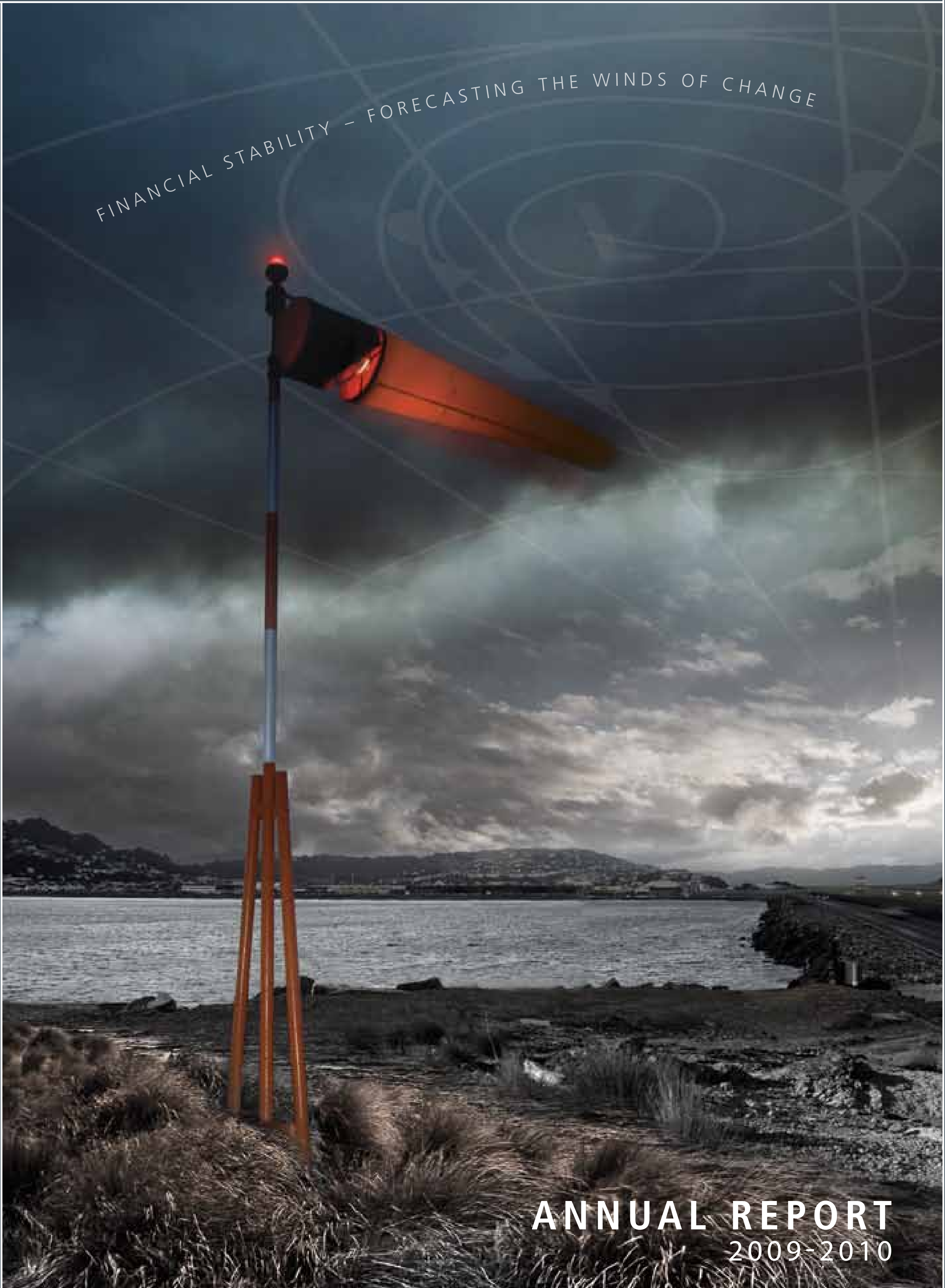
RESERVE
BANK
OF NEW ZEALAND



ANNUAL REPORT
2009-2010

CONTENTS

Reserve Bank of New Zealand Annual Report and Financial Statements for the financial year ended 30 June 2010, prepared pursuant to section 163 of the Reserve Bank of New Zealand Act 1989, published September 2010.

ISSN 0110 7070

THE RESERVE BANK OF NEW ZEALAND – WHAT WE DO

The Reserve Bank of New Zealand (the Bank) is the nation's central bank. It has three main functions, which contribute to New Zealand's prosperity and advancement.

Monetary policy

Under the Reserve Bank of New Zealand Act 1989 (the Act), the Bank is given operational independence to manage monetary policy to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA). (See pages 22-27 for more detail on monetary policy activity in 2009-10.)

Financial stability

The Act also directs the Bank to promote the "maintenance of a sound and efficient financial system" and to avoid "significant damage to the financial system that could result from the failure of a registered bank". (See pages 27-30 for activity in 2009-10.)

To achieve these requirements, the Reserve Bank registers banks and operates a prudential supervision system designed to encourage banks and non-bank deposit takers (NBDTs) to manage their risks carefully. The Reserve Bank acts as banker to the banks, providing inter-bank settlement facilities and related payment services. We advise the government on the operation of the financial system. We manage foreign exchange reserves to enable intervention in the foreign exchange market, if required.

Currency

The Reserve Bank issues New Zealand's currency. As required by statute, we control the design and printing of the nation's currency. We then issue currency to banks, which they, in turn, provide to their customers. We also withdraw from circulation and destroy damaged or unusable currency. (See pages 30-31.)

The Reserve Bank also provides settlement services to the government and financial institutions.

Our internal organisation is illustrated in the chart on page 13. Details of the Reserve Bank Board of Directors are provided on page 14. The role of the Board, and the governance and management of the Bank, is described on pages 15-19.

THE YEAR AT A GLANCE

- Consumers Price Index (CPI) inflation fell from 1.9 percent for the year to June 2009 to 1.8 percent for the year to 30 June 2010.
- The Bank kept the Official Cash Rate (OCR) stable at 2.5 percent throughout the year until June 2010, when it raised the OCR to 2.75 percent. (The Bank raised the OCR to 3.0 percent on 29 July 2010.)
- The Bank started to remove some temporary crisis liquidity measures.
- The Reserve Bank released its prudential liquidity policy for banks.
- Regulations were introduced for non-bank deposit takers (NBDTs), making credit ratings mandatory, requiring a minimum capital ratio, and limiting related parties exposure.
- The Insurance (Prudential Supervision) Bill was introduced.
- The Reserve Bank became a supervisor under the Anti-Money Laundering and Countering Financing of Terrorism Act.
- Parliament ratified a new five-year Funding Agreement for the Reserve Bank.
- The Bank spent a net $41.2 million on activities covered by its Funding Agreement.
- A dividend of $290 million was paid to the Crown after balance date.[1]

1 The dividend to the Crown was confirmed by the Minister of Finance after balance date.

GOVERNOR'S STATEMENT

When an economic recession coincides with a financial crisis, recovery is likely to be slow and fragile. This was the lesson from the 1930s Depression. Governments have learnt much from that terrible experience. This recovery is certainly proving brittle, uncertain, and full of surprises.

Compared to many other countries, New Zealand was hit less hard during the Global Financial Crisis. But any expectations we may have had of an easy recovery during this year have been dispelled. We have now emerged from a long recession, and have experienced some quarters of significant growth. This has been helped by growth in Asia and Australia. But Europe has disappointed with its frail fiscal picture, the US has suffered a very weak labour market, and Japan continues to struggle with deflation. The global financial markets, including our international funding markets, have also remained volatile.

