policy during the second half of 2015 and released a second consultation paper in May 2016. This paper included amendments based on stakeholder feedback, and aimed to provide banks with greater flexibility in achieving the desired policy outcomes. The Bank envisages that the revised policy will be in place in 2017.

The Bank commenced its review of the liquidity policy, which currently applies to all locally incorporated banks. The review followed the finalisation of international standards in the Basel III framework by the Basel Committee on Banking Supervision. The Bank was an early adopter of quantitative prudential liquidity requirements, and its existing framework (introduced in 2010) pre-dates the new international standards. The Bank will be reviewing its policy against the new Basel III requirements to consider the extent, if any, to which it would be appropriate to harmonise with the new international requirements. The Bank will also consider the nature of liquidity disclosure requirements and whether liquidity requirements should apply to banks that operate in New Zealand as branches. The Bank will consult on any proposed changes to its framework arising from the review.

Work is also under way on the Bank's review of the capital adequacy framework for locally incorporated banks. The review is being undertaken in the context of ongoing reforms of the international capital standards in the Basel III framework, which forms the basis for the Bank's capital adequacy requirements. The Bank will review its application of the evolving Basel framework, including the scope of internally modelled approaches to capital adequacy and their relationship to the standardised approaches. The timing of the international developments will influence changes to the Bank's capital framework. The Bank will consult on any proposed changes to its framework arising from the review.

Work continues on amendments to the crisis management powers in the RBNZ Act. The amendments may include: clarifying the legal status of customer payment instructions on a bank's entry into statutory management; and exemption from criminal or civil liability for bank directors when complying in good faith with a direction from the Reserve Bank.

The Bank continues to develop and implement a structured supervisory framework for the insurance sector. The framework is risk-based with a greater intensity of supervision directed towards those insurers of greatest significance to the purposes of IPSA. Structured risk assessments identify key risks within these insurers. Supervisory action plans set out the Bank's objectives for the following year. The industry has responded positively to increased interaction with the Bank. To support the implementation of the supervisory framework, the Bank has begun new data collections that provide a range of relevant and timely statistics across the industry. It has also developed a new monitoring system to track the compliance of insurers with regulatory requirements and to assess issues that affect licensed insurers. The Bank has been supportive of efforts by the Financial Markets Authority to explore market conduct issues around the remuneration of advisers. The transfer of insurance business between insurers remains relatively frequent as insurers seek to minimise costs by consolidating or moving business lines that no longer fit their strategies.

SETTLEMENT SERVICES

The settlement system

The Bank provides specialised financial services, mainly to financial institutions. These services comprise operation of ESAS and the operation of the NZClear securities settlement system.

Most major financial institutions have NZD cash accounts with the Bank. These are known as exchange settlement accounts, and they are used by financial institutions to make payments to each other in real time.

ESAS is a designated payment system under the RBNZ Act. It provides legislative backing to the finality of payments effected. This provides certainty to the recipients of those payments, which is important since typically $29 billion or more is paid through this system each day.

One of the account holders in ESAS is the Continuous Linked Settlement Bank (CLS). CLS is an international institution that processes the majority of foreign exchange payments made in major economies. By making payments through CLS, financial institutions can achieve simultaneous settlements of both legs of foreign exchange transactions.

When the CLS service is used, it eliminates settlement risk for foreign exchange transactions — the risk that one party makes a payment to purchase or sell one currency, but the other party fails to meet its obligation to pay the other currency.

NZClear allows buyers and sellers of securities to settle transactions efficiently and securely. The system provides for buyers of NZD-denominated equities and bonds to receive those securities at the same time as payment of cash is made for those purchases. Each transaction is settled individually – there is no netting of obligations.

NZClear also allows financial institutions to make payments of cash to each other. Once a settlement is effected in NZClear, it may not be reversed. NZClear is also a designated settlement system and is subject to joint regulation by the Financial Markets Authority and the Bank's Prudential Supervision Department. Institutional arrangements are in place to ensure that dealings between the Financial Services Group, which operates both NZClear and ESAS, and the Prudential Supervision Department, occur at arm's length.

The Bank administers securities on behalf of NZClear system members, with a value totalling more than $220 billion, and each day settlements with a value totalling more than $8 billion are made by members of NZClear. ESAS and NZClear, together with CLS, provide certainty to financial institutions in processing their high-value transactions. This is particularly important during periods of financial instability.

The objective of the settlement services function is:

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

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcome

An efficient, reliable and secure payment system that supports the smooth functioning of the economy.

Initiatives and strategies

— The Bank will progress the Payment Systems Replacement project involving the procurement and implementation of software to replace the current system used to provide exchange settlement account services, and the potential for securities settlement services to be provided by parties in the private sector, thus allowing the Bank to stop providing the NZClear service.

Our performance would be measured by:

Success measures

— The availability of ESAS/NZClear during core hours is at least 99.90 percent, as measured over a year.

— Customer satisfaction with operations and with system development is demonstrated through an annual customer survey in which an approval level of 90 percent or more is achieved.

— All risks are well managed, as demonstrated by external audits of ESAS and NZClear.

— International standards for payment and settlement systems are complied with, subject to variations for local New Zealand conditions.

What we did — initiatives and strategies

The Bank has commenced a project to replace the ESAS system. It has contracted with SIA/Perago, a global provider of real-time gross settlement systems, to supply new software. A separate work stream entails the design, implementation and support of new infrastructure. Considerable planning and design work has been completed and implementation effort will commence this coming year.

In March 2016 the Bank decided to retain the NZClear business. Following an earlier strategic review, the Bank sought interest from potential operators of securities settlement services but concluded the search without attracting suitable bids that met the Bank's service requirements and commercial terms. The Bank will invest in a new platform to provide this service. The Bank is advanced in its evaluation of a potential solution and intends to commence contract negotiations for a new system shortly.

What we did — success measures

Tables 1,2 and 3 set out key statistics for the operation of ESAS and NZClear. NZClear settlement volumes have continued to grow, reflecting continued strong growth in trading volumes on the New Zealand share market. The system was available to users 99.84 percent of core hours, which was under the target of 99.90 percent. System downtime was principally due to one event in April 2016 when the automated delivery of messages from ESAS confirming that settlements of payment instructions had occurred was delayed for two days. The impact of the delay on account holders was limited and there was no need to extend daily processing cut-off times.

In the annual customer survey, users of ESAS and NZClear continued to report very high levels of satisfaction. In 2016 the satisfaction rating was 100 percent (2015: 100 percent).

On the Auditor-General's behalf, PricewaterhouseCoopers undertakes reviews of the NZClear system, auditing the internal controls for NZClear once each year, and each quarter reviewing the Bank's securities reconciliation processes for NZClear. Also once each year, the auditor performs an external audit of the internal controls for ESAS. All external audit reports are reviewed by the Bank's Audit Committee. All opinions expressed by PricewaterhouseCoopers are unqualified and internal controls reports for each system are published on the Bank's website. Those reports include the results of audit testing of key controls. An annual report for each system is also prepared and is available on the Bank's website. Improvements designed to enhance the management of risks associated with operating these systems are made on a regular basis, and in particular during the past two years the Bank has made a considerable investment in improving system security. The Bank has also published a self-assessment of ESAS's compliance with the Principles for Financial Market Infrastructures – international standards promulgated jointly by the Bank for International Settlements' Committee on Payment and Settlement Systems and the International Organization of Securities Commissions' Technical Committee.

Table 1

Key ESAS statistics	2012	2013	2014	2015	**2016**
Average daily transaction volumes	8,518	9,411	10,443	11,332	**12,434**
Average daily transaction values	\$25.1bn	\$24.7bn	\$25.9bn	\$29.3bn	**\$29.7b**

Table 2

Key NZClear statistics	2012	2013	2014	2015	**2016**
Average daily transaction volumes	963	1,029	1,242	1,441	**1,679**
Average daily transaction values	\$8.9bn	\$7.9bn	\$8.2bn	\$7.8bn	**\$8.1b**

Table 3

Key ESAS-NZClear statistics	2012	2013	2014	2015	**2016**
ESAS-NZClear System availability during core hours	99.94%	99.85%	99.78%	99.87%	**99. 84%**

CURRENCY

The objective of the currency function is:

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

In our 2015–2018 *Statement of Intent* we undertook to deliver the following:

Outcome

Legal tender that meets the currency needs of the public.

Initiatives and strategies

- Continue to plan for the release and distribution of the new banknote series.
- Communicate and engage with stakeholders on the release of the Series 7 banknotes.
- Undertake a review of the currency operating model and supporting infrastructure to ensure that the currency needs of New Zealanders will be met in the future.
- Consult and collaborate with key stakeholders during 2015–16 to ensure that the review's recommendations are understood and supported.

Our performance would be measured by:

Success measures

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

What we did — success measures

During the year the Bank met all currency orders on schedule and in the denominations requested. The number of counterfeit banknotes in New Zealand remained low by international standards. There were 131 counterfeits (an increase from 111 in the prior year) found in circulation by the Bank, cash-in-transit companies, banks and the New Zealand Police. This represented 0.8 counterfeits per million notes in circulation. This was well below the upper limit of 10 per million specified in the success measures.

What we did — initiatives and strategies

A programme of consultation involving banks, equipment manufacturers, retailers and organisations for the visually impaired prepared New Zealand for the release of the Series 7 *Brighter Money* banknotes. The $5 and $10 banknotes were first issued in October 2015 followed by the $20, $50 and $100 in May 2016. A public awareness and education campaign accompanied each release utilising print, radio, social and online media.

In April the $5 banknote was named Banknote of the Year in a prestigious international competition run by the International Bank Note Society. The annual award recognises outstanding achievement in the design, technical sophistication and security of a banknote or banknote series.

The project to upgrade New Zealand's banknotes concluded on time and under budget, delivering innovative new banknotes incorporating some of the world's most advanced security features and beautifully showcasing New Zealand's history, culture and heritage.

A review of New Zealand's currency operating model and supporting infrastructure will recommence in the 2016–17 financial year, once the *Brighter Money* project has been formally closed.

Chart 5
Banknotes in circulation

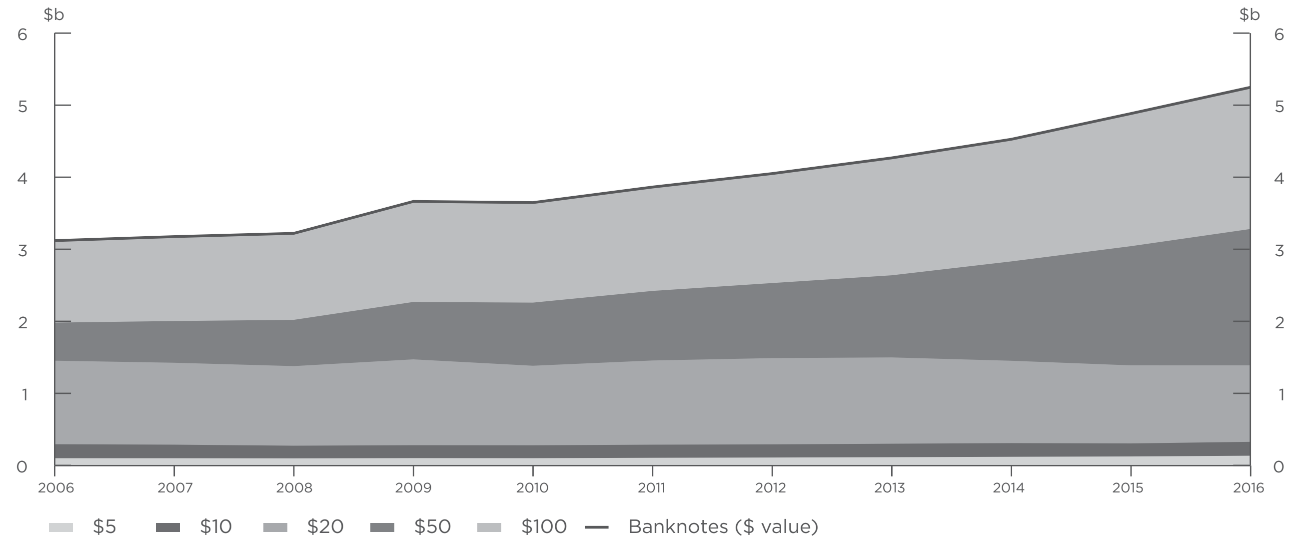
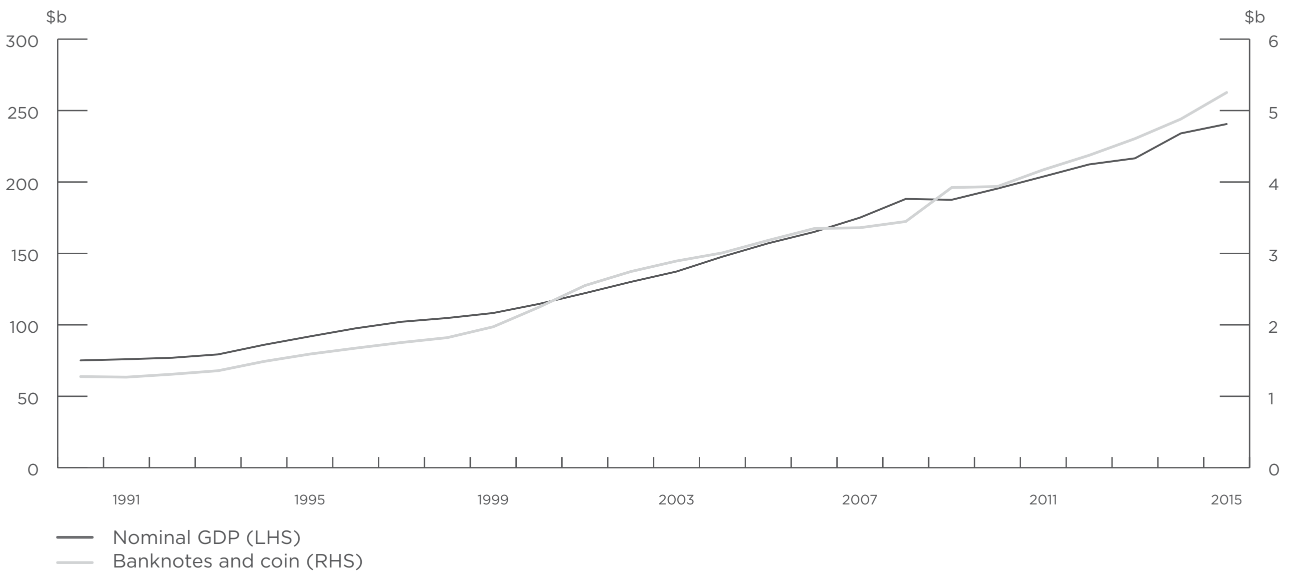


Chart 6
Value of notes in circulation



OPERATIONS

People and culture

The Bank is transforming its operations and capabilities in response to a tighter five-year funding envelope and significant business demands. Changes are underpinned by the principles of continual improvement, collaboration, leadership and engagement, and are aligned with the Bank's vision of being the best small central bank. The success of the change programme will be observed through business results, staff engagement and financial performance. The Bank continues to engage with staff on ways they can contribute to positive change, and the Bank is committed to continuing to improve and measure its performance culture. The Bank's vision requires excellence in its people, processes and resources and the quality of management is a critical factor in strengthening the Bank's performance. The Bank has continued building leadership and management competencies through specific development programmes for managers and emerging leaders and staff have structured training and development opportunities. A high level of staff engagement is a key indicator of a high-performing organisation. An annual survey measures the level of staff engagement with the Bank. The overall engagement index has been stable to slightly improving since 2013. The Bank will continue to focus on keeping staff well connected, providing growth opportunities, and recognising performance and contribution. The link between performance and reward will continue to be strengthened through using the Bank's high-performance framework to encourage appropriate competencies and behaviours.

Health and safety policy and management systems were reviewed and changes implemented to ensure compliance with the new Health and Safety at Work Act 2015. The Bank will continue to embed these changes and encourage excellence in health and safety risk management by all colleagues through the Bank's enterprise risk management framework.

Remuneration

Staff

The Reserve Bank spent $32 million on personnel in 2015–16. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 4 shows the number of staff who received over $100,000 in total remuneration[5], in bands of $10,000.

5. Total remuneration includes the annual cost to the Reserve Bank of all elements of contracted remuneration (salaries, any benefits provided, fringe benefit tax, superannuation), plus any bonuses and redundancy payments. The information in table 4 sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Minister of Finance, having regard to the recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governors. The Bank's remuneration policy is to pay all staff on the basis of performance on the job, while having regard to prevailing market conditions based on salary surveys and assessments made by an independent remuneration consultant.

Table 4
Remuneration in 2015-16

Total remuneration	Staff numbers 2016
100,000 to 109,999	23
110,000 to 119,999	25
120,000 to 129,999	15
130,000 to 139,999	14
140,000 to 149,999	12
150,000 to 159,999	4
160,000 to 169,999	7
170,000 to 179,999	6
180,000 to 189,999	8
190,000 to 199,999	1
200,000 to 209,999	5
210,000 to 219,999	6
220,000 to 229,999	2
230,000 to 239,999	1
240,000 to 249,999	1
260,000 to 269,999	1
290,000 to 299,999	1
310,000 to 319,999	2
320,000 to 329,999	1
340,000 to 349,999	1
430,000 to 439,999	1
490,000 to 499,999	1
550,000 to 559,999	1
660,000 to 669,999	1
Total staff receiving $100,000 or more	**140**

Non-executive directors' remuneration & meeting attendance

Non-executive directors' remuneration consists of directors' fees. Directors' fees represent consideration for services provided to the Bank for acting as directors of the Bank. Certain non-executive directors receive additional remuneration due to their involvement in the Board's Audit Committee or for special duties including MPS and FSR reviews. All remuneration paid to non-executive directors is included in the following table. There are no fees paid to the Governor, who is an executive director of the Bank.

Table 5

	2015	**2016[6]**	**2016**
Non-executive directors	$	**$**	**Attendance**
R Carr (Chair)	51,000	**51,000**	**10**
K Taylor (Deputy Chair)	40,130	**40,199**	**9**
N Quigley	31,500	**31,500**	**10**
K Vautier	30,818	**29,500**	**10**
J Ross	25,500	**25,500**	**10**
B Coates	27,500	**27,500**	**9**
T Simpson	25,500	**25,500**	**8**
Total non-executive directors' remuneration	231,948	**230,699**	

Insurance and indemnity arrangement

Section 179 of the RBNZ Act provides that every officer, employee and director of the Bank is not personally liable for acts done or omitted to be done in the exercise or performance in good faith of that person's functions, duties or powers under the Act. Under section 179A of the Act, the Crown provides an indemnity to every officer, employee and director of the Bank and certain other persons for any liability arising as a result of their exercising or failing to exercise any power conferred under the Act, unless the exercise or failure to exercise the power was in bad faith.

The Bank also provides income protection insurance to specified senior executives. For other staff, it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

Communications

The Communications department continued to support the Bank's strategic priority of communicating on a broader front, guided by insights from the Bank's extensive external stakeholder engagement survey in 2014–15 and ongoing monitoring of stakeholder relationships.

The Bank is using an increasing range of channels and forums to extend engagement, accessibility, relevance and dialogue with our key stakeholders, and encourage a deeper understanding of our roles and policies. We published the Bank's statutory accountability documents, the MPS and FSR, which are subject to hearings by Finance and Expenditure Committee. We facilitated six press conferences, issued 61 news releases, and delivered 118 presentations explaining the Bank's thinking about a range of topics, including the economy, monetary policy and financial stability. We published 13 *Bulletin* articles in addition to 10 Analytical Notes and 12 Discussion Papers. We held more than a dozen briefings for media, political and industry stakeholders to share our thinking and aid their understanding of our policies.

The Bank ceased media and analyst lock-ups following a leak of the March OCR by MediaWorks. We continue to hold post-announcement media briefings, which are live-streamed to viewers worldwide.

A nationwide public awareness and education campaign, to coincide with the release of the new Series 7 Brighter Money banknotes in October 2015 and May 2016, provided a unique opportunity for the Bank to connect with a very wide range of stakeholders. The nationwide campaign involved print, broadcast, digital and social media.

As well as responding to more than 1,200 public and media enquiries, the Communications team facilitated responses to more than 60 Official Information Act requests. Many of these responses were published on the Bank's website to further aid public understanding and transparency. In response to a marked growth in requests requiring considerable research, collation and review, the Bank established a policy on when it will charge for responses to Official Information Act requests. Since the policy was introduced in January 2016, the Bank has sought charges for two complex requests involving very large amounts of information. For the two requests where the bank sought charges, one request was withdrawn and the other was closed when the information became available through Archives New Zealand.

A new online format for the Bank's Monetary Policy Challenge made the competition more accessible to schools all over New Zealand. More than 200 secondary school students and teachers were involved in the annual competition, which encourages students to assess the economic conditions and decide an appropriate setting for the OCR. The competition was won by King's College in Auckland, with Waikato Diocesan School for Girls placed second, and Taupo-nui-a-Tia College third.