New Zealanders have experienced the recession in various ways, and have changed their behaviours as a result. Households have been reducing mortgage debt where possible, and have been very cautious about re-entering the housing market - attitudes that have been reinforced by recent tax changes. Businesses have also been reducing debt and cautious about reinvestment.

This private sector restraint has meant a slower return to growth. But it has helped the rebalancing of the economy, which has been a growing challenge for a long time. The Government's establishment of a Savings Working Group underlines the importance of domestic savings performance to address imbalances, and improve investment and economic growth. The global financial crisis demonstrated the fragility of a banking system that relies so heavily on short-term foreign debt funding. It also highlighted New Zealand's external imbalances, demonstrated by our deficit in the balance of payments on goods and services, and our negative net investment income position. These deficits are now slowly improving.

Government spending, which was stimulative during the recession, is now more restrained.

That is appropriate in view of the financial markets' renewed focus on the sustainability of sovereign debt issuance.

Monetary policy was also stimulative over the period of the crisis, and together with a number of special policies, this helped mitigate the worst of the effects. A temporary weakening of the New Zealand dollar also assisted recovery. Now, most of the crisis policies have been withdrawn or are time-limited, including most of the special liquidity facilities for banks and other institutions, the government's retail deposit guarantee scheme, the wholesale deposit guarantee, and the Bank's increased foreign reserves position.

This means we can manage a return to normality through the traditional monetary policy tool, the Official Cash Rate (OCR). We have already moved to increase the OCR somewhat, but it still remains at an historically low level. Over time, the OCR will move back to more neutral levels, but this process will likely be slow, and the OCR is unlikely to need to rise as far as in previous recoveries. This is due to a combination of circumstances: the cautious behaviour of households and businesses; the low levels of new lending; the high cost of funds; the move back to floating rate mortgages; a different yield curve; contained inflation expectations; and the very low interest rate paths expected in most major economies.

There have been a number of administered price increases, including a GST rise. So far, the pass-through to inflation appears muted, but any ongoing inflationary effect would present a challenge for monetary policy. It is critical that businesses and labour groups do not try to use the GST rise as a veil to increase margins and remuneration.

This means restraint by the electricity sector, other utilities, local government, and others who have a record of using strong market positions to push up prices.

A further focus this year, also based on learnings from the Global Financial Crisis, has been the development of new macro-financial and prudential policy options. The Reserve Bank of New Zealand has been at the forefront of this thinking amongst central banks. Experiences of the last few years point to the illiquidity of bank funding under certain conditions, and for that reason we have introduced a liquidity policy with funding matching criteria and a core funding ratio. This has led to a lengthening of funding maturities on bank books, and has already proved its worth during the unsettling days of the Greek sovereign debt crisis. We are now examining the potential for using the core funding ratio as a device to stabilise the financial cycle in New Zealand.

At the same time, there has been much international focus on new bank regulatory tools: tighter capital definitions, counter-cyclical capital, leverage ratios, bank taxes, and living wills. Some of these policies will become encapsulated as 'Basel III' requirements. New Zealand is not represented in the international committees that have developed this regulation, and some of it may prove to be an unnecessary impediment to the efficiency and effectiveness of our system.

The New Zealand finance company sector has been a major casualty of the crisis, with many failures and significant government support through the retail deposit guarantee scheme. The Reserve Bank of New Zealand is taking over regulation of the non-bank deposit takers. During the year, we have put in place requirements for credit ratings, capital, connected exposures, and the composition of boards. To make this work for New Zealanders, the trustees, who are the front-line supervisors, will have to lift their game.

The government has also decided the Reserve Bank will regulate the insurance industry, and we are putting the building blocks in place for this.

This year, we completed development work to improve the robustness and efficiency of the Reserve Bank's payment and settlement systems, to update inventory systems to manage our currency, and to fundamentally rebuild our financial and economic statistical systems. The crisis reinforced that accurate knowledge and robust controls are crucial for a central bank.

Financially, we have paid a dividend to government of $290 million for the 2010 year. This leaves the Bank with equity of $2,574 million, a strong base for the potential risks inherent in our activities and large balance sheet. This dividend follows a voluntary dividend payment in April 2010 of $45 million, which we determined was surplus to our capital requirements as we emerged from the financial crisis.

As this *Annual Report* shows (pp 40-49), we have maintained stable underlying income from interest earnings and stable operating costs. Nonetheless, we have recorded a loss of $111 million for the year ended 30 June 2010. This incorporates unrealised losses due to revaluations on our assets and liabilities. Most of these losses occurred on our unhedged foreign exchange position, as exchange rate and interest rate movements partially reversed the large unrealised gains of the previous year. While our reserves are still showing a positive return based on purchase costs, we foreshadowed in the 2009 *Annual Report* the likelihood of volatility in accounting profit and loss.

The Bank's operating costs are funded on a five-yearly basis, reflecting its operational independence in several key functions. In June 2010, the Minister of Finance and I entered into a Funding Agreement for the five years ended 30 June 2015. This was ratified by Parliament on 20 July.

The focus of the new Funding Agreement is on extending capacity in new regulatory and surveillance areas, commencing a programme of upgrading bank notes, and establishing a small office in Auckland to offer more security in the event of Wellington disruptions.

As we went to print, Canterbury was struck by a massive 7.1 magnitude earthquake and hundreds of aftershocks. While the economic impact was still being assessed, our sympathy goes to distressed residents and businesses. The fold-out shows how we can use our range of functions to assist.

The Reserve Bank of New Zealand is one of the few OECD central banks to retain all its functions in one organisation. It has been hugely useful during the crisis and recovery to be carrying out monetary policy, financial stability, foreign reserves management, bank regulation, payments and settlements, and currency management all under one roof. It also means we have benefited from the skills and experience of a wide range of employees who are working together for New Zealand's recovery. During this difficult period, we have worked more closely than normal with the New Zealand Treasury and Minister of Finance, and thank them for this cooperation. I particularly acknowledge Deputy Governor, Grant Spencer, and my senior management group for their dedication, focus and advice through this period, and Chair, Dr Arthur Grimes, and Board members for their guidance and judgement. It is their contributions that make the Reserve Bank what it is today. I thank them all.

Alan Bollard

ALAN BOLLARD
GOVERNOR
9 September 2010

BOARD OF DIRECTORS' REPORT
FOR THE YEAR ENDED 30 JUNE 2010

This report is made pursuant to section 53A of the Reserve Bank of New Zealand Act 1989

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.

Reserve Bank Responsibilities

The Reserve Bank of New Zealand Act 1989 specifies a range of functions that the Bank must undertake. The 1989 Act initially required the Bank to implement monetary policy, registration and prudential supervision of banks, and supply the country's currency needs. It also provided for the Reserve Bank to supply payment and settlement services, to manage foreign exchange reserves and to intervene in foreign exchange markets if necessary.

In recent years, the Reserve Bank's roles have increased in breadth. It is now also responsible for aspects of money laundering prevention, development and implementation of the prudential regulatory framework for non-bank deposit takers (NBDTs) and is in the process of becoming the prudential regulator of insurance companies. The addition of these new roles, and the implications of the global financial crisis for the Bank's existing roles, means that the Bank has had an exceptionally busy year fulfilling its responsibilities.