Table 6

Human resource statistics[7]	2010	2011	2012	2013	2014	2015	**2016**
Total staff at 30 June (FTE)	243	250	250	258	272	247	**240**
Average years of service at 30 June	7.9	8.0	8.8	8.3	8.3	8.1	**8.6**
Annual staff turnover	12.5%	12.4%	13.7%	15.1%	11.3%	10.8%	**16%**

6. These figures represent the cost to the Bank of directors' fees. Where fees are paid to a director who supplies services through a GST-registered entity, a portion of the GST paid by the Bank is unable to be recovered from Inland Revenue because of the Bank's status as a financial institution providing exempt supplies.
7. Full-Time Equivalent numbers do not include vacancies at 30 June. Underlying variations between the years 2010 and 2016 are due to the establishment of the Auckland office in 2011 and restructuring in 2015.

The Reserve Bank Museum and Education Centre was visited by 11,182 people during the year. New interactive touchscreen displays received positive feedback, further enhancing the Bank's literacy outreach programme targeting school students from Years 6 to 13.

Internal financial services

In 2015–16 we continued to enhance the systems and processes needed to manage the Bank's complex balance sheet and support the Bank's operations.

We commenced implementation of the Numerix system, which will provide additional functionality for the Bank's dealers and for the middle office. A number of enhancements were made to our core treasury system, including more streamlined deal capture and improved market data management and collateral management processes.

We completed an upgrade to the financial management information system software in December 2015.

Knowledge services

The Knowledge Services department supported a number of the Bank's strategic priorities, including reducing enterprise risk and strengthening our performance. In addition to this, the department continued to deliver an IT infrastructure that provides a high level of uninterrupted service, functionality and security.

A considered approach to hardware and software asset management resulted in the Bank's back-end financial systems being upgraded during the year, along with the web content management system that underpins the Bank's website. Stakeholder feedback on the Bank's web presence remained favourable.

The Bank's enterprise risk management framework supported the strengthening of our IT security infrastructure and the ongoing development of security assessment practices. The Bank reviewed its practices against the protective security requirements and undertook a number of security reviews.

Innovative new systems such as the Repository of Securities and Insurance Supervisory Portal continued to drive operational efficiency and improve the integrity and security of information consumed by both internal and external stakeholders. This efficiency focus continued with the Bank's ITIL-based IT Services Management Transformation programme, which we expect to continue delivering efficient and consistent technology services.

The department will continue to support the delivery of the Bank's strategic priorities, including the replacement of the core payments system and modernisation of our treasury systems, thereby future proofing these systems for the foreseeable future.

Risk assessment and assurance

The Risk Assessment and Assurance department continued to ensure that enterprise risk management practices were adopted across the Bank, so that the Bank manages risks in a proactive, coordinated, prioritised and efficient manner.

The internal audit plan, developed at the outset of the year, provided comprehensive assurance over the control frameworks that manage key risks. This was undertaken as planned, and any material issues were reported to management, the Audit Committee and the Board.

The Bank continued to make extensive use of services provided by in-house legal counsel in support of all its functions. The legal function provided legal services across a broad range of legal matters of a regulatory, operational and commercial nature.

Property/security

The Bank owns its building in Wellington, and maintains business continuity services by leasing a small office in Auckland and domestic and offshore facilities for banknote and coin reserves. The Bank also manages security operations to ensure it has secure and appropriate accommodation at all sites. A significant programme to prepare the Bank's property and security for the new *Brighter Money* banknote series was concluded during the year. A building occupancy programme was commenced to enhance the utilisation of floor space within the building.

International activities

The Bank continued its regular engagement with a wide range of international organisations, including central banks, prudential regulators and international financial institutions.

The Bank engaged frequently with other central banks and prudential regulators on a range of issues and work streams. The Bank collaborated closely with the Australian Prudential Regulation Authority including on bank stress-testing exercises and other home-host supervisory matters.

Through its involvement in the EMEAP group of central banks and monetary authorities, the Bank collaborates on key economic and financial issues affecting the region. In 2015–16 Deputy Governor Grant Spencer chaired several EMEAP committees. During this period EMEAP agreed to changes to the bond funds it uses to develop local currency bond markets in the region, and also considered how to enhance the contribution of its bond fund to the further development of the region's bond market. The Bank hosted the 30th annual meeting of Governors of South Pacific central banks in Wellington in December 2015.

The International Monetary Fund (IMF) will undertake a comprehensive review of New Zealand's financial system in the second half of 2016, under the auspices of the Financial Sector Assessment Programme (FSAP). The publication of the IMF's findings and recommendations is expected in early 2017. New Zealand authorities have been preparing for the FSAP since September 2015, with the Bank coordinating work on behalf of key agencies including the Financial Markets Authority, the Ministry for Business, Innovation and Employment, and the Treasury. The review will focus primarily on the quality of the regulatory framework for both prudential supervision and market conduct. The last New Zealand FSAP took place in 2003–04.

Financial highlights

KEY POINTS

Highlights

- Foreign currency intervention capacity $10.3 billion at year end.
- An appreciating NZD reduced the surplus for the year to $52 million, following the large surplus in the previous year that arose from a depreciating NZD.
- A dividend of $140 million will be paid to the Government in September 2016.
- The Bank remains well capitalised, with equity of $2.8 billion.
- Net operating expenses for 2016 were $9.9 million less than in the funding agreement. This underspend is expected to reverse in the remaining years of the funding agreement.

Table 7

Key indicators	**2016 $m**	2015 $m
Foreign currency intervention capacity	**10,268**	9,846
Currency in circulation	**5,634**	5,255
Equity	**2,828**	2,799
Surplus for the year	**52**	624
Net operating expenses	**54.1**	60.5
Dividend payment to the Government	**140**	510

Chart 7
Foreign currency assets and foreign currency intervention capacity

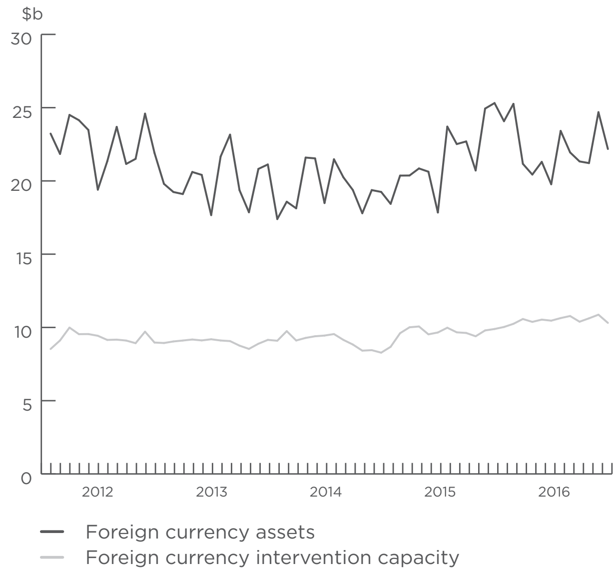
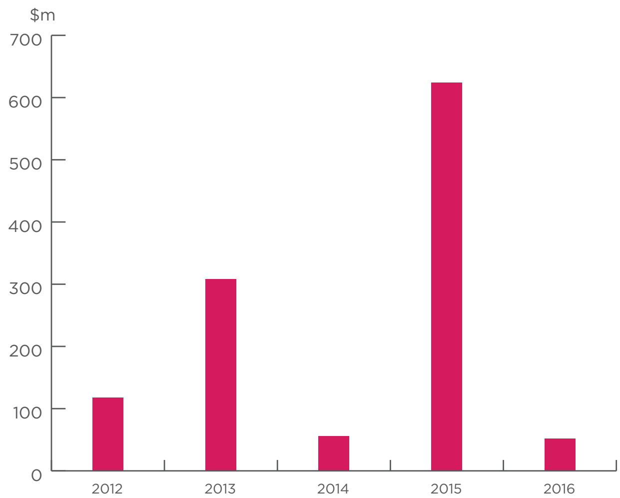


Chart 8
Surplus for the year



FINANCIAL POSITION

Highlights

- NZD financial liabilities at 30 June were $20.4 billion.
- Foreign currency swaps were $16.7 billion.
- Open foreign currency position $3.0 billion, down $0.5 billion from 2015.
- Foreign currency assets were $22.2 billion.
- Currency in circulation increased 7.2 percent to $5.6 billion.

Liabilities and equity

The Bank is funded by deposits from banks, deposits and loans from the Government, Reserve Bank bills issued, notes and coins issued to the public, and the Bank's equity.

Deposits from banks averaged $8 billion in 2016 and are maintained at a level that ensures there is sufficient liquidity in the banking system to facilitate daily interbank payments and ensure that short-term interest rates align closely with the OCR.

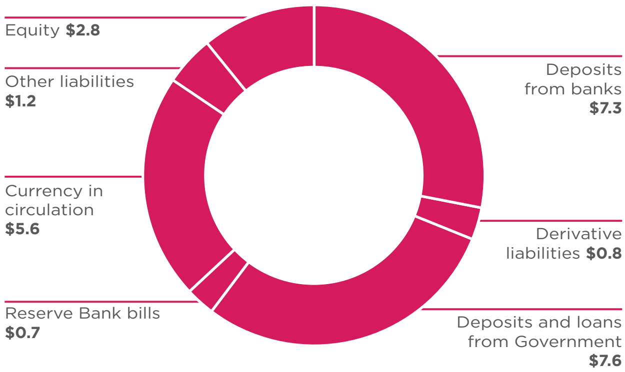
Deposits from banks and the Government vary from day to day and result in fluctuating levels of funds available for investment.

Most of the Bank's funding is denominated in NZD.

The Bank issues currency through banks as required to meet demand from the public. Currency in circulation increased by 7.2 percent in 2016, continuing the trend of yearly increases.

The proceeds received from the issuance of currency are invested by the Bank, producing investment revenue known as seigniorage. Seigniorage in 2016 was $179 million, down from $214 million in 2015 because of lower short-term interest rates, partly offset by an increase in currency in circulation.

Chart 9
Composition of liabilities and equity as at 30 June 2016 ($billion)



Assets and investment

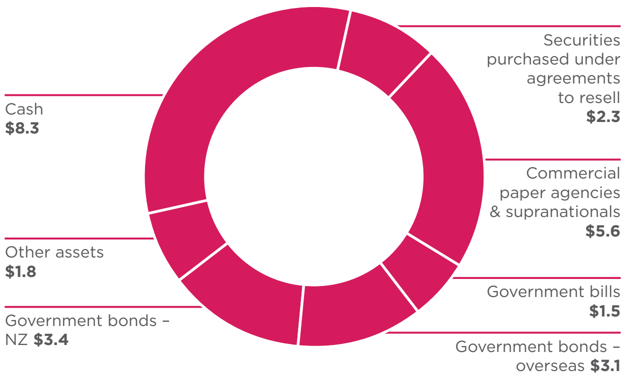
The Bank invests most of the proceeds of its funding into foreign currency assets.

Investments mainly comprise government and near-government securities, which are both very liquid and of high credit quality, allocated across six major currencies.

The Bank also holds a portfolio of New Zealand Government bonds, and owns its Wellington office building.

Readily liquefiable foreign currency assets, less foreign currency liabilities that fall due in the next 12 months, form the Bank's foreign currency intervention capacity. This is maintained should the Bank need to support the country's foreign currency market in a crisis.

Chart 10
Composition of assets as at 30 June 2016 ($billion)



Managing the foreign currency position

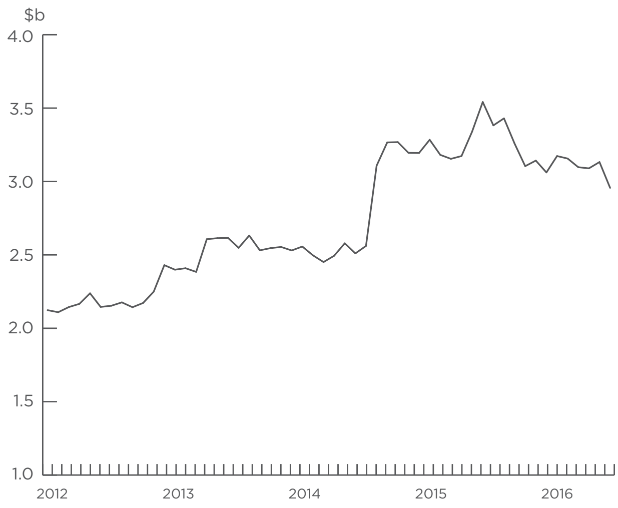
Most of the Bank's NZD funding is converted into foreign currencies using financial derivatives contracts, such as foreign currency swaps, before being invested in foreign currency assets. As at 30 June 2016 there were $16.7 billion of outstanding foreign currency swap commitments. These reduce the Bank's foreign currency exposure, and provide the Bank with a rate of return based on New Zealand, rather than foreign, interest rates.

Some of the NZD funding is invested directly into foreign currency assets, creating an open foreign currency position. The open foreign currency position enables the Bank to respond more effectively in the event of a crisis, and to smooth extreme exchange movements.

The open foreign currency position at 30 June 2016 was $3.0 billion, a reduction of $0.5 billion from 2015 due to a combination of foreign currency sales and appreciation of the NZD.

The open foreign currency position gives rise to revaluation gains and losses as foreign exchange rates change, resulting in volatility of reported profits.

Chart 11
Net open foreign currency position



Risk management

The Bank has a comprehensive approach to managing risk. Strong and effective financial and operational risk management disciplines are in place, and operate within an enterprise risk management framework that spans all functions in the Bank.

The Bank's foreign reserves management and domestic markets operations face a number of types of financial risk, including credit risk, liquidity risk and market risk.

To manage credit risk and liquidity risk, the Bank sets limits on the types of investments it holds, the counterparties with which it trades and the duration of the investments it makes. These limits seek to maintain the highest credit quality and liquidity of investments.

The Bank also takes and gives collateral as security to minimise the credit risk associated with the market value of financial derivatives contracts.

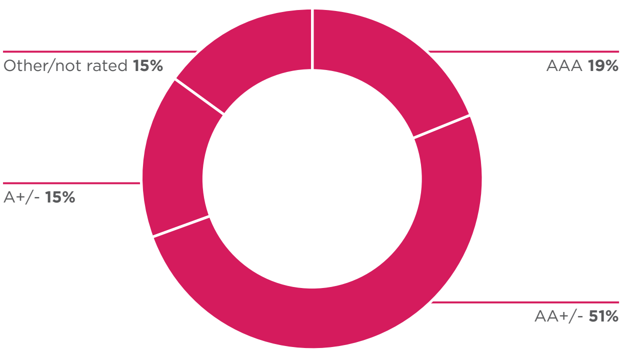
The principal market risks the Bank manages are foreign currency risk and interest rate risk.

Unhedged foreign currency positions, which arise as part of the Bank's activities to support monetary policy and to maintain orderly markets, operate in accordance with the RBNZ Act and under a Memorandum of Understanding with the Minister of Finance.

The Bank's actively managed portfolios operate within limits that manage exposure to gains and losses arising from changes to foreign exchange and interest rates.

Foreign reserves assets are aligned with the Bank's liability structure, and managed in two pools, hedged reserves and unhedged reserves.

Chart 12
Standard & Poor's credit rating of financial assets as at 30 June 2016 ($26 billion)



NET ASSETS/EQUITY

Highlights

- Capital requirement unchanged at $2.3 billion.
- Equity at 30 June 2016 $2.8 billion.
- A dividend of $140 million will be paid to the Government in September 2016.

Capital management

The Bank assesses the amount of capital required to cover the financial risks inherent in undertaking its functions, using a range of potential risk scenarios, at $2.3 billion, unchanged from 2015. This assessment is a guideline for the Bank's capital requirement, including the level of equity the Bank will seek to retain after the impact of the surplus for the year, revaluations and dividend payments.
In accordance with the dividend principles the Bank generally does not distribute unrealised gains, and equity may exceed the capital requirement guideline.

Equity

The Bank's equity at 30 June 2016 was $2.8 billion, which included unrealised profits not eligible for distribution as dividends. The change in equity during the year was:

Table 8

Changes in equity	**2016 $m**
Surplus for the year	**52**
Movements in reserves (see note)	**117**
Total comprehensive revenue for the year	**169**
Dividend payable	**(140)**
Change in equity for the year	**29**
Equity at 1 July 2015	**2,799**
Equity at 30 June 2016	**2,828**

NOTE: Includes gains and losses relating to revaluations of certain assets recorded directly in equity rather than being included in the surplus for the year. These assets include the Bank's holdings of New Zealand Government bonds and its investment in the Bank for International Settlements, which are designated as 'Available for Sale', and the Bank's Wellington building.

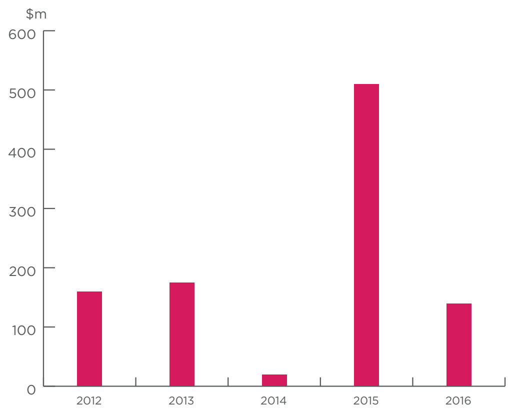
Dividend

Surplus equity is paid to the Government as a dividend. The Bank provided for a dividend of $140 million in the financial statements and will pay this in September 2016.

The dividend is calculated and sourced from realised earnings in line with the dividend principles set out on page 18. Because, under the dividend principles, unrealised gains are generally not distributed, the amount of the dividend may differ from the surplus for the year.

The 2016 dividend is lower than the $510 million dividend paid in 2015. The 2015 dividend was unusually high due to the large surplus, that allowed realised gains from 2014 to be distributed in 2015. In 2014 these gains were retained to bolster equity and offset unrealised foreign exchange revaluation losses.

Chart 13
Dividend payment to Government



FINANCIAL PERFORMANCE

Highlights

- The surplus for the year to 30 June 2016 was $52 million, a reduction of $572 million from 2015.
- Net interest revenue was slightly less in 2016 than 2015 due to lower interest rates.
- A higher NZD at year end resulted in a $201 million loss from foreign exchange rate changes on the Bank's open foreign currency position in 2016, compared with a $379 million gain in 2015.

Surplus

The Bank's surplus or deficit for the year is largely an outcome of decisions made in undertaking its policy functions in financial markets. The primary focus is on carrying out these activities in the most efficient manner rather than on maximising profit in all circumstances, and volatility in the surplus is expected when there is volatility in foreign exchange rates and interest rates.

Net investment revenue and operating expenses are the main components of the Bank's surplus or deficit. (Operating expenses are covered on the next page.)

The main components of net investment revenue are net interest revenue, gains and losses from fair value changes in financial instruments, and gains and losses from foreign exchange rate changes. In 2016:

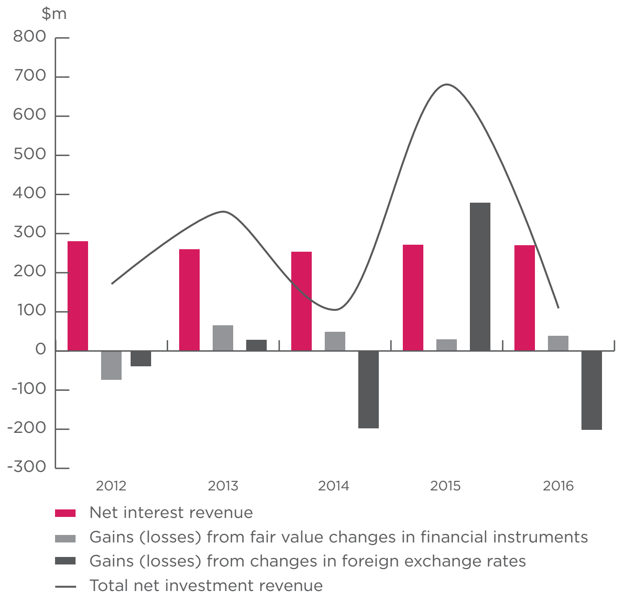
- net interest revenue reduced by $1 million. There were lower interest rates in 2016, which reduced seigniorage revenue earned on currency in circulation, offset by lower funding costs on the open foreign currency position and foreign reserves;
- gains from changes in the fair value of financial instruments were $9 million more than in 2015; and
- the TWI appreciated by 6.6 percent, resulting in a $201 million loss from foreign exchange rate changes on the open foreign currency position, a $580 million decrease from 2015.

Table 9

Surplus	**2016 $m**	2015 $m
Revenue		
Net interest revenue	**270**	271
Gains (losses) from changes in fair value of financial instruments	**39**	30
Gains (losses) from changes in foreign exchange rates	**(201)**	379
Dividend revenue	**1**	1
Net investment revenue	**109**	681
Other operating revenue	**14**	13
Total operating revenue	**123**	694
Total operating expenses	**(71)**	(70)
Surplus for the year	**52**	624

The significant volatility experienced in recent years in foreign exchange rates and the fair value of financial instruments has resulted in volatile net investment revenue over time.

Chart 14
Net investment revenue



OPERATING EXPENSES

Highlights

- Total operating expenses in 2016 were $71.2 million.
- The Bank is undertaking a significant multi-year programme of systems improvements and expenses on two projects are being capitalised, reducing operating expenses in 2016. These costs will be amortised to operating expenses in future years once projects are completed.
- Net operating expenses in 2016 were $9.9 million less than in the funding agreement.

Operating expenses

Total operating expenses in 2016 were $71.2 million, similar to 2015. The main differences from 2015 were:

- currency issue expenses include the costs of introducing the new Series 7 *Brighter Money* banknotes and a $1.6 million provision for the write-off of obsolete banknotes (2015 $6.7 million);
- reduced staff expenses arising from lower staff numbers. In 2015 $1.0 million was provided for restructuring costs;
- the capitalisation of expenses relating to projects to improve payment systems and treasury systems; and
- a $2.7 million loss on the actuarial valuation of the defined benefit superannuation scheme. In 2015 there was a $2.8 million gain.

Table 10

Operating expenses	**2016 $m**	2015 $m
Staff expenses	**32.0**	34.8
Net currency-issued expenses	**10.1**	12.9
Asset management expenses	**8.0**	7.3
Other operating expenses	**18.4**	18.4
Operating expenses	**68.5**	73.4
Actuarial loss (gain) on defined benefit superannuation scheme	**2.7**	(2.8)
Total operating expenses	**71.2**	70.6

Funding agreement

The funding agreement between the Bank and the Government sets out the expectations of the operating expenses, and certain items of income, within which the Bank is expected to manage its operations.

The current funding agreement covers the five-year period ending 30 June 2020.

Net operating expenses were $9.9 million below the funding agreement in 2016 because: revenue from NZClear was at record levels as a result of high equity settlement transaction volumes; expected advisory services associated with the planned divestment of NZClear were not required when divestment did not occur; core operating expenses were below budget for the reasons already outlined; and direct net currency issue expenses were below budget due to the timing of the new currency issuance.

Table 11

Net operating expenses and the funding agreement	**Actual $m**	**Funding agreement $m**
Core operating expenses	58.4	
Income from operations	(14.4)	
Net core operating expenses	**44.0**	**49.6**
Direct net currency-issued expenses	10.1	14.4
Net operating expenses	**54.1**	**64.0**
Under-expenditure compared with the funding agreement *	**(9.9)**	

*2016 and cumulative

This under-expenditure is expected to reverse during the remainder of the funding agreement as capitalised expenditure on system improvements is amortised to operating expenses and the Series 7 *Brighter Money* banknote issuance accelerates. Aggregate net operating expenses in the five years of the funding agreement will be managed within the cumulative amount allowed for in the funding agreement.

CONTENTS OF THE FINANCIAL STATEMENTS

MANAGEMENT STATEMENT

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

24 August 2016

Management Statement

Pursuant to section 165 of the Reserve Bank of New Zealand Act 1989, we hereby certify that:

1. We have been responsible for the preparation of the annual financial statements and for the judgements used in them.
2. We have been responsible for establishing and maintaining a system of internal controls designed to provide reasonable assurance as to the integrity and reliability of the Bank's financial reporting.
3. In our opinion, the annual financial statements for the year ended 30 June 2016 fairly reflect the financial position and operations of the Bank.

Governor

Deputy Chief Executive

2 The Terrace, Wellington 6011
PO Box 2498, Wellington 6140, New Zealand
Telephone +64 4 472 2029 Fax +64 4 473 8554

AUDIT REPORT

Independent Auditors' report

to the readers of the Reserve Bank of New Zealand and Group's financial statements for the year ended 30 June 2016

The Auditor-General is the auditor of the Reserve Bank of New Zealand and Group (the 'Bank'). The Auditor-General has appointed me, Chris Barber, using the staff and resources of PricewaterhouseCoopers, to carry out the audit of the financial statements of the Bank on her behalf.

Opinion

We have audited the financial statements of the Bank on pages 58 to 102, that comprise the statement of financial position as at 30 June 2016, the statement of financial performance, statement of changes in net assets/equity, statement of comprehensive revenue and expense and statement of cash flows for the year ended on that date and the notes to the financial statements that include accounting policies and other explanatory information.

In our opinion the financial statements of the Bank:

- present fairly, in all material respects:
  - its financial position as at 30 June 2016; and
  - its financial performance and cash flows for the year ended; and
- comply with generally accepted practice in New Zealand in accordance with Public Benefit Entity Accounting Standards.

Our audit was completed on 24 August 2016. This is the date at which our opinion is expressed.

The basis of our opinion is explained below. In addition, we outline the responsibilities of the Governor and our responsibilities, and explain our independence.

Basis of opinion

We carried out our audit in accordance with the Auditor-General's Auditing Standards, which incorporate the International Standards on Auditing (New Zealand). Those standards require that we comply with ethical requirements and plan and carry out our audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

Material misstatements are differences or omissions of amounts and disclosures that, in our judgement, are likely to influence readers' overall understanding of the financial statements. If we had found material misstatements that were not corrected, we would have referred to them in our opinion.

An audit involves carrying out procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including our assessment of risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the preparation of the Bank's financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control.

AUDIT REPORT

An audit also involves evaluating:

- the appropriateness of accounting policies used and whether they have been consistently applied;
- the reasonableness of the significant accounting estimates and judgments made by the Governor;
- the adequacy of the disclosures in the financial statements; and
- the overall presentation of the financial statements.

We did not examine every transaction, nor do we guarantee complete accuracy of the financial statements. Also, we did not evaluate the security and controls over the electronic publication of the financial statements.

We believe we have obtained sufficient and appropriate audit evidence to provide a basis for our audit opinion.

Responsibilities of the Governor
The Governor is responsible for the preparation and fair presentation of financial statements for the Bank that comply with generally accepted accounting practice in New Zealand and Public Benefit Entity Accounting Standards.

The Governor's responsibilities arise from the Reserve Bank of New Zealand Act 1989.

The Governor is also responsible for such internal control as he determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The Governor is also responsible for the publication of the financial statements, whether in printed or electronic form.

Responsibilities of the Auditor
We are responsible for expressing an independent opinion on the financial statements and reporting that opinion to you based on our audit. Our responsibility arises from the Public Audit Act 2001.

Independence
When carrying out the audit we followed the independence requirements of the Auditor-General, which incorporate the independence requirements of the External Reporting Board.

In addition to the audit we have carried out assignments in the areas of payment systems audits and systems penetration security testing, which are compatible with those independence requirements. Property advisory services have also been provided by a business acquired by PricewaterhouseCoopers during the year ended 30 June 2016. Appropriate safeguards were put in place to mitigate the threats to audit independence following the acquisition. Other than the audit and these assignments and advisory services, we have no relationship with or interests in the Bank.

Chris Barber
Chris Barber
On behalf of the Auditor-General
Wellington, New Zealand

PricewaterhouseCoopers
PricewaterhouseCoopers

GUIDE TO THE MAIN FUNCTIONS OF THE RESERVE BANK

The Reserve Bank's role is defined by the Reserve Bank of New Zealand Act 1989.

For the year ended 30 June 2016, the Bank classified its outputs according to its main functions in the ways described below.

Monetary Policy Formulation:

Developing monetary policy to achieve and maintain price stability in line with the *Policy Targets Agreement.*

Domestic Market Operations:

Transacting with, monitoring and liaising with financial markets to manage aggregate liquidity in the New Zealand banking system. These actions are for the purpose of implementing monetary policy, facilitating payments and monitoring financial stability.

Prudential Supervision:

Registering and supervising banks, licensing and supervising insurers, regulating non-bank deposit takers and overseeing payment systems, and undertaking policy development in all of these areas. These actions are for the purpose of promoting a sound and efficient New Zealand financial system by limiting damage to the financial system that could arise from bank, non-bank deposit taker and insurer failure(s) or other financial system distress. Supervising banks, non-bank deposit takers and life insurers for compliance with their anti-money laundering obligations.

Macro-financial Stability:

Analysing and managing financial system risks to promote a sound and efficient system that supports the functioning of the economy.

Currency Operations:

Maintaining the supply and integrity of legal tender currency to facilitate cash transactions in the community.

Foreign Reserves Management:

Managing the Bank's foreign reserves held to support monetary policy objectives and the maintenance of orderly markets. This includes the execution of foreign currency intervention activities.

Settlement Services:

Providing New Zealand dollar settlement accounts to financial institutions and the New Zealand Government and providing securities settlement and depository services, mainly to financial institutions.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

As at 30 June	Note	2016 $M	2015 $M
Assets			
Foreign Currency Financial Assets			
Cash Balances	1(d)	**8,351**	6,742
Securities Purchased under Agreements to Resell	1(d)	**2,258**	4,436
Investments	1(d),3	**10,646**	13,727
Derivative Assets	1(d),4	**716**	347
Other Foreign Currency Assets	1(d),5	**271**	154
Total Foreign Currency Financial Assets		**22,242**	25,406
Local Currency Financial Assets			
New Zealand Government Securities	1(d)	**3,449**	3,117
Other Local Currency Financial Assets	1(d)	**191**	496
Total Local Currency Financial Assets		**3,640**	3,613
Total Financial Assets		**25,882**	29,019
Other Assets	1(e),6	**101**	88
Total Assets		**25,983**	29,107
Liabilities			
Foreign Currency Financial Liabilities			
Short-term Foreign Currency Financial Liabilities	1(d),7	**209**	101
Securities Sold under Agreements to Repurchase	1(d)	**662**	704
Derivative Liabilities	1(d),4	**741**	1,739
Term Liabilities	1(d)	**972**	1,127
Total Foreign Currency Financial Liabilities		**2,584**	3,671
Local Currency Financial Liabilities			
Deposits	1(d),8	**13,121**	14,538
Securities Sold under Agreements to Repurchase	1(d)	**110**	1,096
Reserve Bank Bills	1(d)	**674**	309
Currency in Circulation	1(d)	**5,634**	5,255
Other Local Currency Financial Liabilities	1(d),9	**89**	125
Term Liabilities	1(d)	**796**	800
Total Local Currency Financial Liabilities		**20,424**	22,123
Total Financial Liabilities		**23,008**	25,794
Other Liabilities	1(f),10	**147**	514
Total Liabilities		**23,155**	26,308
Net Assets/Equity	11	**2,828**	2,799
Total Liabilities and Net Assets/Equity		**25,983**	29,107

The above statement is to be read in conjunction with the notes set out on pages 63 to 102.

Derivative Instruments are used to manage the Bank's exposure to foreign currency risk. The effective foreign currency exposure as at balance date is recorded in Note 18.

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS/EQUITY

	Note	Contributed Capital $M	Available-for-sale Reserve $M	Property, Currency and Artwork Collections Revaluation Reserve $M	Cash Flow Hedge Reserve $M	Retained Earnings $M	Total $M
Net Assets/Equity as at 1 July 2014		**1,600**	**82**	**46**	**(1)**	**772**	**2,499**
Surplus for the Year		-	-	-	-	624	624
Other Comprehensive Revenue and Expense		-	159	13	14	-	186
Total Comprehensive Revenue and Expense		-	159	13	14	624	810
Transaction with Owners:							
Dividend Payable to the New Zealand Government	11	-	-	-	-	(510)	(510)
Net Assets/Equity as at 30 June 2015	11	**1,600**	**241**	**59**	**13**	**886**	**2,799**
Surplus for the Year		**-**	**-**	**-**	**-**	**52**	**52**
Other Comprehensive Revenue and Expense		**-**	**125**	**-**	**(8)**	**-**	**117**
Total Comprehensive Revenue and Expense		**-**	**125**	**-**	**(8)**	**52**	**169**
Transaction with Owners:							
Dividend Payable to the New Zealand Government	11	**-**	**-**	**-**	**-**	**(140)**	**(140)**
Net Assets/Equity as at 30 June 2016	11	**1,600**	**366**	**59**	**5**	**798**	**2,828**

The above statement is to be read in conjunction with the notes set out on pages 63 to 102.

CONSOLIDATED STATEMENT OF FINANCIAL PERFORMANCE

For the Year Ended 30 June	Note	2016 $M	2015 $M
Interest Revenue		**612**	704
Interest Expense		**342**	433
Net Interest Revenue	21	**270**	271
Net Gains from Fair Value Changes		**39**	30
Net (Losses)/Gains from Foreign Exchange Rate Changes		**(201)**	379
Dividend Revenue		**1**	1
Total Net Investment Revenue	21	**109**	681
Other Revenue		**14**	13
Total Operating Revenue		**123**	694
Total Operating Expenses	23	**71**	70
Surplus for the Year		**52**	624

CONSOLIDATED STATEMENT OF COMPREHENSIVE REVENUE AND EXPENSE

For the Year Ended 30 June	2016 $M	2015 $M
Surplus for the Year from the Consolidated Statement of Financial Performance	**52**	624
Other Comprehensive Revenue and Expense		
Movement in Available-for-sale Revaluation Reserve Taken to Net Assets/Equity	**125**	159
Movement in Property, Currency and Artwork Collections Revaluation Reserve Taken to Net Assets/Equity	**-**	13
Movement in Cash Flow Hedge Reserve Taken to Net Assets/Equity	**(8)**	14
Total Other Comprehensive Revenue and Expense for the Year	**117**	186
Total Comprehensive Revenue and Expense for the Year	**169**	810

The above statements are to be read in conjunction with the notes set out on pages 63 to 102.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the year ended 30 June	Note	2016 $M	2015 $M
Cash Flows from Operating Activities			
Sources from Revenue			
Interest Received:			
Foreign Currency:			
Derivatives		**(14)**	(14)
Other		**48**	28
Local Currency:			
Derivatives		**458**	497
Available-for-sale Securities		**127**	133
Other		**15**	25
Dividend		**3**	1
Fees, Commission and Other Revenue Received		**13**	11
Total Sources of Cash Flows from Revenue		**650**	681
Disbursements for Expenses			
Interest Paid:			
Foreign Currency		**(5)**	(7)
Local Currency		**348**	438
Payments to Suppliers and Employees		**72**	60
Total Disbursements of Cash Flows from Expenses		**415**	491
Operating Cash Flows from Revenue and Expenses		**235**	190
Operating Cash Flows from Changes in Asset and Liability Balances		**1,939**	2,988
Net Cash Flows from Operating Activities	25	**2,174**	3,178
Cash Flows from Investing Activities			
Sources			
Disposal of Available-for-sale Securities		**282**	513
Total Sources of Cash Flows from Investing Activities		**282**	513
Disbursements			
Purchases of Available-for-sale Securities		**451**	601
Purchases of Property, Plant and Equipment and Intangible Assets		**6**	5
Total Disbursements of Cash Flows from Investing Activities		**457**	606
Net Cash Flows from Investing Activities		**(175)**	(93)

The above statement is to be read in conjunction with the notes set out on pages 63 to 102.

CONSOLIDATED STATEMENT OF CASH FLOWS (CONTINUED)

For the year ended 30 June	Note	2016 $M	2015 $M
Cash Flows from Financing Activities			
Sources			
Net Issue of Circulating Currency		**379**	372
Issue of Local Currency Term Liabilities		**-**	700
Total Sources of Cash Flows from Financing Activities		**379**	1,072
Disbursements			
Repayment of Foreign Currency Term Liabilities		**99**	640
Dividend Payments to the New Zealand Government		**510**	20
Total Disbursements of Cash Flows from Financing Activities		**609**	660
Net Cash Flows from Financing Activities		**(230)**	412
Net Cash Flows		**1,769**	3,497
Plus Foreign Exchange Rate Effect on Cash Balances at the Beginning of the Year		**(160)**	608
Net Cash Flows from All Activities		**1,609**	4,105
Cash Balances at the Beginning of the Year		**6,742**	2,637
Cash Balances at the End of the Year		**8,351**	6,742

The above statement is to be read in conjunction with the notes set out on pages 63 to 102.

NOTES TO BE READ AS PART OF THE CONSOLIDATED FINANCIAL STATEMENTS

1. Statement of Accounting Policies

a. Reporting Entity and Statutory Base

These are the consolidated financial statements of the Reserve Bank of New Zealand, a body corporate under the Reserve Bank of New Zealand Act 1989 (the Reserve Bank Act). These consolidated financial statements apply to the financial year ended 30 June 2016. They have been prepared in accordance with Part VI of the Reserve Bank Act.

In these financial statements, the Reserve Bank of New Zealand is also referred to as the 'Reserve Bank' or the 'Bank'. The Bank's controlling entity is the Government of New Zealand. The Bank is domiciled and operates in New Zealand.

The Governor and Deputy Governor (Deputy Chief Executive) of the Reserve Bank authorised these financial statements for issue on 24 August 2016.

b. Compliance with PBE Standards

Under XRB A1: *Accounting Standards Framework,* the Bank is classified as a Public Sector Public Benefit Entity (PBE). A PBE is a reporting entity whose primary objective is to provide goods and services for community or social benefit and, where any equity has been provided, with a view to supporting that primary objective rather than for a financial return to equity holders.

The consolidated financial statements have been prepared with, and comply with, Tier 1 Public Benefit Entity Accounting Standards (PBE Standards), issued by the New Zealand Accounting Standards Board based on International Public Sector Accounting Standards (IPSAS), and comply with Generally Accepted Accounting Practice in New Zealand.

c. Basis of Preparation of Financial Statements

Measurement Basis

The consolidated financial statements have been prepared on a going-concern basis and the accounting policies have been applied consistently throughout the period. These financial statements have been prepared using the general principles of historical cost accounting, modified by fair value accounting for available-for-sale financial assets, all derivative contracts, financial assets and liabilities that are held at fair value through surplus/(deficit), land and buildings, and currency and artwork collections.

Changes in Accounting Policies

There have been no changes in accounting policies and all accounting policies have been applied consistently by the Bank for all the financial years presented (unless otherwise stated).

Standards Issued Not Yet Effective but Early Adopted

In July 2015 amendments to the PBE Standards were incorporated into: the 2015 Omnibus Amendments to PBE Standards; PBE IPSAS 1 *Presentation of Financial Statements;* and PBE IPSAS 23 *Revenue from Non-Exchange Transactions.* These updated standards apply for periods beginning on or after 1 January 2016 but allow for early adoption. The Bank has adopted these amendments in preparing its financial statements for 30 June 2016. No changes in reporting have arisen from applying these Standards.

Basis of Consolidation

These consolidated financial statements have been prepared using the acquisition method. All material inter-company balances and transactions are eliminated. Controlling entity financial statements are not produced because the difference between the controlling entity and the economic entity is not material.

Trust and Custodial Activities

Assets held for third parties under custodial arrangements, and revenue arising thereon, are excluded from these financial statements, as they are not assets or revenue of the Bank (see Note 32).

Functional and Presentation Currency

The Bank's financial statements are presented in New Zealand dollars, the Bank's functional and presentation currency. Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

Foreign Currency Conversions

Transactions denominated in foreign currencies are translated to New Zealand dollars using exchange rates applied on the trade dates of the transactions.

Foreign currency assets and liabilities are translated to New Zealand dollars at the relevant market bid or offer foreign exchange rate as at the reporting date.

Foreign exchange gains and losses resulting from the settlement of foreign currency transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the Statement of Financial Performance, except where such gains and losses are deferred in equity as qualifying cash flow hedges. Where a gain or loss on a non-monetary item is recognised directly in equity, such as equity investments classified as financial assets that are available for sale, the related exchange gain or loss is also recognised in equity.

d. Financial Instruments

Classification and Measurement of Financial Instruments

Financial instruments are classified into various categories and are accounted for as shown in the table below. The classification of a financial instrument into a category occurs at the time of initial recognition.