A corollary of the Bank's added responsibilities is the Board's role in keeping implementation of these added duties under review. We consider that the Bank's performance over the year has continued at a high standard, and the Bank is to be commended for the part it has played in ensuring that the country has come through the worst global financial crisis of the past 70 years in a strong position relative to many other countries. Our assessment of the Bank's performance is based on our monitoring over the year through regular board meetings. This report refers specifically to the Strategic Priorities and other objectives set out by the Bank in its *Statement of Intent 2009-2012* (SOI).

Financial Markets

The Bank's first Strategic Priority over the past year was to: "Ensure the banking system has sufficient liquidity to meet its ongoing funding objectives." After the global market disruptions of 2008-09, there remained the possibility of further financial liquidity problems in 2009-10. We note that access to liquidity by banks and other sound institutions did not constitute a major problem over the past year. Accordingly, the Reserve Bank was able to wind down some of its special liquidity facilities that it had earlier put in place.

The Bank's handling of financial system liquidity since the onset of the global financial crisis has been forward-thinking and effective. Its ability to implement new facilities that met its objectives without any material negative side effects is a testament to the high quality of staff that the Bank was able to draw upon in this field.

Prudential Supervision

As a result of the financial crisis, the Bank, in its SOI, sought to: "Ensure that the registered banks maintain adequate capital, through close monitoring of asset quality and prompt supervisory responses." While the Board does not see individual bank data, we do see aggregated data for the banking system and are kept informed of any breaches of conditions of bank registration. It is reassuring that the New Zealand banking system, operating within the confines of the Reserve Bank's registration and prudential supervision regime, came through the crisis with all banks remaining sound.

While some commentators and some banks had criticised the Reserve Bank's prudential regime prior to the onset of the crisis as being too intrusive, the New Zealand economy has been spared the potentially severe negative effects that would have occurred had one or more registered banks experienced liquidity or solvency problems. Economies where such problems have occurred have had sharper and more prolonged downturns than experienced by New Zealand.

The advent of the Bank's new prudential liquidity policy, and in particular the core funding ratio, should further improve the soundness of banks' balance sheets. The Board continues to support the Reserve Bank's investigation of additional tools that can assist both with financial system and macroeconomic stability. The core funding ratio is an example of such an instrument. Nevertheless, we are also aware that the global trend towards additional financial sector regulation could result in pressures to add regulation that may reduce efficiency. The Board will keep the Bank's responses to these pressures under review.

In its SOI, the Bank signalled its intention to: "Introduce a prudential regime for the insurance sector, and implement new regulatory arrangements for NBDTs". The Bank's new responsibilities in these two fields are major.

The Bank has been building its capability with regard to insurance companies and preparing proposals for a new prudential regime in advance of the passage of new legislation. This build-up in capability is, in the view of the Board, appropriate given the need to develop a full understanding of the insurance sector prior to implementing a new prudential regime for the sector.

The non-bank deposit-taking sector has continued to experience some difficulties over the past year as a result of decisions taken within the sector well before the Reserve Bank was given responsibility for its regulation. The Bank is not the front-line supervisor of NBDTs (a role played by the NBDT trustees) and instead is responsible for the overarching regulatory framework.

Given this legislated system, the Bank has worked with other parties (trustees, NBDTs, Treasury and others) to promote greater stability in the sector.

A major outstanding policy decision in relation to NBDTs and banks concerns the replacement, if any, of the extended deposit guarantee scheme. The extended scheme, run by Treasury, remains in place until December 2011. It is important for everyone involved in the financial markets (depositors, borrowers, institutions and equity-holders) that the policy stance regarding the existence and nature of any scheme that may operate after the extended scheme finishes, is known shortly. This is not a direct responsibility of the Bank, but the Bank plays a role in tendering advice to the Minister and Treasury on this important topic.

Monetary Policy

The Bank's 2009-10 SOI reflected the effects of the global financial crisis in its macroeconomic strategic objective: "Support effective monetary policy for inflation targeting in a world of volatile financial and economic conditions." This strategic objective had several components to it.

First, in accordance with the Act and with the Policy Targets Agreement (PTA) signed between the Minister of Finance and Governor, the Bank is responsible for maintaining annual CPI (consumer price index) inflation "between 1 and 3 percent on average over the medium term." It must do so while seeking "to avoid unnecessary instability in output, interest rates and the exchange rate." CPI inflation in the year to June 2010 was 1.8 percent, following 1.9 percent inflation the previous year. Thus, after the inflationary surge in 2008, CPI inflation was maintained approximately in the middle of the target range over the past two years.

The global downturn has been so severe that it was possible inflation could temporarily have undershot the bottom of the 1 to 3 percent target range. As documented by the Bank, and noted in our Annual Report last year, the Bank reacted to these pressures by reducing the Official Cash Rate (OCR) over 2008-09 from 8.25 percent to 2.5 percent. It signalled that it would maintain the OCR at 2.5 percent throughout most of 2009-10 and did maintain it at that level, raising it to 2.75 percent in June 2010. The Bank's actions first in reducing the OCR, and then signalling its stance of maintaining it at an historically low level for a prolonged period, have helped to stabilise the New Zealand economy following international turmoil, without reigniting near-term inflation outcomes.

The Bank has signalled that it intends to raise the OCR from current levels and so reduce the stimulus that it is providing to the domestic economy. The Bank has further signalled that it will look through the first-round price effects of recently announced policies concerning taxation, excise duties and carbon pricing. We concur with the Bank's approach to these one-off price increases. The Board reviews the analysis that the Bank undertakes with regard to its policy decisions, and is satisfied that the Bank is implementing monetary policy in keeping with its responsibilities under the Act and the PTA.

Interest rates have been remarkably stable over the past year while output (GDP) has been steadily increasing, consistent with the requirement to implement policy so as to avoid unnecessary instability. Exchange rates throughout the world remain volatile, and the volatility seen in the cross rates of the New Zealand dollar against other individual currencies chiefly reflects those global instabilities.

As discussed with reference to prudential supervision, the Bank continues to investigate instruments that may lessen financial and/or macroeconomic instability. The Board remains concerned about imbalances in the New Zealand economy exhibited by a persistent current account deficit and consistently higher non-traded than traded sector inflation on average. We support the Bank's programme to assess additional monetary policy and financial tools that may assist in alleviating these imbalances. Further work has been signalled by the Bank for the coming year on this topic and the Board will be monitoring progress in this field closely.

Bank-wide Objectives

The Board has a responsibility for keeping the Bank's use of resources under review. The Bank's last five-yearly Funding Agreement came to a close in June 2010. Over these five years, the Bank has under-spent the sum agreed for its regular expenditure. A new five-yearly funding agreement for 2010-2015 has been ratified by Parliament. It will require some additional stringency in the Bank's expenditures, but the Board has been assured that the Bank's policy implementation and development will not be weakened as a result.

We noted in our report last year that changes to accounting policies and to the structure of the Bank's balance sheet over 2007-2009 have made the Bank's reported financial outcomes more volatile as a result of asset and liability valuation changes. Favourable valuation gains over 2008-09 were partially reversed over 2009-10. The Board maintains a monthly review of the Bank's financial position and views the volatility of recent years as an inevitable consequence of a balance sheet that is structured so that the Bank can effectively implement its policy duties. The balance sheet is exposed to both interest rate and foreign exchange rate risk. Over recent years, positive returns have resulted.