Classification Category	Instruments	Valuation Basis in the Statement of Financial Position	Elements Recognised Directly in the Statement of Financial Performance	Elements Recognised Directly in Net Assets/ Equity
Fair Value through Surplus/ (Deficit)	**Assets** • Investments • Securities Purchased under Agreements to Resell • Securities Lending • Derivatives **Liabilities** • Term Loans • Reserve Bank Bills • Securities Lending • Securities Sold under Agreements to Repurchase	Fair Value	• Interest Revenue • Interest Expense • Gains/Losses from Fair Value Changes • Gains/Losses from Foreign Exchange Rate Changes	
Available-for-sale Financial Assets	• New Zealand Government Securities (purchased for investment purposes) • Shareholding in Bank for International Settlements	Fair Value	• Interest Revenue • Dividend Revenue • Realised Gains/Losses from Fair Value and Foreign Exchange Rate Changes • Unrealised Losses Resulting from Impairment of Available-for-sale Instruments	Unrealised Gains/ Losses from Fair Value Changes and Foreign Exchange Rate Changes are included in the Available-for-sale Revaluation Reserve
Financial Instruments Designated as Cash Flow Hedges	• Cash Balances	Fair Value	• Interest Revenue • Expenses covered by the Cash Flow Hedge are recorded at spot rates plus or minus hedge reserves transferred when they are settled	Changes in Foreign Currency Translation on Qualifying Cash Flow Hedges are included in the Cash Flow Hedge Reserve until the expenses covered by the Cash Flow Hedge are realised
Loans and Receivables	• Cash Balances • Receivable for Unsettled Sale of Securities • Fee Income Receivable	Amortised Cost	• Interest Revenue • Gains/Losses from Foreign Exchange Rate Changes • Changes in Impairment	Changes in Foreign Currency Translation on Qualifying Cash Flow Hedges are included in the Cash Flow Hedge Reserve
Financial Liabilities at Amortised Cost	• Deposits • Currency in Circulation • Short-term Foreign Currency Liabilities • Payables for Unsettled Purchases of Securities • Other Local Currency Liabilities	Amortised Cost	• Interest Expense • Gains/Losses from Foreign Exchange Rate Changes	

Fair Value through Surplus/(Deficit)

This category has two sub-categories: financial instruments designated as fair value through surplus/(deficit) at inception; and those that are held for trading.

The Bank's assets and liabilities that are designated as fair value through surplus/(deficit) are done so because compliance with the Bank's investment mandates and the performance of the Bank's Foreign Reserves Management and Domestic Market Operations functions are assessed daily on the basis of the fair value of assets and related liabilities funding those assets.

The Bank has active management portfolios, which are classified as held for trading.

Available-for-sale Financial Assets

Available-for-sale financial securities are those non-derivative financial assets that are designated as available for sale or that are not classified as financial assets at fair value through surplus/(deficit), or loans and receivables.

Available-for-sale financial assets include the Bank's holdings of New Zealand government bonds and its shareholding in the Bank for International Settlements (BIS). These assets are intended to be held either to maturity or for an indefinite period of time, and in the case of New Zealand government bonds, these may be sold in the course of the Bank's operations. As part of its liquidity management operations the Bank purchases New Zealand government securities generally up to six months before these securities mature. Government securities purchased for liquidity management operations are classified as financial assets at fair value through surplus/(deficit).

Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides goods or services directly to a debtor with no intention of trading the receivable.

Financial Liabilities at Amortised Cost

Liabilities classified as financial liabilities at amortised cost include short-term liabilities with fixed or determinable payments that are not traded, such as unsettled purchases of securities, cash collateral held, and payables and accruals for services received. Notes and coins issued by the Bank that are either in circulation or demonetised are also classified as financial liabilities at amortised cost.

Additional Information on Recognition and Measurement of Financial Instruments

Purchases and disposals of financial instruments are recognised on trade dates, the dates on which the Bank commits to the purchase or disposal of the financial instruments.

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Bank has transferred substantially all the risks and rewards of ownership. Financial liabilities are derecognised only when the obligation is discharged, cancelled or expired.

The fair values of financial assets that are quoted in active markets are based on current bid prices and offer prices in the case of financial liabilities. In other cases the Bank establishes fair value by using appropriate valuation techniques.

Interest revenue and interest expense are calculated using the effective interest method and are recognised in the Statement of Financial Performance.

Dividends on available-for-sale equity instruments are recognised in the Statement of Financial Performance when the right to receive payment is established.

Hedge Accounting on Qualifying Cash Flow Hedges

Hedge accounting is applied in respect of purchases of foreign currency cash that are effective in hedging the Bank's exposure to foreign currency risks arising from operating expenditure, capital expenditure and purchases of banknotes and coins.

Unrealised gains or losses due to changes in foreign exchange rates on foreign currency cash purchased to hedge operating expenditure, capital expenditure and purchases of banknotes and coins are recognised in Other Comprehensive Revenue and Expense and are included in the Cash Flow Hedge Reserve.

When hedged foreign-currency-denominated operating expenditure, capital expenditure or purchases of banknotes and coins are settled, the relevant transactions are recorded at the foreign currency rates at which the foreign currency cash was purchased.

Offsetting of Financial Assets and Financial Liabilities

Financial assets and liabilities are offset and the net amount reported in the Statement of Financial Position when there is a legally enforceable right to set off the recognised amounts and there is an intention to settle on a net basis, or to realise the assets and settle the liabilities simultaneously.

Additional Information on Specific Financial Assets and Financial Liabilities

Derivatives
Derivatives are initially recognised in the Statement of Financial Position at fair value on the date on which derivative contracts are entered into and are subsequently re-measured at their fair value. Fair values are obtained from quoted market prices in active markets, including recent market transactions, or valuation techniques that use inputs observed in active markets, as appropriate. The best evidence of the fair value of a derivative at initial recognition is the transaction price (i.e., the fair value of the consideration given or received).

Derivative transactions, such as foreign currency swaps, and the payment and receipt of different currencies are stated in the Statement of Financial Position at the net of the fair value of receipts less the fair value of payments, both expressed in New Zealand dollars. The net fair value of each derivative contract is determined individually and carried as an asset if the net fair value is positive, and as a liability if that value is negative.

Gains and losses on all derivatives are recognised in the Statement of Financial Performance.

Securities Purchased under Agreements to Resell
Where the Bank purchases securities under agreements to resell (reverse-repurchase agreements), the securities are not reported in the Statement of Financial Position, but the Bank records as assets the consideration receivable from the agreements to resell the securities.

The consideration receivable under an agreement to resell is recorded at fair value. Movements in the fair value of reverse-repurchase agreements are reported in the Statement of Financial Performance.

Securities Sold under Agreements to Repurchase
Where the Bank sells securities it owns under agreements to repurchase (repurchase agreements), the securities continue to be included as assets in the Bank's Statement of Financial Position, and the Bank records as liabilities the considerations payable under the repurchase agreements.

The consideration payable under the agreement to repurchase is recorded at fair value. Movements in the fair value of repurchase agreements are reported in the Statement of Financial Performance.

Securities Lending Programme
The Bank operates a securities lending programme. Where securities are lent, the Bank receives collateral in the form of cash or other securities and the securities that are lent continue to be recorded as assets in the Bank's Statement of Financial Position.

The Bank's agent administers the securities lending programme and monitors the securities lending and related collateral against requirements agreed with the Bank.

The Bank records an asset being the market value of the securities lent and a liability for the same amount in respect of the collateral to be returned by the Bank at the conclusion of the loan.

The Bank records revenue from securities lending as it accrues. Changes in the value of an asset are reflected in a change in the corresponding liability.

Short Sales of Investments
A short sale is a sale of a security that the Bank does not own. Securities that are sold short are recorded at fair value through surplus/(deficit) using quoted market offer prices.

Any gains or losses are recognised in the Statement of Financial Performance.

Currency in Circulation
Currency issued by the Bank represents a claim on the Bank in favour of the holder. The liability for currency in circulation is recorded at face value in the Statement of Financial Position.

Demonetised Currency
The Bank has a liability for the face value of demonetised currency still in circulation. For currency demonetised before 1 July 2004, this is recognised as a contingent liability except for a provision retained in the Statement of Financial Position to cover expected redemptions. For currency demonetised from 1 July 2004, the Bank records a liability equal to the face value of that currency still in circulation.

Collectors' Currency
The Bank has a liability for the face value of collectors' currency. The face value of collectors' currency issued before 1 July 2004 is recognised as a contingent liability. For collectors' currency issued from 1 July 2004, the Bank records a liability equal to the face value of that currency.

e. Other Assets

Inventories

Inventories of currency on hand are recognised in the Statement of Financial Position at cost. Costs include bringing inventories to their present location and condition.

For the portion of inventories of currency on hand that relates to currency repatriated to the Bank through non-exchange transactions, this cost is measured at fair value and is recorded by crediting currency issue expenses and increasing the value of inventory recognised in the Statement of Financial Position.

When currency is issued, the value of the inventory is reduced and an expense is recorded for currency issuance costs. Currency issuance cost is determined on a first-in, first-out basis.

Where inventories of currency on hand are obsolete, the cost of unissued currency, or the fair value of currency repatriated to the Bank through non-exchange transactions, is written down to net realisable value and an expense is recorded in the Statement of Financial Performance.

Property, Plant and Equipment

Land and Buildings
Land and buildings owned by the Bank are classified as Property, Plant and Equipment.

Land is recorded at fair value. Buildings are recorded at depreciated fair value. Surpluses of book value over historical cost for this class of asset are recorded in the Property Revaluation Reserve. Where the book value of this class of asset falls below historical cost, previous revaluations are reversed and any remaining balance is charged as an expense in the reporting period in which it occurs. Buildings are depreciated on a straight-line basis over 40 years.

The Bank obtains an independent valuation of land and buildings every three years. In the years between independent valuations, the Bank obtains independent short-form reviews of the fair value of the land and buildings. The fair value of the land and buildings is amended only where a material change has occurred.

Currency and Artwork Collections and Archives
Items held in the Bank's currency and artwork collections and archives that have a material commercial value are independently assessed to determine estimated fair values. Surpluses of book value over historical cost for this class of asset are recorded in the Currency and Artwork Collections and Archives Revaluation Reserve. Nominal values have been placed on items with no material commercial value. Collections are not depreciated. Additions are held at cost until subsequent revaluations.

Other Property, Plant and Equipment
Other property, plant and equipment are carried at cost less depreciation and impairment losses. The following assets held by the Bank are depreciated on a straight-line basis for the following terms:

Computer Hardware	3-5 years
Plant and Equipment	5-10 years
Buildings	40 years
Property Improvements	8-15 years

Intangible Assets

Intangible assets comprise acquired and internally developed computer software and development costs incurred for the design of banknotes. Intangible assets are stated at cost less accumulated amortisation and impairment losses. Costs include all direct expenses incurred to acquire and bring to use the specific software and banknote designs.

Costs incurred in bringing to use enhancements to an existing software programme are capitalised only if the enhancement will produce additional economic benefits exceeding costs over more than one year.

Capitalised software development costs are amortised on a straight-line basis over the estimated useful life of the software (three to seven years). Costs associated with maintaining computer software are recognised as expenses when incurred.

Capitalised banknote design and development costs are capitalised and classified as inventory, and are amortised over the estimated life of the relevant banknote series.

Impairment of Property, Plant and Equipment and Intangible Assets

Cash-generating Assets
The Bank does not hold any material cash-generating assets. Assets are considered cash-generating where their primary objective is to generate a commercial return.

Non-cash-generating Assets
Property, plant and equipment and intangible assets held at cost that have finite useful lives are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which an asset's carrying amount exceeds its recoverable service amount. The recoverable service amount is the higher of the asset's fair value less costs to sell and value in use.

If an asset's carrying amount exceeds its recoverable service amount, the asset is regarded as impaired and the carrying amount is written down to the recoverable amount. The total impairment loss is recognised through surplus/(deficit).

The reversal of an impairment loss is recognised through surplus/(deficit).

f. Other Liabilities

Employee Entitlements

Wages and Salaries, Annual and Sick Leave
Liabilities for wages and salaries, including non-monetary benefits and annual leave, are recognised in Other Liabilities in respect of employees' services and

are measured at the amounts expected to be paid when liabilities are settled.

Retirement Gratuity
Retirement gratuities and post-retirement benefits apply to staff members who joined the Bank before 1 October 1991. These gratuities and benefits are recognised in Other Liabilities in respect of employees' services and are measured at the present value of future payments expected to be made in respect of services provided by employees up to the reporting date. This is calculated by an independent actuary using a discounted cash flow model. Expected future payments are discounted to their net present value using market yields at the reporting date on government bonds with terms that match as closely as possible the estimated timing of future cash flows.

Changes in the value of the liability for retirement gratuities and post-retirement benefits are included within the Statement of Financial Performance in staff expenses within Operating Expenses.

Superannuation Obligations
Obligations for contributions to defined benefit superannuation schemes are recognised as an expense in the Statement of Financial Performance as incurred.

A liability is recognised in the Statement of Financial Position where the present value of defined benefit obligations exceeds the fair value of the scheme's assets (as adjusted for unrecognised past-service costs).

An asset is recognised in the Statement of Financial Position where the present value of defined benefit obligations is less than the fair value of the scheme's assets (as adjusted for unrecognised past-service costs). Any net asset recognised in the Statement of Financial Position is limited to the estimated present value of reductions in future employer contributions to the defined benefit scheme.

The present value of the defined benefit obligation is determined by discounting the estimated future cash flows using interest rates of New Zealand government bonds that have terms to maturity approximating the terms of the related superannuation liability. The calculation is performed annually by an independent qualified actuary using the projected unit credit method.

Staff expenses within Operating Expenses in the Statement of Financial Performance include the current-service cost, the past-service cost, an interest cost and an expected return for the defined benefit superannuation scheme. The actuarial gain or loss on the defined benefit superannuation scheme is included as a separate item within Operating Expenses.

g. Revenue and Expenses

Fee Revenue

Fee revenue earned from the provision of services is recognised in the Statement of Financial Performance on an accruals basis as the services are provided.

Revenue and Expenses Allocated to Functions

The Reserve Bank Act requires the Bank to account for revenue and expenses by reference to the functions the Bank performs. Each function receives revenue and incurs expenses relating directly to the assets and liabilities used exclusively by that function. Earnings from the investment of the Bank's equity are allocated to each function based on the estimated amount of equity required for each function.

Revenue and expense flows are attached to the notional funding for each function. The Bank operates notional balance sheets to calculate the notional revenue and expenses for each of the Bank's functions as though each function operates autonomously. The Bank also has systems to allocate operating costs to functions. Operating costs are allocated as closely as possible to reflect their consumption. Direct operating costs are assigned directly to functions. Indirect operating costs are allocated to functions based on predetermined cost drivers and related activity or usage information. These structures enable each function to report more accurately the financial outcome of the services provided.

Income Tax

Section CW38 of the Income Tax Act 2007 exempts the Bank from income tax. Accordingly, no provisions are raised for current or deferred income taxes.

h. Cash Flows

For the purposes of the Statement of Cash Flows, cash and cash equivalents include balances with other central banks and amounts available at call with other financial institutions.

Certain cash flows have been netted to provide more meaningful disclosure. Netting of cash flows occurs where cash receipts and payments on behalf of customers reflect the activities of the customers rather than the Bank, or where cash receipts or payments are for items in which turnover is quick, amounts are large, and maturities are short.

i. Significant Accounting Estimates and Judgements in Applying Accounting Policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Fair Value of Financial Instruments

Financial instruments classified as held for trading or designated at fair value through surplus/(deficit), and financial assets classified as available for sale, are recognised in the financial statements at fair value. All derivatives are measured and recognised at fair value.

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Financial instruments are priced either with reference to quoted market prices for those instruments or by using a valuation model. Where the fair value is calculated using financial market pricing models, the methodology used is to calculate the expected cash flows under the terms of each specific contract and then discount these values back to the present value. These models use as their basis independently sourced market parameters including, for example, interest rate yield curves and currency rates. Most market parameters are either observable directly or implied from instrument prices.

Judgement is applied also in assessing the extent of impairment of financial and other assets.

Superannuation and Post-retirement Obligations

The Bank has obligations under the defined benefit superannuation plan and for certain post-retirement obligations as described on page 68. The carrying amount of these obligations is based on actuarial valuations, which in turn depend on a series of assumptions. Key valuation assumptions include price inflation, earnings growth, employee retirement dates and investment returns. Valuations are performed on the basis that the scheme will not be wound up.

Valuation of Land and Buildings

The fair value of the Bank's land and buildings is assessed by an independent registered property valuer. Estimated fair value is arrived at by the valuer, based on a number of assumptions, principally with respect to market rates of rental and market capitalisation rates.

2. Nature and Extent of Activities

The Reserve Bank's role as a central bank determines the nature and extent of its activities with respect to financial instruments. This role is defined by the Reserve Bank Act.

a. Local Currency Activities

The Bank provides exchange settlement account facilities to financial institutions and to the New Zealand Government. The Bank manages the aggregate level of liquidity held by financial institutions in their exchange settlement accounts.

The financial instruments used to inject funds into the banking system include local currency reverse-repurchase transactions, outright purchases of New Zealand government securities shortly before maturity, and foreign currency swaps. The Bank uses its holdings of New Zealand government securities in repurchase transactions and issues Reserve Bank bills to withdraw funds from the banking system for liquidity management purposes.

Balances in exchange settlement accounts are repayable on demand and the Bank pays interest on overnight balances. From time to time the Bank may also hold small trading positions in New Zealand government securities or registered bank securities as part of market test activities.

The Bank issues notes and coins to registered banks to meet the currency needs of the public. When currency is issued to a registered bank, the settlement account of that bank is debited with the face value of currency issued.

The Bank also operates the NZClear System. This includes carrying out securities registry and paying agent responsibilities.

b. Foreign Currency Activities

The Bank's foreign currency activities arise mainly from:

— holding foreign currency assets for crisis management purposes;

— the investment of proceeds of foreign currency swaps entered into for managing the aggregate level of liquidity of the New Zealand banking system; and

— the purchase and sale of foreign currency in support of monetary policy objectives.

Foreign reserve assets held for crisis management purposes are funded by a combination of foreign currency and local currency loans from the Treasury, which are made on arm's-length terms, and New-Zealand-dollar-denominated liabilities, including currency in circulation and deposits placed with the Bank by financial institutions. Cross-currency basis swaps are used to convert New Zealand dollar funding into foreign currency and to manage a significant portion of foreign currency risk. A proportion of foreign currency assets held for crisis management purposes is maintained without hedging their foreign currency risk. The hedged/unhedged position will vary over time as the Bank determines appropriate.

The Bank routinely injects and withdraws New Zealand dollars into and from the New Zealand banking system as part of its liquidity management operations. The injection of New Zealand dollars entails the Bank entering into foreign currency swap transactions for a finite term. The swap entails the Bank paying New Zealand dollars to the counterparty and receiving foreign currency for the term of the swap. The foreign currency received from a swap is invested in foreign-currency-denominated securities for a term coinciding with the term of the swap. Proceeds received on the maturity of the foreign currency investment are used by the Bank to repay the foreign currency at the end of the term of the foreign currency swap transaction and the counterparty repays the New Zealand dollars together with any interest.

Foreign currency purchased or sold when the Bank intervenes in the foreign exchange market to support monetary policy objectives would usually entail the Bank borrowing or lending New Zealand currency to finance the foreign currency transaction.

Financial instruments held within foreign currency portfolios consist mainly of sovereign securities, securities issued by quasi-government entities or highly rated supranational institutions, securities held under reverse-repurchase transactions, and balances held with other central banks. Liquidity and credit risks are key criteria in determining the types of instruments held.

The Bank manages the foreign currency exposure arising from certain operating and capital expenditure commitments denominated in foreign currency. The Bank will purchase foreign currency cover for those foreign-currency-denominated commitments that will fall due during the following financial year.

For further information on the risk management policies relating to financial instruments, see Notes 13 to 20.

c. Foreign Exchange Dealing

Section 16 of the Reserve Bank Act gives the Bank the power to deal in foreign currency for the purpose of carrying out its functions and powers. All dealings in foreign currency assets and liabilities occur under that section, except for transactions that occur at the direction of the Minister of Finance.

Sections 17 and 18 of the Reserve Bank Act provide for the Minister of Finance to direct the Bank to deal in foreign exchange, or for the Minister of Finance to fix the foreign exchange rates for foreign exchange dealing by the Bank. Section 21 of the Reserve Bank Act requires the Bank to either pay any foreign currency exchange gains to the Crown or be reimbursed for any foreign exchange losses as a result of dealing in foreign exchange under sections 17 or 18 of the Reserve Bank Act. In the year ended 30 June 2016 there have been no directions from the Minister under section 17 or 18 and there have been no payments to or from the Crown under section 21 of the Reserve Bank Act (2015: nil).

Under section 24 of the Reserve Bank Act the Minister, in consultation with the Bank, determines the level or range of foreign reserve assets that must be maintained by the Bank.

d. Derivatives

The Bank's involvement in derivatives includes primarily foreign currency swaps, bond and interest rate futures, interest rate swaps and cross-currency basis swaps.

Foreign currency swaps are used to manage transactions for foreign exchange for both Domestic Market Operations and Foreign Reserves Management. The arrangements are described in more detail above in (b) Foreign Currency Activities.

Bond and interest rate futures and interest rate swaps are used to enhance expected returns on foreign currency assets and, from time to time, to manage interest rate and foreign exchange risks.

e. Title to Assets

As part of its foreign currency operations the Bank enters into security repurchase transactions. These foreign currency securities sold by the Bank under repurchase agreements are recorded as assets within Investments in the Bank's Statement of Financial Position. These foreign-currency-denominated transactions are also recognised as liabilities within Securities Sold under Agreements to Repurchase in the Bank's Statement of Financial Position.

The Bank enters into security repurchase transactions as part of its liquidity management operations and market testing activities. These local-currency-denominated securities sold by the Bank under repurchase agreements are recorded as assets in New Zealand Government Securities in the Bank's Statement of Financial Position.

The Bank also purchases securities under reverse-repurchase agreements in both its foreign currency and local currency operations. These transactions are recognised as Securities Purchased under Agreements to Resell in the Bank's Statement of Financial Position.

The Bank can be required to deliver collateral under swap arrangements. Any securities delivered by the Bank as collateral remain in the Statement of Financial Position.

Note 3 gives details of the collateral taken or provided as at balance date.

FINANCIAL POSITION NOTES

3. Analysis of Financial Assets and Financial Liabilities

Foreign Currency Investments

Foreign Currency Investments of $10,646 million (2015: $13,727 million) comprise direct and indirect investments in fixed interest securities issued by foreign governments, foreign near-government entities and supranational organisations. Further details, such as the credit rating and the country in which the issuer is resident, are provided in Note 15 in respect of all financial assets, including Foreign Currency Investments.

Analysis of Financial Assets and Liabilities by Measurement Basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies describes how the classes of financial instrument are measured, and how revenue and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the Consolidated Statement of Financial Position by class and by category as defined by PBE IPSAS 29 *Financial Instruments: Recognition and Measurement* (PBE IPSAS 29).

		Fair Value Through Surplus/(Deficit)					
As at 30 June 2016	Total $M	Designated upon Initial Recognition $M	Derivatives Deemed Held for Trading $M	Available-for-sale Financial Assets $M	Financial Instruments Designated as Cash Flow Hedge $M	Loans and Receivables $M	Financial Liabilities at Amortised Cost $M
Assets							
Foreign Currency Financial Assets							
Cash Balances	8,351	-	-	-	55	8,296	-
Securities Purchased under Agreements to Resell	2,258	2,258	-	-	-	-	-
Investments	10,646	10,494	-	-	-	152	-
Derivative Assets	716	-	716	-	-	-	-
Other Foreign Currency Assets	271	-	-	144	-	127	-
Total Foreign Currency Financial Assets	22,242	12,752	716	144	55	8,575	-
Local Currency Financial Assets							
New Zealand Government Securities	3,449	-	-	3,449	-	-	-
Other Local Currency Financial Assets	191	-	-	-	-	191	-
Total Local Currency Financial Assets	3,640	-	-	3,449	-	191	-
Total Financial Assets	**25,882**	**12,752**	**716**	**3,593**	**55**	**8,766**	**-**
Liabilities							
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	209	-	-	-	-	-	209
Securities Sold under Agreements to Repurchase	662	662	-	-	-	-	-
Derivative Liabilities	741	-	741	-	-	-	-
Term Liabilities	972	972	-	-	-	-	-
Total Foreign Currency Financial Liabilities	2,584	1,634	741	-	-	-	209
Local Currency Financial Liabilities							
Deposits	13,121	-	-	-	-	-	13,121
Securities Sold under Agreements to Repurchase	110	110	-	-	-	-	-
Reserve Bank Bills	674	674	-	-	-	-	-
Currency in Circulation	5,634	-	-	-	-	-	5,634
Other Local Currency Financial Liabilities	89	-	-	-	-	-	89
Term Liabilities	796	796	-	-	-	-	-
Total Local Currency Financial Liabilities	20,424	1,580	-	-	-	-	18,844
Total Financial Liabilities	**23,008**	**3,214**	**741**	**-**	**-**	**-**	**19,053**

As at 30 June 2015	Total $M	Fair Value Through Surplus/(Deficit) Designated upon Initial Recognition $M	Fair Value Through Surplus/(Deficit) Derivatives Deemed Held for Trading $M	Available-for-sale Financial Assets $M	Financial Instruments Designated as Cash Flow Hedge $M	Loans and Receivables $M	Financial Liabilities at Amortised Cost $M
Assets							
Foreign Currency Financial Assets							
Cash Balances	6,742	-	-	-	66	6,676	-
Securities Purchased under Agreements to Resell	4,436	4,436	-	-	-	-	-
Investments	13,727	13,292	-	-	-	435	-
Derivative Assets	347	-	347	-	-	-	-
Other Foreign Currency Assets	154	-	-	153	-	1	-
Total Foreign Currency Financial Assets	25,406	17,728	347	153	66	7,112	-
Local Currency Financial Assets							
New Zealand Government Securities	3,117	-	-	3,117	-	-	-
Other Local Currency Financial Assets	496	-	-	-	-	496	-
Total Local Currency Financial Assets	3,613	-	-	3,117	-	496	-
Total Financial Assets	29,019	17,728	347	3,270	66	7,608	-
Liabilities							
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	101	-	-	-	-	-	101
Securities Sold under Agreements to Repurchase	704	704	-	-	-	-	-
Derivative Liabilities	1,739	-	1,739	-	-	-	-
Term Liabilities	1,127	1,127	-	-	-	-	-
Total Foreign Currency Financial Liabilities	3,671	1,831	1,739	-	-	-	101
Local Currency Financial Liabilities							
Deposits	14,538	-	-	-	-	-	14,538
Securities Sold under Agreements to Repurchase	1,096	1,096	-	-	-	-	-
Reserve Bank Bills	309	309	-	-	-	-	-
Currency in Circulation	5,255	-	-	-	-	-	5,255
Other Local Currency Financial Liabilities	125	-	-	-	-	-	125
Term Liabilities	800	800	-	-	-	-	-
Total Local Currency Financial Liabilities	22,123	2,205	-	-	-	-	19,918
Total Financial Liabilities	25,794	4,036	1,739	-	-	-	20,019

Fair Value of Financial Assets and Liabilities

All financial assets and liabilities are recorded at fair value based on either quoted market prices or prices derived from market yield curves, as described in the Bank's accounting policies, except as detailed below. Refer below for details of the classification by valuation hierarchy of financial assets and financial liabilities carried at fair value.

a. Unsettled Transactions

The reported value of unsettled sales and purchases is considered to approximate their fair value due to the very short period between balance date and the settlement date.

b. Cash Balances and Short-term Deposits

The carrying value of cash balances and short-term deposits is considered to approximate their fair value, as they are payable on demand.

c. Currency in Circulation

Currency in Circulation is reported at its face value, as currency in circulation is payable on demand. PBE IPSAS 29 requires that the fair value cannot be less than the face value.

d. Cash Collateral Assets and Liabilities

Collateral received or paid under two-way Credit Support Annex agreements is recorded within Investments and Other Local Currency Financial Assets and in Short-term Foreign Currency Financial Liabilities. The carrying value is considered to approximate the fair value of these financial assets and liabilities due to the short-term nature of the margin calls.

e. Dividend Receivable and Accounts Payable

Any dividends receivable from the BIS are recorded in Other Foreign Currency Assets. Accounts payable are recorded in Other Local Currency Financial Liabilities. The carrying values are considered to approximate the fair values due to the short period between balance date and the receipt or payment of these financial assets and liabilities.

f. Demonetised Currency

The Bank has a liability for currency in circulation that has been demonetised but not returned to the Bank. The liability is recorded in Other Local Currency Financial Liabilities and is reported at its face value as demonetised currency is payable on demand.

Determination of Fair Value of Financial Instruments Carried at Fair Value

Each financial instrument carried at fair value is categorised within the hierarchy based on the lowest-level input that is significant to the fair value measurement of the whole instrument.

Fair values are determined according to the following hierarchy:

a. Quoted Market Price

Financial instruments with quoted prices for identical instruments in active markets (level 1).

b. Valuation Technique Using Observable Inputs

Financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets, and financial instruments valued using models where all significant inputs are observable (level 2).

The determination of what constitutes 'observable' requires significant judgement by the Bank. The Bank considers observable data to be market data that is available readily, distributed or updated regularly, reliable and verifiable, not proprietary, and provided by independent sources that are involved actively in the relevant market. Judgement is required also in determining appropriate margins to representative forward prices and interest rate yield curves in order to model more accurately the market price of the specific instrument that is being valued.

Where necessary, valuation models include estimated future cash flows and discount rates that are calculated using forward prices and interest rate yield curves. Forward prices and interest rate yield curves are sourced from the relevant published market-observable exchange rates and interest rates applicable to the remaining life of the instrument at the valuation date. Also, where necessary, margin adjustments are made to representative prices and interest rate yield curves in order to allow for features of the instrument that would be taken into account in valuing a financial instrument, where those features are not included or priced into representative forward prices and interest rate yield curves.

c. Valuation Technique with Significant Non-observable Inputs

Financial instruments valued using models where one or more significant inputs are not observable (level 3).

As at 30 June 2016	Total $M	Valuation Techniques: Quoted Market Price $M	Using Observable Inputs $M	With Significant Non-observable Inputs $M
Assets				
Foreign Currency Financial Assets				
Securities Purchased under Agreements to Resell	2,258	-	2,258	-
Investments	10,494	4,206	6,288	-
Derivative Assets	716	-	716	-
Other Foreign Currency Assets	144	-	-	144
Total Foreign Currency Financial Assets Carried at Fair Value	13,612	4,206	9,262	144
Local Currency Financial Assets				
New Zealand Government Securities	3,449	3,449	-	-
Total Local Currency Financial Assets Carried at Fair Value	3,449	3,449	-	-
Total Financial Assets Carried at Fair Value	17,061	7,655	9,262	144
Liabilities				
Foreign Currency Financial Liabilities				
Securities Sold under Agreements to Repurchase	662	-	662	-
Derivative Liabilities	741	-	741	-
Term Liabilities	972	-	972	-
Total Foreign Currency Financial Liabilities Carried at Fair Value	2,375	-	2,375	-
Local Currency Financial Liabilities				
Securities Sold under Agreements to Repurchase	110	-	110	-
Reserve Bank Bills	674	-	674	-
Term Liabilities	796	-	796	-
Total Local Currency Financial Liabilities Carried at Fair Value	1,580	-	1,580	-
Total Financial Liabilities Carried at Fair Value	3,955	-	3,955	-

As at 30 June 2015	Total $M	Valuation Techniques: Quoted Market Price $M	Using Observable Inputs $M	With Significant Non-observable Inputs $M
Assets				
Foreign Currency Financial Assets				
Securities Purchased under Agreements to Resell	4,436	-	4,436	-
Investments	13,292	6,115	7,177	-
Derivative Assets	347	-	347	-
Other Foreign Currency Assets	153	-	-	153
Total Foreign Currency Financial Assets Carried at Fair Value	18,228	6,115	11,960	153
Local Currency Financial Assets				
New Zealand Government Securities	3,117	3,117	-	-
Total Local Currency Financial Assets Carried at Fair Value	3,117	3,117	-	-
Total Financial Assets Carried at Fair Value	21,345	9,232	11,960	153
Liabilities				
Foreign Currency Financial Liabilities				
Securities Sold under Agreements to Repurchase	704	-	704	-
Derivative Liabilities	1,739	-	1,739	-
Term Liabilities	1,127	-	1,127	-
Total Foreign Currency Financial Liabilities Carried at Fair Value	3,570	-	3,570	-
Local Currency Financial Liabilities				
Securities Sold under Agreements to Repurchase	1,096	-	1,096	-
Reserve Bank Bills	309	-	309	-
Term Liabilities	800	-	800	-
Total Local Currency Financial Liabilities Carried at Fair Value	2,205	-	2,205	-
Total Financial Liabilities Carried at Fair Value	5,775	-	5,775	-

Collateral Pledged

The carrying amount of securities pledged as collateral for liabilities comprising Securities Sold under Agreements to Repurchase was $110 million (2015: $1,096 million) and the fair value of collateral pledged was $107 million (2015: $1,096 million). Cash collateral of $315 million was provided (2015: $928 million).

Collateral Received

Investments

The Bank has entered into reverse-repurchase agreements in respect of New-Zealand-dollar-denominated and foreign-currency-denominated marketable securities. The table below shows the principal amount subject to reverse-repurchase agreements and the fair value of collateral received. The Bank may sell or re-pledge that collateral even if the counterparty is not in default of its obligations.

	NZ-Dollar-denominated Investments		Foreign-Currency-denominated Investments	
	2016 $M	2015 $M	**2016 $M**	2015 $M
Principal Amount Subject to Reverse-Repurchase Agreements	**-**	-	**1,597**	3,733
Fair Value of Collateral Received	**-**	-	**1,655**	3,811

Other Collateral Received

In addition, cash collateral received was $133 million (2015: $43 million). Cash collateral received is recorded in the Statement of Financial Position within Short-term Foreign Currency Financial Liabilities.

Under the Bank's securities lending programme, the Bank has lent securities with a fair value of $662 million (2015: $704 million). The Bank has accepted securities with a fair value of $678 million (2015: $718 million) as collateral for the securities lent under this programme.

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse-repurchase agreements.

Additional Information for Financial Liabilities

The carrying amount as at balance date of financial liabilities designated at fair value through surplus/(deficit), excluding derivatives, was $8 million less (2015: $5 million less) than the contractual amount at maturity.

Interest rates used as observable inputs in determining the fair value of financial liabilities will inherently include a component for credit risk. However, given the Bank's status as a sovereign issuer, it is difficult to isolate and measure accurately the change in interest rates and the resulting change in fair value of financial liabilities directly attributable to credit risk.

Collateral has been pledged for all Securities Sold under Agreements to Repurchase. All other liabilities of the Bank are unsecured and rank equally in the event that the Bank ceases to trade.

4. Derivatives

The Bank's involvement in derivatives includes interest rate futures, cross-currency basis swaps and foreign exchange swaps. Refer to page 70 for a description of the Bank's use of derivatives.

	Carrying Value 2016 $M	Notional Principal 2016 $M	Carrying Value 2015 $M	Notional Principal 2015 $M
Interest Rate Futures				
Interest Rate Futures Assets	-	-	-	163
Interest Rate Futures Liabilities	(2)	151	-	178
Net Interest Rate Futures Position	(2)	151	-	341
As at 30 June 2016 the Bank had 585 open Interest Rate Futures contracts (2015: 1,471).				
Cross-Currency Basis Swaps				
Cross-Currency Basis Swaps Assets	395	4,332	329	1,930
Cross-Currency Basis Swaps Liabilities	(670)	5,927	(972)	7,278
Net Cross-Currency Basis Swaps Position	(275)	10,259	(643)	9,208
Foreign Exchange Swaps				
Foreign Exchange Swaps Assets	321	11,085	18	1,691
Foreign Exchange Swaps Liabilities	(69)	4,281	(767)	13,155
Net Foreign Exchange Swaps Position	252	15,366	(749)	14,846
Total Derivative Assets	716	15,417	347	3,784
Total Derivative Liabilities	(741)	10,359	(1,739)	20,611
Net Derivatives Recognised in the Statement of Financial Position	(25)	25,776	(1,392)	24,395

5. Other Foreign Currency Financial Assets

	2016 $M	2015 $M
Shareholding in the Bank for International Settlements	144	153
Dividend Receivable	-	1
Receivable for Unsettled Sales of Securities	127	-
	271	154

As at 30 June 2016 the Bank owned 3,211 shares (2015: 3,211 shares) issued by the BIS. This represents approximately 0.6 percent of all shares on issue. The shares have a par value of SDR 5,000 each and are paid up to SDR 1,250 each. The Bank's investment in shares issued by the BIS is valued at fair value, which is determined as being 70 percent of the Bank's interest in the BIS's net asset value.

6. Other Assets

	2016 $M	2015 $M
Property, Plant and Equipment	69	69
Intangible Assets	6	3
Inventory	26	16
	101	88

The Bank obtains an independent valuation of land and buildings every three years. The most recent valuation of land and buildings, dated 30 June 2015, was prepared by Jones, Lang LaSalle Limited, an independent registered valuer. The valuation was prepared by discounting rental and nominal rental flows at current market capitalisation rates. The valuation report included details of recent sales of broadly comparable premises. The capitalisation rate applied in valuing the property was a weighted average of 7.7 percent per annum. The aggregate market value of land and buildings was $53.8 million. The original cost was $10 million.

For 30 June 2016 the Bank engaged Jones, Lang LaSalle Limited to conduct a short-form review of the fair value of the land and buildings. This short-form review, which does not constitute a full valuation, supports the current carrying value.

7. Short-term Foreign Currency Financial Liabilities

	2016 $M	2015 $M
Payable for Unsettled Purchases of Securities	**76**	58
Short-term Deposits	**133**	43
	209	101

Cash collateral received in respect of reverse-repurchase agreements is recorded as Short-term Deposits.

8. Deposits

	2016 $M	2015 $M
New Zealand Government Deposits	**5,802**	6,112
Settlement Bank Deposits	**7,280**	8,321
Central Bank Deposits	**32**	47
International Monetary Fund Deposits	**7**	58
	13,121	14,538

New Zealand Government Deposits

The Bank provides the Crown Settlement Account for the Government. This account serves as the Crown's central 'disbursement account', although one of the registered banks provides actual cheque processing and other transactional banking services for the Government. The balances with this bank are 'cleared' to the Crown Settlement Account at the Reserve Bank each day.

Settlement Bank Deposits

The Bank provides exchange settlement account facilities to financial institutions and to the New Zealand Government. Balances in exchange settlement accounts are repayable on demand and the Bank pays interest on overnight balances.

Central Bank Deposits and International Monetary Fund Deposits

The Bank provides New Zealand dollar transactional banking services for other central banks and the International Monetary Fund (IMF). Balances in these accounts are repayable on demand and the Bank pays no interest on overnight balances.

9. Other Local Currency Financial Liabilities

	2016 $M	2015 $M
Accounts Payable	**8**	7
Payable for Unsettled Purchase of Securities	**-**	37
Demonetised Currency	**81**	81
	89	125

10. Other Liabilities

	Note	2016 $M	2015 $M
Dividend Payable to the New Zealand Government	11	**140**	510
Accrued Salaries and Holiday Pay		**3**	2
Accrued Retirement Gratuities		**2**	2
Superannuation Liability	27	**2**	-
		147	514

No provision is made for non-vesting sick leave, as the pattern of sick leave taken indicates that no additional liability will arise for non-vesting sick leave.

11. Management of the Bank's Capital and Dividend or Similar Distributions

The Bank is not subject to any regulatory capital requirements.

The Bank's capital management objective is to ensure that the Bank has sufficient equity to perform its functions. Specifically, the Bank employs an economic capital framework that ensures the Bank is unlikely, within a 99.9 percent confidence level, to suffer a financial loss through credit, market or operational risks that would result in negative equity.

The Bank uses market and credit risk models using both standard and stressed value at risk (VaR) models, and applies these to its traded, and non-traded, portfolios to model the Bank's capital requirement. An allowance for operational risk is also added. Modelling uses assumptions and judgement. Key inputs in capital modelling include interest rate and foreign currency positions and limits, foreign and local currency investments and counterparty credit exposures, as well as the probability of loss with respect to each of these factors. Based on a 99.9 percent confidence level, the Bank's modelled capital requirement is assessed as being $2,300 million (2015: $2,300 million).

The calculation of required capital is assessed by the Bank's Asset and Liability Committee and the Governing Committee. In making that assessment, consideration is given to whether a capital buffer needs to be retained for hypothetical events such as an extreme economic shock or foreign currency market event. No additional capital buffers were provided as at the reporting date (2015: nil). The Board and Minister review the Bank's assessment of required capital when considering the Bank's annual dividend recommendation.

Dividends

The Bank is required to recommend to the Minister the amount of a dividend in respect of each financial year ended 30 June. The Bank must determine the dividend recommendation in accordance with the dividend principles set out in the *Statement of Intent.* These principles are:

- 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; and
- 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.

For 2016 the Bank has recommended that a dividend of $140 million be paid. The Board has supported that recommendation and the Minister of Finance has determined that a dividend of $140 million be paid for 2016. In 2015 a dividend of $510 million was paid.

The following table shows the components of equity, including the amount of unrealised gains, and sets out how equity excluding unrealised gains is compared with required equity to arrive at the recommended dividend.

Net Assets/Equity comprises:

	Total Net Assets/ Equity 2016 $M	Net Assets/ Equity Excluding Unrealised Gains 2016 $M	Unrealised Gains 2016 $M	Total Net Assets/ Equity 2015 $M	Net Assets/ Equity Excluding Unrealised Gains 2015 $M	Unrealised Gains 2015 $M
Accumulated Comprehensive Revenue and Expense						
Realised Gains before Provision for Dividend	974	974	-	1,213	1,213	-
Changes in the Fair Value of Financial Instruments Not yet Realised	98	-	98	93	-	93
Foreign Exchange Losses Not yet Realised in New Zealand Dollars	(134)	(134)	-	90	-	90
Total Accumulated Comprehensive Revenue and Expense before Provision for Dividend and Excluding Revaluation Reserves	938	840	98	1,396	1,213	183
Available-for-sale Revaluation Reserve	366	-	366	241	-	241
Property, Currency and Artwork Collections Revaluation Reserve	59	-	59	59	-	59
Cash Flow Hedge Reserve	5	-	5	13	-	13
	430	-	430	313	-	313
Total Accumulated Comprehensive Revenue and Expense and Revaluation Reserves before Provision for Dividend	1,368	840	528	1,709	1,213	496
Capital Contributed by the New Zealand Government	1,600	1,600	-	1,600	1,600	-
	2,968	2,440	528	3,309	2,813	496
Less Provision for Dividend	(140)	(140)	-	(510)	(510)	-
Total Net Assets/Equity after Provision for Dividend	2,828	2,300	528	2,799	2,303	496

To ensure that unrealised gains are not distributed, after a provision for dividend is made, Net Assets/Equity Excluding Unrealised Gains should not be less than required capital. For 2016, after providing for a dividend of $140 million, Net Assets/Equity Excluding Unrealised Gains was $2,300 million against required equity of $2,300 million.