The Board supported the Bank's payment of a $290 million dividend to the Crown for 2009-10. This was in addition to the voluntary dividend payment of $45 million paid in April 2010.

The Board is confident that past under-expenditure of the Funding Agreement has not placed the Bank's capability at risk. The Bank continues to invest, as required, in updating systems that underpin its policy role and its financial and risk management duties. One of these developments has been the staged introduction of the Financial Sector Information System which has the role of: "significantly improving the management of statistics and enabling new prudential data collections." This investment has proceeded largely according to schedule and is meeting expectations within the Bank. It continues a pattern whereby major systems upgrades have come on-stream broadly on time and on budget, indicating strong project management capability within the Bank.

One project that has been delayed has been the establishment of an Auckland office. The delay was principally due to a temporary deferment of the establishment plan while the resource implications of the Capital Markets Taskforce's recommendations on payments systems were being processed. The Board was kept aware of the reasons and implications of this delay. We have noted in past reports that the Board regards the establishment of an office outside Wellington as an item of major importance in order to ensure the Bank can continue to perform if a major regional disaster were to hit the city. We recognise that additional costs will be incurred by running a small office in Auckland but regard this cost in the nature of an insurance premium that will be of benefit should a major disaster occur. We are pleased that this cost has been recognised and accommodated in the new five-yearly funding agreement. We expect the office to be established over the coming year.

While not appearing in its 2009-10 Strategic Priorities, the Bank continues to provide excellent services in the fields of payment and settlements services and currency provision. We note moves over the past year to improve interoperability of the Bank's settlements system with that run by NZX Limited. We have been kept up to date with the analysis lying behind this approach and consider that the Bank's work in this regard has been thorough.

On the currency side, the Bank is looking forward to a replacement set of banknotes some years into the future. We support preparatory work being conducted on this matter, especially as technologies advance, potentially placing existing notes at greater risk of counterfeiting.

We are pleased to see the need to progress this work being recognised in the new five-yearly Funding Agreement.

For the past two years, the Bank's staff have had to perform at the highest level given the severe tests facing us from global influences. The achievements of the Bank over this time are testament to the high quality of staff throughout the Bank. The Board is delighted to see that, despite this testing climate, surveyed staff satisfaction remains high, and has increased since the last survey two years ago. In part, this reflects the attention to developing high quality management skills within the Bank. The Governor, Dr Alan Bollard, has promoted and exemplified these skills. We express our strongest appreciation to him for his leadership and to the Bank's staff for their performance.

Finally, 2009-10 saw a number of changes in Board membership. Alison Paterson left the Board after three five-year terms, having been both Deputy Chair of the Board and Chair of the Board's Audit Committee. She has given outstanding service to the Bank over this time. Sir John Goulter left the Board after serving two terms and again has contributed greatly to the Board. We thank them both for their contributions as Directors. Hugh Fletcher was elected to the roles of Deputy Chair of the Board and Chair of the Audit Committee. Three new Directors joined the Board: Keith Taylor, Neil Quigley and Kerrin Vautier, all of whom have deep experience in fields central to the Bank's responsibilities, and we welcome them as Directors.

ARTHUR GRIMES
CHAIR
12 August 2010

HUGH FLETCHER
DEPUTY CHAIR
12 August 2010

PLANNING AND REPORTING FRAMEWORK

	2008/09	2009/10	2010/11	2011/12	2012/13	20013/14	20014/15
(I) PLANNING	5 YEAR FUNDING AGREEMENT		5 YEAR FUNDING AGREEMENT				
			STATEMENT OF INTENT				
			DETAILED BUDGET				
(II) REPORTING		*ANNUAL REPORT*					
MONETARY POLICY STATEMENTS (QUARTERLY)							
FINANCIAL STABILITY REPORTS (SIX-MONTHLY)							

TABLE 1

This Annual Report covers the last year of the Funding Agreement for the five years ended 30 June 2010, which reflected the need to invest in the replacement and upgrading of information management, forecasting and financial reporting systems, strengthen our supervisory capability, and ensure that robust business continuity arrangements remain in place.

The Funding Agreement was amended in April 2008 by increasing the approved level of net operating expense for 2008-09 and 2009-10 to fund increased responsibilities associated with greater oversight of non-bank financial institutions. For the year ended 30 June 2010, the Funding Agreement provided $46.9 million for the Bank's net operating expenses.

A new Funding Agreement was signed on 8 June 2010 and ratified by Parliament on 20 July 2010. This provides funding of $47.8 million for 2010-11, increasing to $56.4 million by the final year 2014-15. The increase in expenditure reflects additional regulatory responsibilities, the initial stages of upgrading New Zealand's bank notes, and the establishment of an office in Auckland.

STRATEGIC PRIORITIES AND OUTCOMES 2009-10

The Bank adopts a number of Strategic Priorities in addition to its business-as-usual activities. Last year we adopted a number of priorities, which we report on here. Priorities for the 2010-11 year are on page 50.

PRIORITY 1:	OUTCOME:
BANKING SYSTEM LIQUIDITY Ensure the banking system has sufficient liquidity to meet its ongoing funding needs.	Financial market participants had less need for the Bank's liquidity facilities over the year as funding markets in New Zealand and offshore returned towards more normal conditions. The Bank gradually removed some of the exceptional facilities introduced to deal with the abnormal market conditions of the global financial crisis, but we continue to monitor conditions as they remain uncertain.
PRIORITY 2:	**OUTCOME:**
REGISTERED BANK MONITORING Ensure that the registered banks maintain adequate capital, through close monitoring of asset quality and prompt supervisory responses.	Registered banks maintained, and usually significantly exceeded, the required minimum capital ratios and liquidity requirements that were set out in conditions of registration. We have carefully monitored the asset quality of registered banks, requiring them to provide frequent detailed information on their asset quality on a monthly basis. These measures helped to ensure that banks registered in New Zealand remained sound, and gave us confidence they were well placed to deal with stresses from domestic or international sources.
PRIORITY 3:	**OUTCOME:**
MONETARY POLICY ANALYSIS Support effective monetary policy for inflation targeting in a world of volatile financial and economic conditions.	Over the past year, the Bank has focused on effective monetary policy in volatile financial conditions. Due to the uncertainty surrounding the economy and financial markets, interest rates were held at an especially low level for more than a year. Once the economy had stabilised we began to remove this stimulus. We continue to monitor the domestic and international situation for any change in conditions.
PRIORITY 4:	**OUTCOME:**
FSIS IMPLEMENTATION Implement our Financial Sector Information System (FSIS), significantly improving the management of statistics and enabling new prudential data collections.	A significant milestone in the path to improving the quality, accessibility, relevance and reliability of Reserve Bank statistics was achieved this year. The first stage of implementation of the FSIS was completed, and we expect to continually improve the scope and usability of this tool. The greater accessibility and use of data assists in providing high quality monetary policy advice to the Governor.

PRIORITY 5:	OUTCOME:
INSURANCE PRUDENTIAL REGIME AND NBDT REGULATIONS Introduce a prudential regime for the insurance sector, and implement new regulatory arrangements for NBDTs.	The Insurance (Prudential Supervision) Bill was introduced to Parliament in December 2009 and reported back with very few significant amendments from Select Committee in early June 2010. The second reading occurred later in June and the Bill was enacted on 7 September 2010. Over the past year, as part of the new regulatory framework, the Bank issued guidelines on risk management for NBDTs, regulations requiring credit ratings, and regulations on capital and related party exposures. Consultation on the second stage of the NBDT regulatory regime, including licensing requirements and powers for the Bank to manage NBDT distress and failure, is underway.
PRIORITY 6:	**OUTCOME:**
AUCKLAND BUSINESS SUPPORT OFFICE Improve business continuity and disaster-recovery capability through the establishment of a business support office in Auckland.	We completed initial planning for the establishment of a small Auckland office for business continuity planning purposes. Work is underway and we expect the Auckland office will be operational in 2011.
PRIORITY 7:	**OUTCOME:**
ENGAGE AND DEVELOP STAFF Engage and develop staff to meet the challenges of a volatile financial and economic environment.	With the global financial crisis evolving into a fragile recovery, the focus within the Bank moved to financial stability and future-proofing. The Bank encouraged engagement and motivation of staff through team work, cross-functional collaboration, increased internal communications, increased involvement of managers in strategic planning and staff participation in a personal leadership development programme. Staff satisfaction continued to increase since the last staff satisfaction survey two years ago.

RESERVE BANK DEPARTMENTAL STRUCTURE

AS AT 30 JUNE 2010

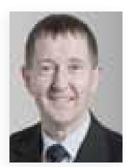
GOVERNORS

Governor
Alan Bollard

Assistant Governor
Head of Economics
John McDermott

Deputy Governor
Head of Financial Stability
Grant Spencer

Assistant Governor
Head of Operations
Don Abel

	DEPARTMENT/HEADS	EXTERNAL FUNCTIONS	INTERNAL SERVICES
	Economics	• Monetary policy formulation	
	***Financial Markets*** *Simon Tyler*	• Market operations • Foreign reserves management	
	***Prudential Supervision*** *Toby Fiennes*	• Financial system surveillance and policy	
	***Currrency and Building Services*** *Alan Boaden*	• Currency operations	• Property management • Security
	***Financial Services*** *Mike Wolyncewicz*	• Settlement services • Registry and depository services	• Accounting services • Treasury services
	***Knowledge Services*** *Tanya Harris*		• Technology services • Library services • Project management • Web publishing
	***Human Resources*** *Lindsay Jenkin*		• Human resources strategy and services
	***Communications/ Board Secretary*** *Mike Hannah*		• Communications strategy and services • Reputation management • Board secretariat
	***Risk Assessment and Assurance*** *Steve Anderson*		• Risk assessment and assurance • Audit services • Legal services

BOARD OF DIRECTORS

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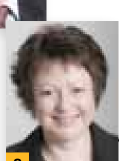

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NON-EXECUTIVE

Dr Arthur Grimes 1

» Chair Reserve Bank of New Zealand Board of Directors
» Economist

CORPORATE INTERESTS
- The Hugo Group Ltd - Chair

OTHER INTERESTS
- GT Research & Consulting - Principal
- Motu Economic & Public Policy Research Trust - Senior Fellow
- National Infrastructure Advisory Board - Member
- Reserve Bank Superannuation Fund - Trustee
- University of Waikato - Adjunct Professor of Economics
- Victoria University of Wellington - Member, Tax Working Group[2]
- Urban Technical Advisory Group to Minister of the Environment - Member[3]
- Wellington Jazz Trust - Trustee

First appointed 13 March 2002 - current term expires 12 March 2012

Alison Paterson QSO 2

» Deputy Chair Reserve Bank of New Zealand Board of Directors (to 16 September 2009)
» Chair Reserve Bank of New Zealand Board of Directors' Audit Committee (to 31 January 2010)
» Company Director

CORPORATE INTERESTS
- Abano Healthcare Group Ltd - Chair
- BPAC NZ Ltd - Chair
- Metrowater Ltd - Director
- NGC Holdings Ltd - Director
- Stevenson Agriculture Ltd - Chair
- Vector Limited - Director

OTHER INTERESTS
- Ambulance New Zealand - Chair, Oversight Committee
- Centre of Research Excellence Growth and Development, University of Auckland - Chair, Governing Board
- Massey University Council - Member
- Nga Pae o te Maramatanga (Maori CORE, University of Auckland) - Director

First appointed 1 February 1995 - term expired 31 January 2010

Hugh Fletcher 3

» Deputy Chair Reserve Bank of New Zealand Board of Directors (from 17 September 2009)
» Chair Reserve Bank of New Zealand Board of Directors' Audit Committee (from 1 February 2010)
» Company Director

CORPORATE INTERESTS
- Fletcher Building Ltd - Director
- Fletcher Building Finance - Director
- IAG Finance (New Zealand) Ltd - Director
- IAG New Zealand Holdings Ltd - Chair
- IAG New Zealand Limited - Chair
- Insurance Australia Group Ltd - Director
- NGC Holdings Ltd - Director
- NZI Staff Superannuation Fund Nominees Ltd - Director
- Rubicon Forests Ltd - Director
- Rubicon Ltd - Director
- Vector Ltd - Director

OTHER INTERESTS
- Dilworth Trust - Trustee
- L.E.K. Consulting - Member New Zealand Advisory Board
- The New Zealand Portrait Gallery - Trustee
- University of Auckland Council - Member
- University of Auckland Foundation - Member

First appointed 10 June 2002 - current term expires 9 June 2012

Sir John Goulter KNZM JP 4

» Company Director

CORPORATE INTERESTS
- Ngapuhi Asset Holding Company Ltd - Chairman
- Northland Deepwater JV Ltd - Chairman
- Opua Commercial Estate Ltd - Director
- Packard House Ltd - Director
- Paraparaumu Airport Ltd - Chairman
- Television New Zealand Ltd - Director

OTHER INTERESTS
- NZ Business and Parliament Trust - Chairman

First appointed 9 February 2000 - term expired 8 February 2010

Professor Neil Quigley 5

» Deputy Vice-Chancellor (Research), Victoria University of Wellington

CORPORATE INTERESTS
- Victoria Link Ltd - Chair
- Wetox Ltd - Director

OTHER INTERESTS
- Ministerial appointment to the ACC Stocktake Group
- iPredict Ltd - Chair
- New Zealand Tertiary Education Consortium - Chair
- Adam Art Gallery Trust - Trustee
- Wellington College Board of Trustees - Chair
- Education New Zealand Trust - Trustee

First appointed 1 February 2010 - term expires 31 January 2015

Dr Chris Eichbaum 6

» University Lecturer
» Senior Lecturer (Public Policy), School of Government, Victoria University of Wellington

First appointed 1 August 2008 - current term expires 31 July 2013

Keith Taylor 7

» Company Director

CORPORATE INTERESTS
- Butland Management Services Ltd - Director
- Catalyst Risk Management Ltd (subsidiary of ACC) - Director
- Gough Gough & Hamer Ltd - Director
- Port Marlborough Ltd - Director
- Securitised Equipment Holdings Ltd - Director
- Transport Specialties Ltd - Director
- Transport Wholesale Ltd - Director

OTHER INTERESTS
- Earthquake Commission - Deputy Chairman
- Government Superannuation Fund - Board member
- New Zealand Qualifications Authority - Board member
- Takeovers Panel - Member

First appointed 1 July 2009 - term expires 30 June 2014

Sue Sheldon CNZM 8

» Company Director

CORPORATE INTERESTS
- Christchurch International Airport Ltd - Deputy Chairman[4]
- Contact Energy Ltd - Director
- Paymark Ltd - Director
- Freightways Ltd - Director
- Smiths City Group Ltd - Director
- Telecom Corporation of New Zealand Ltd - Director[5]
- Wool Grower Holdings Ltd - Director
- Wool Industry Network Ltd - Chairman