For 2015, after providing for a dividend of $510 million, Net Assets/Equity Excluding Unrealised Gains was $2,303 million against required equity of $2,300 million.

12. Concentrations of Funding

	Total 2016 $M	New Zealand Government $M	New Zealand Public $M	New Zealand Financial Institutions $M	Overseas Financial Institutions $M	Other $M
Financial Liabilities						
Foreign Currency Term Liabilities	**972**	**972**	**-**	**-**	**-**	**-**
Securities Sold under Agreements to Repurchase	**772**	**-**	**-**	**110**	**662**	**-**
Deposits	**13,121**	**5,802**	**-**	**5,369**	**1,887**	**63**
Local Currency Term Liabilities	**796**	**796**	**-**	**-**	**-**	**-**
Reserve Bank Bills	**674**	**-**	**-**	**674**	**-**	**-**
Currency in Circulation	**5,634**	**-**	**5,634**	**-**	**-**	**-**
Other Liabilities	**1,039**	**-**	**81**	**230**	**720**	**8**
Total Financial Liabilities	**23,008**	**7,570**	**5,715**	**6,383**	**3,269**	**71**

	Total 2015 $M	New Zealand Government $M	New Zealand Public $M	New Zealand Financial Institutions $M	Overseas Financial Institutions $M	Other $M
Financial Liabilities						
Foreign Currency Term Liabilities	1,127	1,127	-	-	-	-
Securities Sold under Agreements to Repurchase	1,800	-	-	1,080	720	-
Deposits	14,538	6,112	-	6,630	1,765	31
Local Currency Term Liabilities	800	800	-	-	-	-
Reserve Bank Bills	309	-	-	309	-	-
Currency in Circulation	5,255	-	5,255	-	-	-
Other Liabilities	1,965	-	81	664	1,213	7
Total Financial Liabilities	25,794	8,039	5,336	8,683	3,698	38

All figures are stated at carrying values in the Statement of Financial Position.

RISK MANAGEMENT NOTES

13. Risk Management

The Reserve Bank is involved in policy-oriented activities, therefore elements of the Bank's risk management framework might differ from the risk management frameworks of most other financial institutions. The main financial risks to which the Bank is exposed include credit risk, foreign currency risk and interest rate risk on both foreign and local currency assets. In the management of foreign reserves, minimising liquidity risk is a major consideration in maintaining an effective foreign exchange intervention capability. Policies for managing credit, interest rate, foreign currency and liquidity risks are outlined in Notes 15 to 19. As for other financial institutions, the nature of the Bank's operations creates exposure to a broad range of enterprise risks, including operational and reputational risks.

The Bank seeks to ensure that strong and effective risk management and control systems identify, assess, monitor and manage risk exposures. An Asset and Liability Committee (ALCO), comprising the governors and senior management, is responsible for advising the Governing Committee with respect to all balance sheet-related activities, including the appropriateness of risk-return trade-offs underlying the Bank's strategy. Specialist staff conduct the Bank's local currency, foreign currency reserves management and foreign-exchange-dealing operations in accordance with a clearly defined risk management framework, including delegated authorities and limits set by the Governing Committee. The risk management framework is subject to regular review by ALCO. The overall risk management framework is designed to promote the sound and prudent management of the Bank's risks.

The majority of the Bank's financial risks arise from the Foreign Reserves Management and Domestic Market Operations units of the Bank's Financial Markets department. Within this department, a separate risk management team is responsible for maintaining the Bank's financial risk management framework and operating independent risk reporting systems that monitor and report compliance with various risk limits and policies.

The Risk Assessment and Assurance department (which includes an internal audit unit) is responsible for an enterprise-wide risk management system and reports on internal audit, enterprise-wide risk management and related issues to the Governing Committee. A risk-based framework, which evaluates key business risks and internal controls, determines the extent and frequency of internal audits conducted. All Bank departments are subject to periodic internal audit reviews. The Head of Risk Assessment and Assurance and the Manager, Internal Audit have direct and independent access to the Audit Committee of the Board of Directors, which comprises three of the Bank's non-executive directors. Summary information on the outcomes of internal audits is reported to the Audit Committee.

The Bank is subject to an annual external audit by the Auditor-General under the Public Audit Act 2001. Auditing arrangements are overseen by the Audit Committee of the Board of Directors, which meets regularly to monitor the financial reporting, risk and audit functions within the Bank. The committee reviews the internal audit function and has direct access to the external auditor. The Audit Committee reports to the Board of Directors on its activities. The Board of Directors monitors the Bank's management of risk as part of its role of keeping the Bank's performance and use of resources under constant review.

The Bank continues to self-insure all property, plant and equipment, including the Bank's Wellington building.

14. Operational Risk

Operational risk is the risk of loss, in both financial and non-financial terms, resulting from human error and the failure of processes and systems.

The Bank has a broad range of functions spanning policy, financial stability, payment systems and internal corporate support, all of which are exposed to operational risk.

Managing operational risk in the Bank is an integral part of day-to-day operations and management, and includes an explicit consideration of both the opportunities and the risks of all business activities. Operational risk management includes Bank-wide corporate policies that describe the standard of conduct required of staff, a number of mandated requirements (e.g., a proactive problem management process whereby problems and incidents are reported and analysed for potential risk management improvements), an active internal audit function, and specific internal control systems designed around the particular characteristics of various Bank activities.

The above policies and procedures for managing operational risk are reinforced by the requirements of section 165 of the Reserve Bank Act. The Reserve Bank Act requires that the financial statements of the Bank include a statement signed by the Governor and Deputy Chief Executive accepting responsibility for, among other things, the establishment and maintenance of a system of effective internal control within the Bank.

15. Credit Risk

Credit risk is the risk of loss due to a borrower or counterparty failing to meet their financial obligations in accordance with agreed terms.

Within the Bank credit risk arises principally through the investment of funds through Foreign Reserves Management and Domestic Market Operations functions. The Bank faces counterparty risk to the extent that derivative contracts are utilised by these two functions as part of normal operations.

a. Foreign Reserves Management Credit Risk Management

Credit risk for Foreign Reserves Management is monitored and managed daily. Exposures are controlled through comprehensive individual counterparty and issuer credit limits. Individual credit limits are set taking into account the credit profile of the counterparty or issuer. Individual credit exposures are also aggregated and managed against cumulative limits, such as country exposure limits.

As part of the arrangements for using financial instruments, credit risk is mitigated by receiving collateral. Collateral usually takes the form of cash or government securities. The value of collateral held is required to be within a prescribed range of the value of the exposure to the counterparty. Valuations are updated daily and, as a result, additional collateral may be called for or excess collateral returned to the counterparty.

b. Domestic Market Operations Credit Risk Management

Repurchase, reverse-repurchase and swap transactions generated by the Domestic Market Operations function also give rise to credit risk. The Bank accepts a wide range of pre-approved securities for reverse-repurchase transactions. Where funds are advanced by reverse-repurchase agreements, the amount advanced is subject to specified discounts depending on the type of security so as to ensure that the value of security held exceeds the amount advanced. Where funds are advanced by swap transactions, collateral is taken or given in cash. The value of security held is monitored daily and calls are made for additional collateral to be requested from, or excess collateral returned to, the counterparty as required.

c. Concentrations of Credit Exposure

The following table presents the Bank's financial assets based on end-of-year concentrations of credit exposure, classified by the country in which the issuer is resident. For this table, where collateral is held for reverse-repurchase agreements, the exposure measured is that to the issuer of the collateral as opposed to the counterparty to the reverse-repurchase agreement.

Country in which Issuer is Resident:	Total 2016 $M	Sovereign 2016 $M	Financial Institutions 2016 $M	Total 2015 $M	Sovereign 2015 $M	Financial Institutions 2015 $M
United States	**7,585**	**7,183**	**402**	11,765	11,435	330
New Zealand	**3,745**	**3,449**	**296**	3,665	3,117	548
Supranational	**3,454**	**-**	**3,454**	2,114	-	2,114
Japan	**3,454**	**3,454**	**-**	1,599	1,599	-
France	**1,994**	**935**	**1,059**	2,094	1,399	695
Germany	**1,953**	**649**	**1,304**	2,666	697	1,969
Netherlands	**1,658**	**1,547**	**111**	2,070	792	1,278
Australia	**554**	**454**	**100**	598	487	111
United Kingdom	**425**	**380**	**45**	549	549	-
Canada	**325**	**277**	**48**	328	324	4
Asian Bond Funds	**180**	**-**	**180**	186	-	186
China	**144**	**144**	**-**	156	156	-
Denmark	**140**	**-**	**140**	347	-	347
Austria	**140**	**-**	**140**	123	-	123
Other Non-European	**74**	**-**	**74**	227	-	227
Switzerland	**57**	**-**	**57**	-	-	-
Sweden	**-**	**-**	**-**	532	-	532
Total Financial Assets	**25,882**	**18,472**	**7,410**	29,019	20,555	8,464

The following table presents the Bank's financial assets based on end-of-year concentrations of credit exposure, classified by the country in which the counterparty is resident.[8] For this table, any collateral held is not included in determining exposures.

Country in which Counterparty is Resident:	**Total 2016 $M**	**Sovereign 2016 $M**	**Financial Institutions 2016 $M**	Total 2015 $M	Sovereign 2015 $M	Financial Institutions 2015 $M
United States	**5,989**	**4,884**	**1,105**	8,033	6,999	1,034
New Zealand	**3,745**	**3,449**	**296**	3,665	3,117	548
Supranational	**3,454**	**-**	**3,454**	2,114	-	2,114
Japan	**3,454**	**3,454**	**-**	1,599	1,599	-
United Kingdom	**2,056**	**380**	**1,676**	4,281	549	3,732
France	**1,994**	**935**	**1,059**	2,094	1,399	695
Germany	**1,953**	**649**	**1,304**	2,666	700	1,966
Netherlands	**1,658**	**1,547**	**111**	2,070	792	1,278
Australia	**519**	**419**	**100**	598	487	111
Canada	**325**	**277**	**48**	328	324	4
Asian Bond Funds	**180**	**-**	**180**	186	-	186
China	**144**	**144**	**-**	156	156	-
Denmark	**140**	**-**	**140**	347	-	347
Austria	**140**	**-**	**140**	123	-	123
Other Non-European	**74**	**-**	**74**	227	-	227
Switzerland	**57**	**-**	**57**	-	-	-
Sweden	**-**	**-**	**-**	532	-	532
Total Financial Assets	**25,882**	**16,138**	**9,744**	29,019	16,122	12,897

8. The differences between amounts disclosed by issuer and by counterparty relate to Securities Purchased under Agreements to Resell.

d. Credit Exposure by Credit Rating

The following table presents the Bank's financial assets based on the Standard & Poor's credit rating of the issuer. AAA is the highest-quality rating possible and indicates that the entity has an extremely strong capacity to pay interest and principal. AA is a high-grade rating, indicating a very strong capacity, and A is an upper-medium grade, indicating a strong capacity to pay interest and principal. BBB is the lowest investment-grade rating, indicating a medium capacity to pay interest and principal. Ratings lower than AAA can be modified by + or - signs to indicate relative standing within the major categories. N/R indicates the entity has not been rated by Standard & Poor's.

For this table, where collateral is held for reverse-repurchase agreements, the credit rating is that for the issuer of the collateral, not the credit rating for the counterparty to the reverse-repurchase agreement.

Credit Rating Country in which Issuer is Resident:	Total 2016 $M	AAA 2016 $M	AA+/- 2016 $M	A+/- 2016 $M	Various 2016 $M	N/R 2016 $M
United States	**7,585**	-	**7,206**	**378**	-	**1**
New Zealand	**3,745**	-	**3,741**	-	-	**4**
Supranational[9]	**3,454**	**421**	**108**	-	-	**2,925**
Japan	**3,454**	-	-	**3,454**	-	-
France[10]	**1,994**	-	**1,314**	**91**	-	**589**
Germany	**1,953**	**1,953**	-	-	-	-
Netherlands	**1,658**	**1,658**	-	-	-	-
Australia	**554**	**454**	**100**	-	-	-
United Kingdom	**425**	-	**381**	**42**	-	**2**
Canada	**325**	**277**	**21**	**27**	-	-
Asian Bond Funds	**180**	-	-	-	**180**	-
China	**144**	-	-	-	**144**	-
Denmark	**140**	**140**	-	-	-	-
Austria	**140**	-	**140**	-	-	-
Other Non-European	**74**	-	**74**	-	-	-
Switzerland	**57**	-	-	**57**	-	-
Total Financial Assets	**25,882**	**4,903**	**13,085**	**4,049**	**324**	**3,521**

Credit Rating Country in which Issuer is Resident:	Total 2015 $M	AAA 2015 $M	AA+/- 2015 $M	A+/- 2015 $M	Various 2015 $M	N/R 2015 $M
United States	11,765	-	11,440	324	-	1
New Zealand	3,665	-	3,662	-	-	3
Germany	2,666	2,665	-	-	-	1
Supranational[9]	2,114	1,581	-	-	-	533
France	2,094	-	2,035	59	-	-
Netherlands	2,070	-	2,070	-	-	-
Japan	1,599	-	1,599	-	-	-
Australia	598	487	111	-	-	-
United Kingdom	549	549	-	-	-	-
Sweden	532	532	-	-	-	-
Denmark	347	347	-	-	-	-
Canada	328	324	3	1	-	-
Other Non-European	227	-	227	-	-	-
Asian Bond Funds	186	-	-	-	186	-
China	156	-	-	-	156	-
Austria	123	-	123	-	-	-
Total Financial Assets	29,019	6,485	21,270	384	342	538

9. Exposures to Supranationals that do not have credit ratings are exposures to the BIS.
10. Exposures to France that do not have credit ratings by Standard & Poor's are rated as Aa2 by Moody's.

16. Market Risk

Market risk is the risk that the fair value of a financial instrument will fluctuate because of changes in market prices and rates. In respect of the Bank, market risk comprises interest rate risk and foreign currency risk.

The Bank uses a range of position size, delta, and stop-loss limits, together with VaR to measure and manage market risk.

Interest Rate Risk and Limits

Interest rate risk is the risk that the fair value of a financial instrument will fluctuate due to changes in interest rates. Interest rate deltas measure the change in fair value of a financial instrument due to a 0.01 percent increase in interest rates. Interest rate delta limits are established for the aggregate balance sheet as well as individual portfolios.

Foreign Currency Risk and Limits

Foreign currency risk is the risk that the fair value of a financial instrument will fluctuate due to a change in foreign exchange rates. Foreign exchange position limits are established for the aggregate net foreign currency position that may be taken, together with limits for the net exposure to individual foreign currency positions.

VaR and VaR Limits

VaR estimates financial loss potential based on historical observations of market rate and price movements. The Bank's VaR models test Bank portfolios against various periods of historical data, including the most recently recorded data, and data recorded during stressed market conditions (such as those recorded during 2008). The Bank's primary VaR model captures the potential financial loss over one day, at 99 percent confidence, referencing the most recent 250 days of price data. A 99 percent confidence interval suggests that the Bank may incur losses greater than those predicted by VaR once every 100 trading days, or 2.5 times a year.

VaR limits are utilised to manage market risk arising from the Bank's actively managed portfolios.

	Foreign Reserves Management Portfolios					
	Foreign Currency Risk		Interest Rate Risk		Total Market Risk	
VaR	**2016 $M**	2015 $M	**2016 $M**	2015 $M	**2016 $M**	2015 $M
As at 30 June	**43**	43	**6**	5	**43**	43
Peak over the Year	**50**	43	**6**	6	**50**	43
Low over the Year	**42**	22	**5**	4	**42**	22
Average over the Year	**46**	30	**6**	5	**46**	30

Total Market Risk is the sum of Foreign Currency Risk and Interest Rate Risk and also includes a deduction for correlation benefits.

Stop-loss Limits

Stop-loss limits are set to control losses that may arise in the Bank's actively traded portfolios. Should market risk losses exceed the stop-loss limit, the associated positions are closed.

Sensitivity to Interest Rate Risk and Foreign Currency Risk

The sensitivity of the fair value of the Bank's financial assets and liabilities to assumed across-the-board changes in interest rates and the exchange rate is shown below.

	Total Gain/ (Loss) Affecting Compre-hensive Revenue and Expense 2016 $M	Gain/ (Loss) Reported in the Statement of Financial Perform-ance 2016 $M	Gain/ (Loss) Reported Directly in Net Assets/ Equity 2016 $M	Total Gain/ (Loss) Affecting Compre-hensive Revenue and Expense 2015 $M	Gain/ (Loss) Reported in the Statement of Financial Perform-ance 2015 $M	Gain/ (Loss) Reported Directly in Net Assets/ Equity 2015 $M
Impact of:						
A Rise of 10 Percent in the Value of the New Zealand Dollar	**(269)**	**(256)**	**(13)**	(322)	(308)	(14)
A Fall of 10 Percent in the Value of the New Zealand Dollar	**329**	**313**	**16**	394	377	17
A Rise of One Percentage Point in the Local Currency Yield Curve	**(255)**	**(17)**	**(238)**	(184)	(19)	(165)
A Fall of One Percentage Point in the Local Currency Yield Curve	**285**	**17**	**268**	200	19	181
A Rise of One Percentage Point in the Yield Curve for All Foreign Currencies	**(25)**	**(25)**	**-**	(19)	(19)	-
A Fall of One Percentage Point in the Yield Curve for All Foreign Currencies	**28**	**28**	**-**	19	19	-

The Bank's exposures to foreign currency risk and interest rate risk can change materially over time, depending on the Bank's policy objectives and economic conditions.

17. Interest Rate Risk

Interest rate risk is the risk that the fair value of a financial instrument will fluctuate due to changes in interest rates.

Foreign Reserves Management Interest Rate Risk Management

The Bank holds an open foreign currency position, effectively financing a portion of its foreign currency assets using New Zealand dollar funding. This exposes the Bank to the risk of changes in the relative interest rates of New Zealand and overseas currencies. Interest rate risk also arises as a result of mismatches between the maturity, or interest rate resets, of assets and liabilities where the assets and liabilities are denominated in the same currency. The Bank utilises risk limits to cap the amount of interest rate risk that the Bank manages actively.

Domestic Market Operations Interest Rate Risk Management

The Bank's exposure to interest rate risk that arises from domestic market operations is also constrained through interest rate risk limits.

The average duration of the Bank's holding of New Zealand government securities in its investment portfolio (which excludes outright purchases of government securities for liquidity management purposes) as at 30 June 2016 was 7.3 years (2015: 7.1 years). Interest rate risk on New Zealand government securities is not dynamically managed and it is intended that these securities be held to maturity.

Assets and liabilities will mature or reprice within the following periods:

	Total 2016 $M	Non-interest Sensitive $M	Overnight $M	3 Months or Less $M	Between 3 and 12 Months $M	Between 1 and 2 Years $M	Between 2 and 5 Years $M	More Than 5 Years $M
Assets								
Investments	10,646	-	182	7,209	545	1,165	1,201	344
Securities Purchased under Agreements to Resell	2,258	-	-	2,258	-	-	-	-
New Zealand Government Securities	3,449	-	-	1,017	-	501	831	1,100
Other Financial Assets	9,529	299	8,534	696	-	-	-	-
Other Assets	101	101	-	-	-	-	-	-
Total Assets	**25,983**	**400**	**8,716**	**11,180**	**545**	**1,666**	**2,032**	**1,444**
Liabilities								
Foreign Currency Term Liabilities	972	-	-	972	-	-	-	-
Local Currency Term Liabilities	796	-	-	796	-	-	-	-
Securities Sold under Agreements to Repurchase	772	-	-	772	-	-	-	-
Deposits	13,121	39	13,082	-	-	-	-	-
Reserve Bank Bills	674	-	-	674	-	-	-	-
Currency in Circulation	5,634	5,634	-	-	-	-	-	-
Other Financial Liabilities	1,039	165	115	759	-	-	-	-
Other Liabilities	147	147	-	-	-	-	-	-
Net Assets/Equity	2,828	2,828	-	-	-	-	-	-
Total Liabilities and Equity	**25,983**	**8,813**	**13,197**	**3,973**	**-**	**-**	**-**	**-**
Interest Rate Sensitivity Gap excluding Futures Contracts	-	(8,413)	(4,481)	7,207	545	1,666	2,032	1,444
Futures Contracts	(151)	-	-	-	-	(127)	-	(24)
Total Interest Rate Sensitivity Gap	**(151)**	**(8,413)**	**(4,481)**	**7,207**	**545**	**1,539**	**2,032**	**1,420**
Interest Rate Sensitivity Gap by Currency[11]								
New Zealand Dollar	(2,959)	(8,103)	(12,894)	15,606	-	501	831	1,100
United States Dollar	541	(396)	3,670	(3,421)	25	473	168	22
Euro	725	53	1,547	(1,681)	312	-	494	-
Japanese Yen	178	14	3,165	(3,291)	-	222	68	-
British Pound	373	16	6	1	186	-	188	(24)
Australian Dollar	419	3	18	-	22	175	181	20
Canadian Dollar	270	-	7	(7)	-	168	102	-
Chinese Renminbi	144	-	-	-	-	-	-	144
Other	158	-	-	-	-	-	-	158
	(151)	**(8,413)**	**(4,481)**	**7,207**	**545**	**1,539**	**2,032**	**1,420**

New Zealand government inflation-indexed bonds, with a market value of $1,020 million, are included in the 'three months or less' category. These bonds have an earnings rate that is linked to the Consumer Price Index and are reset each quarter.