OTHER INTERESTS
- National Provident Fund Board of Trustees - Chairman[4]
- Sue Sheldon Advisory Ltd

First appointed 1 May 2009 - current term expires 30 April 2014

Kerrin Vautier CMG 9

» Consulting Research Economist

CORPORATE INTERESTS
- Fletcher Building Ltd - Director
- Fletcher Building Finance Ltd - Director

OTHER INTERESTS
- Deloitte Partnership Board - External Advisor
- High Court - Lay Member under the Commerce Act
- Musica Sacra Trust - Chair

» First appointed 9 February 2010 - term expires 8 February 2015

EXECUTIVE

Dr Alan Bollard

» Governor

SECRETARIAT

Mike Hannah

» Board Secretary

2 To December 2009
3 From February 2010 to July 2010
4 To 30 September 2009
5 From 21 June 2010
6 To 30 September 2009

GOVERNANCE

Authority and accountability

The Reserve Bank of New Zealand is wholly owned by the New Zealand government. The Bank's authority, funding and accountability are based on:

- **the Reserve Bank of New Zealand Act 1989**, which specifies the Reserve Bank's functions and duties;
- **the Policy Targets Agreement (PTA)**, a written contract between the Minister of Finance and the Governor detailing the monetary policy outcomes that the Bank is required to achieve;
- **the 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; and
- **the *Statement of Intent***, an annual three-year statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the three years, and projected income and expenditure for the first financial year.
- **the *Annual Report***, an annual accountability document, including presentation of financial statements.

The Reserve Bank also subscribes to a statement of its Vision and Values. These can be found on the inside front cover.

The Governor

The Reserve Bank Act makes the Bank's Chief Executive - the Governor - accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor. The Governor is appointed for a five-year term. The Act sets specific criteria for the appointment, reappointment, and dismissal of a Governor. The current Governor, Dr Alan Bollard, took up his appointment in September 2002 and was reappointed in May 2007 to a further five-year term expiring in September 2012.

Management structure

The Bank's senior management team is made up of the Governor, a Deputy Governor, a Head of Financial Stability, a Head of Operations, a Head of Economics, and the heads of the Bank's various departments, as outlined on page 13. The posts of Governor and Deputy Governor are required by statute, the current Deputy Governor also being the Head of Financial Stability. In addition, the Head of Operations and the Head of Economics are currently designated Assistant Governors.

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

- the Senior Management Group, which meets weekly to consider the management and day-to-day operation of the Bank;
- the Monetary Policy Committee, which meets fortnightly to advise the Governor on economic and financial market conditions to assist monetary policy deliberations;
- the Official Cash Rate Advisory Group, which advises the Governor on monetary policy decisions, typically eight times a year;[7]
- the Financial Systems Oversight Committee, which meets fortnightly to consider policy issues relating to prudential regulation and supervision of the financial system;
- the Macro-Financial Committee, which meets fortnightly to advise the Governor on macro-financial stabilisation policies and tools;
- the Asset and Liability Committee, which meets monthly to consider strategic management of the Bank's assets and liabilities; and
- the Communications Committee, which meets weekly to consider external communications issues and the Bank's credibility and reputational interests.

7 This group also includes the Bank's two part-time external monetary policy advisers, who provide outsiders' perspectives to mitigate the risk of narrow information sources. At year's end, the two external advisers were Mr Earl Rattray and Ms Pip Dunphy.

Board of Directors

The Reserve Bank has a Board of Directors, the membership of which is shown on page 14. Under the Act, the Board of Directors must comprise not less than five and not more than seven non-executive members, who are appointed for five-year terms by the Minister of Finance. In addition, the Governor is a Board member. The Chair must be a non-executive member, and is appointed by the non-executive directors for a renewable term of 12 months. The current Chair is Dr Arthur Grimes.

The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. The Board provides the Minister of Finance with an annual assessment of the Bank's performance, which is reproduced on pages 6-9. It has the responsibility to confirm that *Monetary Policy Statements* are consistent with the PTA, and it monitors the six-monthly *Financial Stability Reports*. It offers its view to the Minister on the amount to be paid as a dividend. The Board performs its role through regular meetings at which it receives extensive briefings on the Bank's activities, decisions and policies. At these meetings, the Board also provides advice to the Governor. The Board does not direct Bank policy, monetary or otherwise.

When required, the Board makes recommendations to the Minister of Finance on the appointment or reappointment of the Governor. If it believes that the Governor's performance, in meeting the requirements of the PTA or in carrying out his or her other duties, has been 'inadequate', then it can recommend to the Minister of Finance that the Governor be dismissed. The Board also appoints the Deputy Governor on the recommendation of the Governor.

The Board of Directors' Audit Committee monitors the external and internal audit functions. The Committee also receives reports from the Bank's external auditor and reviews the Bank's annual financial statements. Directors on that committee during the year were Alison Paterson (Chair) (to 31 January 2010), Hugh Fletcher (Chair from 1 February 2010), Sir John Goulter (to 8 February 2010), Sue Sheldon, Keith Taylor (from 13 August 2009) and Kerrin Vautier (from 18 February 2010).

The Board of Directors held nine scheduled meetings and the Audit Committee three scheduled meetings, as well as considering and advising on additional information during the year.

Parliamentary scrutiny

The Bank's activities are scrutinised by Parliament's Finance and Expenditure Select Committee. Typically, hearings are held covering the quarterly *Monetary Policy Statements*, the six-monthly *Financial Stability Reports*, and the Bank's annual financial performance.

Public accountability

An important aspect of the governance of the Bank is its transparency.

The Bank publishes an annual *Statement of Intent* and an *Annual Report*, which report on the Bank's governance, objectives, strategies, key performance indicators and performance. It releases a quarterly *Monetary Policy Statement,* which explains current monetary policy and provides detailed economic projections. It also publishes a six-monthly *Financial Stability Report*, assessing the robustness of the New Zealand financial system. On our website (www.rbnz.govt.nz), a *Statement of Principles* summarises our bank registration and supervision policies.

We also make information on our policies and activities widely available via an extensive website, quarterly *Reserve Bank Bulletins*, research papers, discussion papers, speeches, media interviews and brochures.

Financial management

Financial management overview

Foreign reserves management, New Zealand dollar liquidity management and currency operations materially impact on the size and structure of the Bank's balance sheet as well as its financial performance. The nature and extent of the Bank's principal financial activities are described in more detail in the financial statements on pages 58-105.

The Governor is responsible for the Bank's financial management. He decides on its financial management strategy and he makes all key financial management decisions after consulting the Bank's Asset and Liability Committee. Implementation of strategic decisions is delegated to the Financial Markets department. The Board's role is to provide advice to the Governor and to monitor the Bank's financial performance.

The Bank's financial performance is primarily impacted by:

- The size and performance of the Bank's foreign reserves management and market operations functions. This includes management of the Bank's open foreign exchange position, as well as provision of New Zealand dollar liquidity to participants in the domestic financial system.
- Changes in both foreign exchange rates and interest rates.
- The extent of available funds in the form of equity and currency in circulation[8].

In previous *Annual Reports* the Bank has signalled that its reported net income and equity will be more volatile than in the past. This is because the Bank's unhedged foreign currency reserves will generate profits and losses as foreign exchange rates change, and also because the Bank's holdings of New Zealand government securities will cause gains and losses in equity as interest rates change[9].

In 2008-09, the Bank recorded substantial unrealised profit when the New Zealand dollar depreciated in value affecting the value of our foreign currency reserves, and as global interest rates fell to very low levels.

In 2009-10, the Bank recorded an unrealised loss in the financial year as the New Zealand dollar increased in value and interest rates rose. However, the value of our foreign reserves and holdings remains higher than their purchase value.

Funding of the Bank's operations

The Bank's main source of income is the return on the substantial investments the Bank holds, which are funded by the issue of currency and by the government's equity contribution.

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

The Bank's funding arrangements are designed to strike an appropriate balance between providing a high degree of operational independence, and providing strong incentives for effective management of operating expenditure, while ensuring accountability for use of resources. Capital expenditure is funded by the Bank, with depreciation of fixed assets included in annual operating expenses.

If operating expenses (net of specified revenue) in any year exceed the amount provided in the funding agreement, the Bank will fund that excess from equity.

The 2005-2010 Funding Agreement expired on 30 June 2010. In June 2010, the Minister of Finance and the Governor entered into a Funding Agreement for the five years ended 30 June 2015. The new Funding Agreement provides for $47.8 million in the first year (2010-11) increasing to $56.4 million in year five (2014-15). The new Funding Agreement was ratified by Parliament on 20 July 2010.

8 No interest is paid on currency in circulation. When notes and coins are issued to a trading bank, the trading 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 'seignorage'.

9 The Bank's adoption of New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) means its holdings of New Zealand government securities are reported in the financial statements at market value, with unrealised gains and losses booked directly to equity. Prior to the Bank's adoption of NZ IFRS, the portfolio of New Zealand government securities was valued on a yield-to-maturity basis, which did not take account of changes to market interest rates.

The focus of the new Funding Agreement is on extending capacity in new regulatory and surveillance areas and commencing a programme of upgrading bank notes, together with establishing a small office in Auckland.

Annual distributions paid by the Bank

The Act requires the Bank to publish in its *Statement of Intent* a 'Statement of dividend principles'. The Bank's statement of dividend principles is shown below.

STATEMENT OF DIVIDEND PRINCIPLES

The Bank should maintain sufficient equity for the financial risks of 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.

Each year the Bank makes a recommendation to the Minister of Finance of the amount to be paid as a dividend. The Minister decides how much should be paid having regard for the recommendation of the Bank, the views of the Board of the Bank and any other relevant matters.

Equity

The Bank requires capital to cover the financial risks of performing its functions. In April 2010, after completing an interim review of its capital requirements, the Bank determined that $45 million of equity was excess to that required, and made a voluntary dividend payment to the government.

Risk management

The Bank faces a wide range of risks, some general and others unique to central banks. Of these, the most fundamental risk is making policy errors in relation to monetary policy, or the financial or banking systems, thereby causing damage to the economy and to the Bank's reputation and credibility. Other more specific risks include:

- credit and interest rate risks associated with our day-to-day liquidity management in domestic financial markets;
- risks associated with holding foreign currency reserves, including credit, interest, and exchange rate risks;
- risks associated with processing and storing currency, including risks of forgery, theft and robbery;
- risks associated with the operations of payments systems, which can arise from technical faults; and
- risks associated with being a small organisation, such as the loss of key staff.

The Bank sees risk management as an integral part of the general management task and the responsibility of day-to-day management.

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

- The Bank's Risk Assessment and Assurance department, which is responsible for providing advice on and monitoring the Bank's risk management frameworks. The internal audit role also rests with this department.
- A Risk Unit within the Bank's Financial Markets Department, which provides specialised advice on financial market risk management. This includes recommendations on interest rate, credit and liquidity risk limits, and the reporting of specialised measures of financial risk.

In addition, succession planning is a management priority. A Business Continuity Process strategy has been adopted, with a number of initiatives completed, including a decision to establish an Auckland office to mitigate business support risk in the event of a regional disaster in Wellington.

The Board and its Audit Committee also contribute to the review of the Bank's risk management processes.

Conflicts of interest

The Bank maintains policies and practices to avoid or manage conflicts of interest among all Bank staff, including Governors and directors. The policy requires that all staff act honestly and impartially, and in no circumstances reveal or make private use of confidential, market-sensitive information. The policy states that staff 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 provide the Bank with regular updates as to their personal interests, so that any potential conflict of interest is recorded. This is done quarterly. If any other staff have a particular concern, they can also record their interests in the same way.

Staff must not be personally involved, directly or indirectly, in regular trading in wholesale financial markets in which the Bank has, or might have, a significant influence. This includes domestic wholesale money, bond and foreign exchange markets, interest and exchange rate futures, options and swaps markets, and instruments linked to shares of regulated entities. At no time can Reserve Bank staff own or control shares in entities (or their parent companies) that the Reserve Bank regulates. The policy states that staff must not 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 provide lists of their other directorships and major interests in relation to which they would not wish to receive relevant Board papers or participate in discussions.

Governors' interests

The Governors note the following related interests. In each case, appropriate steps have been taken to ensure that no conflicts arise:

- Dr Bollard: The interests of his wife, Jenny Morel, in No 8 Ventures Management Limited and family interests in forestry.
- Mr Spencer: None.
- Dr Abel: None.
- Dr McDermott: None.