11. The Interest Rate Sensitivity Gap by Currency differs from the open foreign exchange position by the notional principal on open futures contracts.

	Total 2015 $M	Non-interest Sensitive $M	Overnight $M	3 Months or Less $M	Between 3 and 12 Months $M	Between 1 and 2 Years $M	Between 2 and 5 Years $M	More Than 5 Years $M
Assets								
Investments	13,727	-	419	9,136	1,263	1,476	1,091	342
Securities Purchased under Agreements to Resell	4,436	-	-	4,436	-	-	-	-
New Zealand Government Securities	3,117	-	-	955	-	-	1,137	1,025
Other Financial Assets	7,739	158	7,192	389	-	-	-	-
Other Assets	88	88	-	-	-	-	-	-
Total Assets	29,107	246	7,611	14,916	1,263	1,476	2,228	1,367
Liabilities								
Foreign Currency Term Liabilities	1,127	-	-	1,127	-	-	-	-
Local Currency Term Liabilities	800	-	-	800	-	-	-	-
Securities Sold under Agreements to Repurchase	1,800	-	-	1,800	-	-	-	-
Deposits	14,538	104	14,434	-	-	-	-	-
Reserve Bank Bills	309	-	-	309	-	-	-	-
Currency in Circulation	5,255	5,255	-	-	-	-	-	-
Other Financial Liabilities	1,965	183	84	1,693	5	-	-	-
Other Liabilities	514	514	-	-	-	-	-	-
Net Assets/Equity	2,799	2,799	-	-	-	-	-	-
Total Liabilities and Equity	29,107	8,855	14,518	5,729	5	-	-	-
Interest Rate Sensitivity Gap excluding Futures Contracts	-	(8,609)	(6,907)	9,187	1,258	1,476	2,228	1,367
Futures Contracts	(300)	-	-	10	-	(305)	(5)	-
Total Interest Rate Sensitivity Gap	(300)	(8,609)	(6,907)	9,197	1,258	1,171	2,223	1,367
Interest Rate Sensitivity Gap by Currency								
New Zealand Dollar	(3,536)	(8,699)	(13,980)	16,676	305	-	1,137	1,025
United States Dollar	690	(2)	5,182	(5,489)	366	417	149	67
Euro	747	60	793	(670)	206	358	-	-
Japanese Yen	193	15	1,059	(1,320)	299	61	79	-
British Pound	520	17	30	-	-	68	405	-
Australian Dollar	487	-	2	-	82	49	354	-
Canadian Dollar	324	-	7	-	-	218	99	-
Chinese Renminbi	156	-	-	-	-	-	-	156
Other	119	-	-	-	-	-	-	119
	(300)	(8,609)	(6,907)	9,197	1,258	1,171	2,223	1,367

18. Foreign Currency Risk

Foreign currency risk is the risk that the fair value of a financial instrument will fluctuate due to a change in foreign exchange rates.

Foreign currency risk arises from:

— the maintenance of a portion of foreign currency reserves on an unhedged basis for crisis management purposes;

— currency interventions to meet monetary policy objectives; and

— active management undertaken in trading portfolios.

The Bank intends to hold some of its reserves on an unhedged basis through most of the exchange rate cycle. The Bank has a policy of maintaining a passive 'benchmark' open foreign exchange position of SDR 1 billion (2015: SDR 1 billion), but can vary the actual open position, and thus the amount of unhedged reserves, around that benchmark level, depending on the behaviour of the exchange rate and foreign exchange markets. This variation might be significant.

For non-trading portfolios, foreign currency risk is managed by way of open position limits, target open-currency composition weights and deviation bands. Additionally, the Bank monitors VaR and stressed-VaR outcomes for these portfolios.

Stop-loss and VaR limits are also used to help manage the Bank's trading portfolios, which account for a minor proportion of the Bank's total open foreign exchange position.

As at 30 June 2016, the Bank's net exposure to major currencies, in New Zealand dollar terms, was:

	2016 $M	2015 $M
Australian Dollar	**419**	487
British Pound	**397**	520
Canadian Dollar	**270**	324
Chinese Renminbi	**144**	156
Euro	**725**	884
Japanese Yen	**178**	193
United States Dollar	**668**	863
Various Currencies (Asian Bond Fund 2)	**158**	119
Total Net Open Foreign Exchange Position	**2,959**	3,546

At 30 June 2016 the net open foreign exchange position was SDR 1,512 million (2015: SDR 1,709 million). The quantum of the open position varies over time to the level the Bank determines is warranted by its policy objectives (specified in SDR terms) and economic conditions. The largest net open foreign exchange position (measured in SDR terms) during the 12 months ended 30 June 2016 was SDR 1,703 million (2015: SDR 1,743 million). The smallest net open foreign exchange position (measured in SDR terms) during the 12 months ended 30 June 2016 was SDR 1,481 million (2015: SDR 1,420 million). The largest net open foreign exchange position (measured in New Zealand dollar terms) during the 12 months ended 30 June 2016 was $3,540 million (2015: $3,553 million). The smallest net open foreign exchange position (measured in New Zealand dollar terms) during the 12 months ended 30 June 2016 was $2,959 million (2015: $2,500 million).

19. Liquidity Risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting financial obligations associated with financial liabilities that are settled by delivering cash or other financial assets. Liquidity risk also includes the risk that the Bank may have to sell a financial asset quickly at less than its fair value.

The objectives of the Bank's liquidity policy are to:

- ensure that all financial obligations are met when due;
- ensure that foreign reserves assets held for currency intervention purposes are able to be liquidated in an orderly fashion, within agreed timeframes; and
- ensure that the Bank manages the aggregate level of New Zealand dollar liquidity in the New Zealand banking system so as to, in turn, ensure that interest rates in inter-bank markets are consistent with monetary policy settings, and to facilitate the smooth operation of the inter-bank payment system.

a. Foreign Currency Activities

Liquidity is a key criterion in determining the composition of the Bank's foreign-currency assets. This reflects the potential requirement to liquidate foreign reserves for intervention purposes should the need arise. Accordingly, the Bank employs a number of controls that aim to ensure quick access to funds. These controls include a required composition of portfolios based on the liquidity characteristics of securities, with defined minimum levels, durations and limits on the minimum and maximum proportion of reserves that may be held in any one currency.

At 30 June 2016 foreign currency assets valued at $20,771 million were classified as being able to be settled within two business days of being liquidated (30 June 2015: $24,027 million).

The Bank also manages refinancing risk on foreign reserves funded from borrowing by applying limits on the amount of borrowing maturing in any 12-month period.

b. Local Currency Activities

The Bank's management of its own New Zealand dollar liquidity risk is a function of the Bank's management of the daily aggregate liquidity that is available within the New Zealand banking system.

The Bank manages its own New Zealand dollar cash flows by advancing funds to, and withdrawing funds from, the New Zealand banking system. This is achieved through a range of financial transactions, including entering into foreign exchange swap and basis swap transactions and asset repurchase and reverse-repurchase agreements, and by issuing Reserve Bank bills. As New Zealand's central bank, the Bank is able to create New Zealand dollar liquidity through its daily market operations. Therefore the Bank is not required to maintain liquid assets to meet its New Zealand dollar obligations.

20. Cash Flows by Remaining Contractual Maturities

The following table sets out the maturity profile of the Bank's financial assets and liabilities. The table discloses the contractual principal receivable or due at the maturity date, together with interest receivable or payable for the period to the maturity date based on interest rates and foreign exchange rates prevailing as at balance date. Financial liabilities payable on demand includes Currency in Circulation. However, historical experience has shown that such balances provide a stable source of long-term funding for the Bank.

Deposits, which are on-demand liabilities, are managed taking into account the Bank's ability to create New Zealand dollar liquidity through its daily market operations. In all other respects the Bank manages liquidity on a contractual maturity basis, which is consistent with the expected maturities of financial instruments.

The balances in this table do not equate with the balances in the Consolidated Statement of Financial Position, as the table incorporates all cash flows on an undiscounted basis.

The table excludes the following financial assets that have no fixed maturity dates: Asian Bond Fund 1, Asian Bond Fund 2, and BIS Investment Pool Sovereign China, which had an aggregate carrying value at 30 June 2016 of $324 million (2015: $342 million). These financial assets are included within Foreign Currency Financial Investments in the Consolidated Statement of Financial Position. Also excluded from the table are shares in the BIS, which had a value at 30 June 2016 of $144 million (2015: $153 million) and are included within Other Foreign Currency Financial Assets in the Consolidated Statement of Financial Position.

Dividend outflows of $140 million (2015: $510 million) are also excluded from the table as they are not contractual cash flows.

	Total 2016 $M	On Demand $M	3 Months or Less $M	3 to 12 Months $M	1 to 2 Years $M	2 to 5 Years $M	More Than 5 Years $M
Foreign Currency Financial Assets							
Cash Balances	8,351	8,351	-	-	-	-	-
Securities Purchased under Agreements to Resell	2,258	-	2,258	-	-	-	-
Investments	10,349	152	7,267	568	1,100	1,245	17
Other Foreign Currency Financial Assets	127	-	127	-	-	-	-
	21,085	8,503	9,652	568	1,100	1,245	17
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	209	133	76	-	-	-	-
Securities Sold under Agreements to Repurchase	662	-	662	-	-	-	-
Term Liabilities	972	-	(1)	1	972	-	-
	1,843	133	737	1	972	-	-
Foreign Currency Derivatives							
Contractual Inflows	6,718	-	5,459	364	219	676	-
Contractual Outflows	(23,896)	-	(14,549)	(1,404)	(708)	(3,343)	(3,892)
	(17,178)	-	(9,090)	(1,040)	(489)	(2,667)	(3,892)
Foreign Currency Net Gap in Contractual Maturities	2,064	8,370	(175)	(473)	(361)	(1,422)	(3,875)
Local Currency Financial Assets							
New Zealand Government Securities	3,930	-	12	114	584	1,008	2,212
Other Local Currency Financial Assets	191	191	-	-	-	-	-
	4,121	191	12	114	584	1,008	2,212
Local Currency Financial Liabilities							
Deposits	13,121	13,121	-	-	-	-	-
Securities Sold under Agreements to Repurchase	110	-	110	-	-	-	-
Reserve Bank Bills	674	-	674	-	-	-	-
Currency in Circulation	5,634	5,634	-	-	-	-	-
Term Liabilities	866	-	4	11	14	628	209
Other Local Currency Financial Liabilities	89	81	8	-	-	-	-
	20,494	18,836	796	11	14	628	209
Local Currency Derivatives							
Contractual Inflows	19,351	-	10,344	1,389	560	2,957	4,101
Contractual Outflows	(1,500)	-	(1,017)	(379)	(2)	(102)	-
	17,851	-	9,327	1,010	558	2,855	4,101
Local Currency Net Gap in Contractual Maturities	1,478	(18,645)	8,543	1,113	1,128	3,235	6,104
Total Net Gap in Contractual Maturities	3,542	(10,275)	8,368	640	767	1,813	2,229

	Total 2015 $M	On Demand $M	3 Months or Less $M	3 to 12 Months $M	1 to 2 Years $M	2 to 5 Years $M	More Than 5 Years $M
Foreign Currency Financial Assets							
Cash Balances	6,742	6,742	-	-	-	-	-
Securities Purchased under Agreements to Resell	4,436	-	4,436	-	-	-	-
Investments	13,425	435	9,141	1,284	1,490	1,075	-
Other Foreign Currency Financial Assets	1	-	1	-	-	-	-
	24,604	7,177	13,578	1,284	1,490	1,075	-
Foreign Currency Financial Liabilities							
Short-term Foreign Currency Financial Liabilities	101	43	58	-	-	-	-
Securities Sold under Agreements to Repurchase	704	-	704	-	-	-	-
Term Liabilities	1,131	-	(2)	102	-	1,031	-
	1,936	43	760	102	-	1,031	-
Foreign Currency Derivatives							
Contractual Inflows	3,677	-	2,632	192	377	476	-
Contractual Outflows	(23,999)	-	(14,744)	(1,786)	(2,002)	(2,225)	(3,242)
	(20,322)	-	(12,112)	(1,594)	(1,625)	(1,749)	(3,242)
Foreign Currency Net Gap in Contractual Maturities	2,346	7,134	706	(412)	(135)	(1,705)	(3,242)
Local Currency Financial Assets							
New Zealand Government Securities	3,669	-	13	110	123	1,355	2,068
Other Local Currency Financial Assets	496	496	-	-	-	-	-
	4,165	496	13	110	123	1,355	2,068
Local Currency Financial Liabilities							
Deposits	14,538	14,538	-	-	-	-	-
Securities Sold under Agreements to Repurchase	1,096	-	1,096	-	-	-	-
Reserve Bank Bills	309	-	309	-	-	-	-
Currency in Circulation	5,255	5,255	-	-	-	-	-
Term Liabilities	932	-	6	15	21	459	431
Other Local Currency Financial Liabilities	125	81	44	-	-	-	-
	22,255	19,874	1,455	15	21	459	431
Local Currency Derivatives							
Contractual Inflows	20,023	-	11,435	1,769	1,869	1,828	3,122
Contractual Outflows	(506)	-	(4)	(11)	(384)	(107)	-
	19,517	-	11,431	1,758	1,485	1,721	3,122
Local Currency Net Gap in Contractual Maturities	1,427	(19,378)	9,989	1,853	1,587	2,617	4,759
Total Net Gap in Contractual Maturities	3,773	(12,244)	10,695	1,441	1,452	912	1,517

FINANCIAL PERFORMANCE NOTES

21. Net Investment Revenue

Net Investment Revenue includes:

	Total 2016 $M	Foreign Currency $M	Local Currency $M	Total 2015 $M	Foreign Currency $M	Local Currency $M
Interest Revenue						
Cash Balances	**4**	**4**	**-**	2	2	-
Securities Purchased under Agreements to Resell	**6**	**5**	**1**	3	1	2
Investments	**39**	**39**	**-**	35	35	-
Derivatives	**422**	**(14)**	**436**	506	(14)	520
New Zealand Government Securities	**127**	**-**	**127**	156	-	156
Other	**14**	**1**	**13**	2	-	2
Total Interest Revenue	**612**	**35**	**577**	704	24	680
Interest Expense						
Securities Sold under Agreements to Repurchase	**9**	**-**	**9**	14	-	14
Term Liabilities[12]	**14**	**(5)**	**19**	6	(8)	14
New Zealand Government Deposits	**70**	**-**	**70**	120	-	120
Settlement Bank Deposits	**206**	**-**	**206**	277	-	277
Reserve Bank Bills	**43**	**-**	**43**	16	-	16
Total Interest Expense	**342**	**(5)**	**347**	433	(8)	441
Net Interest Revenue	**270**	**40**	**230**	271	32	239
Net Gains/(Losses) from Fair Value Changes	**39**	**(17)**	**56**	30	47	(17)
Net Gains/(Losses) from Foreign Exchange Rate Changes	**(201)**	**(201)**	**-**	379	379	-
Dividend Revenue	**1**	**1**	**-**	1	1	-
Total Net Investment Revenue/(Expense)	**109**	**(177)**	**286**	681	459	222

Interest Revenue from the New Zealand Government (including entities controlled by the New Zealand Government) comprised 21 percent (2015: 22 percent) of the total interest received.

Components of Net Investment Revenue from Financial Instruments

Net Investment Revenue includes net revenue/(expenses) arising from:

	2016 $M	2015 $M
Financial Assets and Financial Liabilities Classified as Fair Value through Surplus/(Deficit) upon Initial Recognition	**(203)**	430
Derivatives Deemed to be Classified as Held for Trading	**422**	506
Financial Assets and Financial Liabilities Classified as Held for Trading	**2**	1
Interest and Dividend Revenue from Available-for-sale Financial Assets	**129**	135
Realised Gains on Disposal of Available-for-sale Financial Assets	**31**	4
Financial Assets Classified as Loans and Receivables	**4**	2
Financial Liabilities Classified as Financial Liabilities at Amortised Cost	**(276)**	(397)
Total Net Investment Revenue	**109**	681

12. Interest rates on foreign currency Term Liabilities with the New Zealand Government are re-set every quarter, based on market reference rates less a margin agreed at the inception of the loans. During 2016, with market interest rates at very low levels, interest was received by the Bank after the fixed margin was applied.

22. Revenue and Expenses by Function

The following table sets out operating revenue and operating expenses for each of the Bank's main functions.

	Operating Revenue 2016 $M	Attribution of Earnings on Investments Funded by Net Assets/Equity 2016 $M	Operating Expenses 2016 $M	Surplus/ (Deficit) 2016 $M
Functions				
Monetary Policy Formulation	-	-	10	(10)
Domestic Market Operations	43	17	5	55
Prudential Supervision	-	-	13	(13)
Macro-financial Stability	-	-	8	(8)
Currency Operations	179	-	21	158
Foreign Reserves Management	(191)	62	6	(135)
Settlement Services	13	-	8	5
Total for Bank before Earnings on Investments Funded by Net Assets/Equity	44	79	71	52
Earnings Not Allocated to Functions				
Earnings on Investments Funded by Net Assets/Equity	79	(79)	-	-
Total for Bank	123	-	71	52

	Operating Revenue 2015 $M	Attribution of Earnings on Investments Funded by Net Assets/Equity 2015 $M	Operating Expenses 2015 $M	Surplus/ (Deficit) 2015 $M
Functions				
Monetary Policy Formulation	-	-	10	(10)
Domestic Market Operations	20	23	5	38
Prudential Supervision	-	-	12	(12)
Macro-financial Stability	-	-	8	(8)
Currency Operations	214	-	22	192
Foreign Reserves Management	359	65	6	418
Settlement Services	13	-	7	6
Total for Bank before Earnings on Investments Funded by Net Assets/Equity	606	88	70	624
Earnings not Allocated to Functions				
Earnings on Investments Funded by Net Assets/Equity	88	(88)	-	-
Total for Bank	694	-	70	624

Operating income for each function includes allocations of notional interest income and expenditure on New Zealand dollar funding provided by (or provided to) the function through internal lending and borrowing. Notional interest rates take into account the estimated term of the funding and the associated external interest earned or incurred. Earnings on net assets/equity are not allocated to individual functions. The total operating expenses for each function include internal transfers between functions.

23. Operating Expenses

	Note	2016 $M	Budget Unaudited 2016 $M	2015 $M	Budget Unaudited 2015 $M
Staff Expenses		**32**	**34**	35	35
Net Currency-issued Expenses		**10**	**14**	13	7
Asset Management Expenses		**8**	**8**	7	7
Other Operating Expenses		**18**	**19**	18	20
Total Operating Expenses Excluding Actuarial Loss/(Gain) on Defined Benefit Superannuation Scheme		**68**	**75**	73	69
Actuarial Loss/(Gain) on Defined Benefit Superannuation Scheme	27	**3**	**-**	(3)	-
Total Operating Expenses		**71**	**75**	70	69

The budgets for 2016 and 2015 are the annual budgets prepared by the management of the Bank and are published in the *Statement of Intent.*

	2016 $000	2015 $000
Net Currency-issued Expenses includes		
Write-down of inventories to net realisable value	**1,604**	6,663
Asset Management Expenses includes		
Depreciation of Property, Plant and Equipment	**3,855**	3,613
Amortisation of Intangible Assets	**1,530**	1,356
Impairment Charges for Property, Plant and Equipment	**-**	-
Impairment Charges for Intangible Assets	**-**	-
Other Operating Expenses includes		
Restructuring Costs	**37**	960
Bad Debt Expenses	**-**	-
Rental and Lease Expenses	**132**	131

Staff Expenses have been reduced by $0.79 million (2015: nil) for the capitalisation of the staff expenses directly attributable to the implementation of three major systems: replacements for the current systems used to provide real-time gross settlement services (ESAS) and securities settlement and depository services (NZClear), and a Trade Valuation Solution to support front-office trading and middle-office valuation and risk management processes.
The capitalised staff expenses have been added to the costs of these systems. The full costs of these systems will be amortised over their useful lives.

Funding Agreement

A funding agreement is agreed between the Bank and the Government for periods of five years. The Funding Agreement sets out the expectations of the levels of operating expenses net of certain items of revenue within which the Bank should manage its operations. The table below sets out the net operating expenses for 2016, 2015 and cumulatively over the five years as specified in the Funding Agreement for the five years ended 30 June 2020.

	2016 Unaudited $M	**Cumulative 5-year Funding Agreement Unaudited $M**	2015 Unaudited $M
Net Operating Expenses	**54.1**	**54.1**	60.5
Net Operating Expenses Specified in Funding Agreement	**64.0**	**64.0**	56.4

Key Management Personnel

Key management personnel form the Governing Committee, which comprises the Governor, two Deputy Governors and the Assistant Governor. Because non-executive Board members are not responsible for decision-making by the Bank, and their statutory role is to monitor the performance of the Bank, they are not considered to be key management personnel as defined in PBE IPSAS 20 *Related Party Disclosures.* For the year ended 30 June, aggregate compensation paid to key management personnel comprised:

	2016 $000	2015 $000
Salaries, Superannuation Contributions and Other Short-term Benefits	**2,150**	2,082
Total Key Management Personnel Compensation	**2,150**	2,082

This table includes all compensation paid to key management personnel.

OTHER NOTES

24. Auditor's Remuneration

	2016 $000	2015 $000
Statutory Audit	**254**	251
Payment Systems Assurance	**77**	76
Advisory Services	**59**	4
	390	331

The Statutory Audit expense comprises the fee for the audit of the annual financial statements of the Bank.

The Payment Systems Assurance expense comprises fees paid for the contractual assurance engagements of the NZClear depository system and ESAS.

The Advisory Services expense comprises fees for advice relating to the utilisation of the Bank's building that were paid to a business that was acquired by the external auditors during the year ended 30 June 2016, and penetration testing of the Bank's key systems. These advisory services were approved in accordance with the Bank's External Auditor Independence Policy, which requires that prior to engaging the external auditor for any of these services, the advice of the Chair of the Audit Committee must be sought and approval must be given by the Governor or Deputy Governor.

25. Reconciliation of Net Cash Flows from Operating Activities with Surplus for the Year

	2016 $M	2015 $M
Surplus for the Year	**52**	624
Add/(Subtract) Items Included in Surplus Relating to Cash Flows from Changes in Operating Asset and Operating Liability Balances and Investing and Financing Activities:		
Foreign Exchange Losses/(Gains)[13]	**201**	(379)
Market Value Changes	**(39)**	(30)
Add/(Subtract) Non-cash Items:		
Depreciation and Amortisation	**5**	5
Amortisation of Premium/Discount on Financial Instruments	**24**	(28)
Net Movement in Repatriated Currency Revenue and Expense	**-**	3
	191	(429)
Movements in Other Working Capital Items		
Decrease/(Increase) in Current Assets:		
Movement in Accounts Receivable	**-**	(2)
Movement in Inventories	**(10)**	6
Movement in Interest Receivable	**-**	(10)
	(10)	(6)
Increase/(Decrease) in Current Liabilities:		
Movement in Miscellaneous Liabilities	**3**	(1)
Movement in Interest Payable	**(1)**	2
	2	1
Net Movements in Other Working Capital Items	**(8)**	(5)
Operating Cash Flows from Revenue and Expenses	**235**	190
Cash Flows from Changes in Operating Asset and Operating Liability Balances	**1,939**	2,988
Net Cash Flows from Operating Activities	**2,174**	3,178

13. Foreign Exchange Losses/(Gains) include the Foreign Exchange Rate Effect on Cash Balances at the Beginning of the Year in the Consolidated Statement of Cash Flows on pages 61 and 62.

26. Statement of Commitments

a. Provision of Funding to the New Zealand Financial System

As New Zealand's central bank, the Bank is able to create New Zealand dollar liquidity through its liquidity management operations, which include the daily open market operations. The Bank's open market operations include providing New Zealand dollar liquidity facilities to eligible borrowers on terms stipulated by the Bank, including the provision of approved collateral.

b. Reciprocal Funding Arrangements with Foreign Central Banks

On 24 April 2014 the People's Bank of China (PBOC) and the Bank renewed a reciprocal currency arrangement (swap line) to support the settlement of trade and investment transactions between New Zealand and Chinese businesses in circumstances where it might otherwise be difficult to settle obligations in Chinese renminbi (RMB). The swap facility provides for the PBOC and the Bank to enter foreign exchange swap transactions that have a total value at any point of up to RMB25 billion (NZD5 billion), with the terms of the foreign exchange swaps to be agreed at the time the swaps are entered into. The swap line is for a term of three years, which may be extended if both parties agree. No drawings were made under this arrangement in the year ended 30 June 2016 (2015: nil).

The Bank also has a reciprocal arrangement with the Hong Kong Monetary Authority, which allows either party to enter repurchase agreements with the other to raise up to USD250 million, secured by United States government securities. The existing arrangement expires on 31 March 2017 but may be extended by mutual agreement. No drawings were made under this arrangement in the year ended 30 June 2016 (2015: nil).

c. Commitments to the New Zealand Government

The Bank has agreed to make foreign currency available to the New Zealand Government on arm's-length terms so that the Government may meet any calls made by the IMF under two standby loan facilities.

The two standby loan facilities entered into by the Government are:

— to provide loans to the IMF up to SDR 340 million (2015: SDR 624.34 million) if the IMF makes a call on the New Zealand Government in respect of the Government's commitment under the IMF's 'New Arrangements to Borrow' facility; and

— to provide loans to the IMF of up to USD1 billion if the IMF makes a call on the New Zealand Government in respect of the Government's commitment under the IMF's '2012 Borrowing Arrangements' facility.

During the year ended 30 June 2016, no funds were made available to the Government under these arrangements (2015: nil).

d. Commitments for Capital Expenditure and Purchase of Inventories

At reporting date the Bank had commitments for capital expenditure and the purchase of inventories totalling $64.48 million (2015: $74.32 million).

27. Superannuation Commitments

The Bank has a superannuation fund for staff. The superannuation fund includes both a defined contribution scheme and a defined benefit scheme. Contributions, as specified in the rules of the respective schemes, are made by the Bank as required.

Defined Benefit Scheme

The following information is provided in respect of the defined benefit scheme.

As at 31 March	**2016 $000**	2015 $000
Superannuation Asset/Superannuation Liability Recognised in the Statement of Financial Position		
Present Value of Wholly or Partly Funded Obligations	**34,684**	33,751
Fair Value of Plan Assets	**32,626**	35,069
Present Value of Net Obligations/(Assets)	**2,058**	(1,318)
Actuarial Gains Not Recognised in the Statement of Financial Position	**-**	896
Net Liability/(Asset) Recognised in the Statement of Financial Position	**2,058**	(422)

The net asset (if any) recognised at the end of the year is limited to the estimated present value of reductions in future employer contributions to the defined benefit plan. The value of the net assets of the defined benefit superannuation scheme not recognised as an asset of the Bank was nil (2015: $896,000).

The primary actuarial assumptions used in the above calculations, expressed as weighted averages, are as follows:

	2016 %	2015 %
Discount Rate at the Beginning of the Year	**3.17**	3.72
Expected Rate of Return on Plan Assets at the Beginning of the Year	**4.50**	4.50
Future Salary Increases	**3.00**	3.50
Other Material Actuarial Assumptions - Pension Increases	**1.55**	2.50

Statutory actuarial valuations of the schemes are undertaken every three years, with the last statutory valuation being undertaken as at 31 March 2015. Each year the actuary provides an assessment of the value of the liabilities of the superannuation fund in relation to the assets of the superannuation fund, with the last valuation performed at 31 March 2016. There were no material changes to the fund's financial position between 31 March 2016 and 30 June 2016. Contributions to the defined benefit scheme are at a rate, reviewed annually, sufficient to keep the scheme solvent, based on actuarial assessments. The defined benefit scheme was closed to new members in 1991.

28. Controlled Entity

The Bank has a wholly owned New-Zealand-incorporated controlled entity, New Zealand Central Securities Depository Limited (NZCSD).

NZCSD is a non-trading company, incorporated solely for the purpose of acting as a custodian trustee. It holds assets on behalf of the participants in the NZClear System, as described in Note 32.

29. Related Parties

In the normal course of its operations the Bank enters transactions with related parties. Related parties include the Crown, various government departments and Crown entities. Unless stated otherwise, all transactions with related parties take place at arm's length.

Transactions entered into include:

— banking services;
— foreign exchange transactions;
— funding from the Treasury as part of the Foreign Reserves Management operations; and
— purchases and disposals of New Zealand government securities.

Material transactions with entities controlled by the Crown and balances with entities controlled by the Crown were:

Year Ended 30 June	2016 $M	2015 $M
Receipts from and Payments to Entities Controlled by the New Zealand Government		
Receipts of Revenue from Entities Controlled by the New Zealand Government		
Interest Revenue	**127**	156
Rental Revenue	**2**	1
Receipts of a Capital Nature from Entities Controlled by the New Zealand Government		
Receipt of Proceeds on Disposal of New Zealand Government Securities - Available for Sale	**282**	513
Receipt of Proceeds on Maturity of New Zealand Government Securities - Fair Value through Surplus/(Deficit)	**-**	2,174
Issuance of Local Currency Term Liability to the New Zealand Government	**-**	700
Payments of Expenses to Entities Controlled by the New Zealand Government		
Interest Expense	**93**	141
Payments of Capital to Entities Controlled by the New Zealand Government		
Net Decrease/(Increase) in Deposits	**298**	(2,620)
Repayment of Foreign Currency Term Liabilities	**99**	640
Payment for Purchase of New Zealand Government Securities	**451**	601

As at 30 June	2016 $M	2015 $M
Balances with Entities Controlled by the New Zealand Government		
Assets that Comprise Claims on Entities Controlled by the New Zealand Government		
New Zealand Government Securities	**3,449**	3,117
Liabilities that Comprise Claims by Entities Controlled by the New Zealand Government		
Deposits	**6,204**	6,502
Term Liabilities	**1,768**	1,927

In addition, as part of the Bank's domestic market operations, the Bank enters securities reverse-repurchase and securities repurchase agreements with Crown-owned entities on standard commercial terms. Except as noted above, all amounts advanced or borrowed under these agreements were repaid during the year. The table above includes interest revenue and interest expenses in relation to these activities.

30. Contingent Liabilities

a. In terms of a Trust Deed dated 16 May 1980, the Reserve Bank has a contingent liability to maintain the actuarial soundness of the Reserve Bank of New Zealand Staff Superannuation and Provident Fund (the Fund).

The actuary carried out a review of the financial position of the Fund as at 31 March 2016.

The Fund's Trust Deed provides for the Defined Benefit division of the Fund to be wound up in the event that the Bank is wound up or by resolution of the Bank's directors. In the event that the Fund is wound up, the Fund is required to purchase annuities having values equal to the actuarial value of benefits payable by the Fund. The actuary reported that, based on current estimates of the cost of annuities, in the event the Defined Benefit division of the Fund is wound up, the purchase cost of annuities would exceed the value of the Defined Benefit assets of the Fund. On winding up, the Bank is required by the Trust Deed to make good any shortfall. The Bank considers that the likelihood of the Fund being wound up is remote.

b. The Bank has a contingent liability for currency in circulation that has been demonetised but not returned to the Bank, but only to the extent that the Bank has not recognised an actual liability. The total face value of demonetised currency as at 30 June 2016 was $104.3 million (2015: $104.4 million). Of the total face value of demonetised currency, $81.3 million (2015: $81.4 million) is recognised as a liability in the Statement of Financial Position.

c. The Bank has a liability for the face value of collectors' currency. However, it is most unlikely that significant amounts of collectors' currency will be returned for redemption at face value. The face value of collectors' currency issued before 1 July 2004 and that is not recognised as a liability is $9.8 million (2015: $9.8 million).

d. As at 30 June 2016, the Bank had a contingent liability of $23.56 million (SDR 12.04 million) (2015: $24.98 million [SDR 12.04 million]) in respect of uncalled and unpaid capital attached to its shareholding in the BIS.

31. Income Tax

Section CW38 of the Income Tax Act 2007 exempts the Bank from income tax. The Bank incurs and meets liabilities for goods and services tax, fringe benefit tax and other withholding tax.

32. Custodial Activities

The Bank operates the NZClear system, which is a securities clearing and settlement system. It holds assets, on behalf of the participants, in the name of NZCSD, which it has appointed as custodian trustee in terms of the Trustee Act 1956.

NZCSD is a wholly owned New-Zealand-incorporated subsidiary of the Bank that, in terms of a Deed of Appointment between the Bank and NZCSD, is incorporated solely to act as a custodian trustee. The Bank undertakes to accept liability for all costs and debts of NZCSD as a means of reinforcing that role. NZCSD is a non-trading company, but has legal ownership of securities beneficially owned by members of the NZClear System. With the exception of the local currency securities owned by the Bank and held through NZCSD, the Bank has no beneficial interest in the securities that NZCSD holds, or any management obligations apart from safekeeping or acting as paying agent in certain circumstances.

The total value of securities held by NZCSD as at 30 June 2016 was $227.3 billion (2015: $203.4 billion).

Under the NZClear System Rules, the Bank's and NZCSD's liability to any member of NZClear arising out of, or in connection with, the system is limited to direct losses up to an aggregate of $5 million for any one event.

33. Significant Post-reporting Date Events

There have been no significant post-reporting date events.

FIVE-YEAR HISTORICAL FINANCIAL INFORMATION

Five-year Financial Position

As at 30 June	NZ IFRS PBE Audited 2012 $M	NZ IFRS PBE Audited 2013 $M	PBE Standards Audited 2014 $M	PBE Standards Audited 2015 $M	**PBE Standards Audited 2016 $M**
Assets					
Foreign Currency Financial	21,971	21,163	19,286	25,406	**22,242**
Local Currency Financial	4,695	2,844	3,093	3,613	**3,640**
Other Assets	78	75	82	88	**101**
Total Assets	26,744	24,082	22,461	29,107	**25,983**
Liabilities and Equity					
Foreign Currency Financial	4,129	3,657	3,193	3,671	**2,584**
Local Currency Financial	19,841	17,667	16,742	22,123	**20,424**
Other Liabilities	172	186	27	514	**147**
Net Assets/Equity	2,602	2,572	2,499	2,799	**2,828**
Total Liabilities and Net Assets/Equity	26,744	24,082	22,461	29,107	**25,983**

Five-year Financial Performance

For the Year Ended 30 June	NZ IFRS PBE Audited 2012 $M	NZ IFRS PBE Audited 2013 $M	PBE Standards Audited 2014 $M	PBE Standards Audited 2015 $M	**PBE Standards Audited 2016 $M**
Operating Revenue					
Net Investment Revenue	171	356	105	681	**109**
Other Revenue	8	9	11	13	**14**
Total Operating Revenue	179	365	116	694	**123**
Operating Expenses					
Staff Expenses	28	30	32	35	**32**
Net Currency-issued Expenses	5	6	7	13	**10**
Asset Management Expenses	7	6	6	7	**8**
Other Operating Expenses	15	16	19	18	**18**
Total Operating Expenses Excluding Actuarial Loss/(Gain) on Defined Benefit Superannuation Scheme	55	58	64	73	**68**
Actuarial Loss/(Gain) on Defined Benefit Superannuation Scheme	6	(1)	(4)	(3)	**3**
Total Operating Expenses	61	57	60	70	**71**
Surplus for the Year	118	308	56	624	**52**

Five-year Outcomes under the Funding Agreement

For the Year Ended 30 June	NZ IFRS PBE Unaudited 2012 $M	NZ IFRS PBE Unaudited 2013 $M	PBE Standards Unaudited 2014 $M	PBE Standards Unaudited 2015 $M	**PBE Standards Unaudited 2016 $M**
Actual Net Expenses under the Funding Agreement	47.0	48.3	53.3	60.5	**54.1**
Net Expenditure Specified under the Funding Agreement	50.2	52.7	55.2	56.4	**64.0**
Funding Agreement Under-expenditure/(Over-expenditure)	3.2	4.4	1.9	(4.1)	**9.9**

Five-year Dividends Paid to the New Zealand Government

For the Year Ended 30 June	NZ IFRS PBE Audited 2012 $M	NZ IFRS PBE Audited 2013 $M	PBE Standards Audited 2014 $M	PBE Standards Audited 2015 $M	**PBE Standards Audited 2016 $M**
Dividends Paid to the New Zealand Government	160	175	20	510	**140**

No adjustments to the financial information prepared under New Zealand equivalents to International Financial Reporting Standards (PBE) were made on transition to PBE Standards. No adjustments would be necessary to make the historical financial information presented under NZ IFRS (PBE) comply with PBE Standards.

GLOSSARY

(RBNZ) ACT
The Reserve Bank Act 1989

AML/CFT
Anti-Money Laundering and Countering the Financing of Terrorism
Under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, the Reserve Bank is one of three supervisors tasked with ensuring firms comply with new obligations designed to help deter and detect money laundering and terrorist financing.

AUD
Australian Dollar

BASEL III
Global regulatory standards on bank capital adequacy and liquidity, published by the Basel Committee on Banking Supervision in December 2012.

BIS
Bank for International Settlements
An international financial institution based in Switzerland, owned by about 50 central banks and providing a range of financial services to central banks, international financial institutions and governments.

CAD
Canadian Dollar

CLS system
An international system run by CLS Bank International intended to reduce foreign exchange settlement risk (Herstatt risk). The CLS system does this by ensuring payment of both currencies in a foreign exchange transaction are made simultaneously and irrevocably. The Reserve Bank is a member of the international CLS Oversight Committee.

CPI
Consumers Price Index
The All Groups Consumers Price Index published by Statistics New Zealand. The CPI measures the rate of change in prices of goods and services purchased by New Zealand households.

EMEAP
Executive Meeting of East Asian and Pacific central banks and monetary authorities
A cooperative organisation of central banks and monetary authorities in the East Asia and Pacific region, comprising Australia, China, Hong Kong, Indonesia, Japan, South Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.

ESAS
Exchange Settlement Account System
The Reserve Bank's banking service for certain qualifying institutions that need to make regular high-value payments with each other.

EUR
Euro zone euro

FSAP
Financial Sector Assessment Programme
A comprehensive review of a country's financial system, with a particular focus on the quality of financial sector regulation.

FSIS
Financial Sector Information System
The Bank's central database for time-series data.

FSR
Financial Stability Report
A six-monthly report assessing the soundness and efficiency of the New Zealand financial system.

GBP
United Kingdom pound

IMF
International Monetary Fund
The International Monetary Fund is an organization of 189 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

IPSA
The Insurance (Prudential Supervision) Act 2010
The Act provides for the Bank's role as prudential supervisor of the insurance sector.

JPY
Japanese Yen

LVR
Loan-to-value ratio
A loan-to-value ratio (LVR) is a measure of how much a bank lends against mortgaged property, compared to the value of that property.

MPS
Monetary Policy Statement
A quarterly assessment, accompanying an OCR review, of how the Bank proposes to achieve its monetary policy target (see PTA); how it proposes to formulate and implement monetary policy during the next five years; and how monetary policy has been implemented since the last MPS.

NBDTs
Non-bank deposit takers
Finance companies, building societies and credit unions, which take deposits from the investing public and which are not registered banks under the Act.

NZCLEAR
A real-time settlement system providing the financial markets with clearing and settlement services for high-value debt securities and equities.

NZD
New Zealand Dollar

OCR
Official Cash Rate
The interest rate set by the Bank to meet the inflation target specified in the PTA.

PTA
Policy Targets Agreement
A contract, negotiated between the Government and the Governor of the Reserve Bank, defining the Bank's price stability target.

SDR
Special Drawing Right
Unit of account of international reserve assets created by the International Monetary Fund (IMF) to supplement the reserves of IMF member countries. Its value is based on a basket of key international currencies.

SBI
Settlement Before Interchange
The process, operated under Payments New Zealand Ltd's rules, by which any two banks prepare and process files containing details of their customers' bilateral transactions. The net value of the transactions is settled by one bank making a payment from its ESAS account to the other bank's ESAS account. Once settled, the file containing details of the customers' transactions is delivered to the destination bank, which will then update its customers' records.

SIFMI
Systemically Important Financial Market Infrastructures

TWI
Trade-Weighted Index
A measure of the value of the New Zealand dollar relative to the currencies of New Zealand's major trading partners.

USD
United States Dollar

After years of planning, design and testing, the Reserve Bank of New Zealand's Series 7 *Brighter Money* banknotes began circulating in 2015 and 2016. The new notes reflect the Bank's continued commitment to innovation, learning from the past to prepare for the future.

To continue this innovation, and to reduce the environmental effects of printing, an interactive version of this year's *Annual Report* is available online at **annualreport.rbnz.govt.nz**