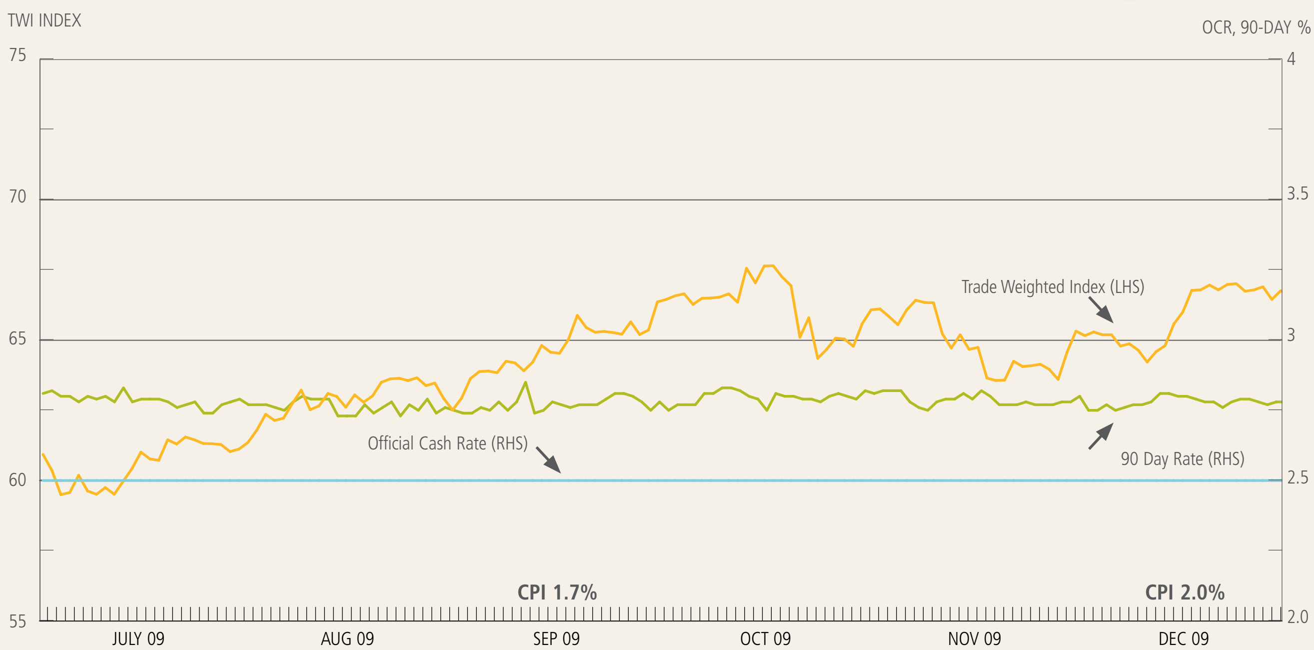
Management and monitoring processes

Within the Bank, all activities and expenditure must be authorised and in accordance with a comprehensive set of Bank policies and procedures. The Board receives monthly reports comparing actual outcomes against budget, prepared by the Bank's Financial Services Group. Departments are required to provide regular reports that describe progress to date on outputs and projects, and to explain any significant variances. The expenses of the Governor are reviewed by the Chair of the Board of Directors' Audit Committee. Bank involvement in the management of reserves and liquidity is controlled by specific dealing authorisations. Outcomes are monitored closely.

The internal audit function within the Bank is performed by its Risk Assessment and Assurance Department. The Bank is audited externally by the Auditor-General, who has contracted John Meehan, using the staff and resources of PricewaterhouseCoopers, as her agent. In addition, the Minister of Finance can order a performance audit.

CHRONOLOGY

MONETARY POLICY AND MONETARY CONDITIONS 2009 –10



2009

13 JULY

The Reserve Bank releases non-bank risk management guidelines.

30 JULY

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

JULY/AUGUST

The Reserve Bank marks its 75th anniversary, hosting a Museum exhibition, and a public lecture, *The Financial Crisis - who's to blame? Problems and remedies,* by Howard Davies, Director of the London School of Economics.

1 SEPTEMBER

Baroda (New Zealand) Limited is registered as a bank in New Zealand.

10 SEPTEMBER

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

14 OCTOBER

The Reserve Bank removes some temporary crisis liquidity measures.

16 OCTOBER

The Reserve Bank becomes a supervisor under the Anti-Money Laundering and Countering Financing of Terrorism Act.

22 OCTOBER

The Reserve Bank releases its prudential liquidity policy for banks.

29 OCTOBER

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

29 OCTOBER

The Insurance (Prudential Supervision) Bill is introduced in Parliament.

11 NOVEMBER

The Reserve Bank releases its November 2009 *Financial Stability Report.*

18 NOVEMBER

Legislation providing legal backing for settlement systems is passed.

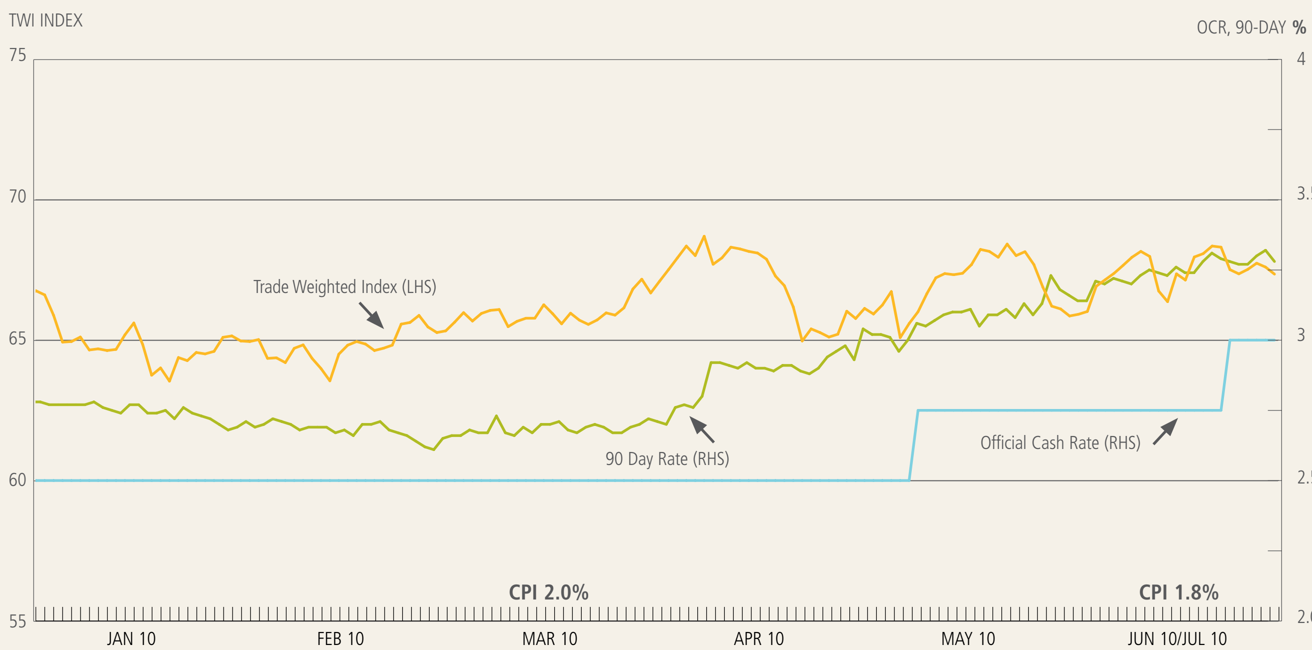
2 DECEMBER

The Reserve Bank and NZX Ltd initiate discussions on a joint approach to the provision of clearing and settlement services in New Zealand.

10 DECEMBER

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

MONETARY POLICY AND MONETARY CONDITIONS 2009–10



Graph 1

2010

19 JANUARY

Neil Quigley and Kerrin Vautier are appointed to the Reserve Bank Board.

28 JANUARY

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

2 FEBRUARY

The Reserve Bank releases a consultation paper on policy options for liquidity requirements for NBDTs.

1 MARCH

Credit ratings become mandatory for non-bank deposit takers (NBDTs).

11 MARCH

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

29 APRIL

The Reserve Bank leaves the OCR unchanged at 2.5 percent.

19 MAY

The Reserve Bank releases its May 2010 *Financial Stability Report.*

10 JUNE

The Reserve Bank raises the OCR to 2.75 percent.

25 JUNE

Regulations are gazetted requiring NBDTs to maintain a minimum capital ratio, and to limit the amount of credit they can provide to related parties.

30 JUNE

The Reserve Bank releases its *Statement of Intent 2010-2013.*

After balance date

20 JULY

Parliament ratifies a new five-year Funding Agreement for the Reserve Bank.

29 JULY

The Reserve Bank raises the OCR to 3.0 percent.

THE YEAR IN REVIEW

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 (PTA) requires that the Bank "keep future CPI inflation outcomes between 1 and 3 percent on average over the medium term". It also requires that: "In pursuing its price stability objective, the Bank shall...seek to avoid unnecessary instability in output, interest rates and the exchange rate."

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

OUTCOME

- Stability in the general level of prices.

INITIATIVES AND STRATEGIES

- Increase monitoring and assessment of global economic and financial markets developments.
- Increase monitoring of domestic credit conditions and their impact on the domestic economy.
- Monitor and evaluate international thinking about how monetary and financial stability policy should interact.
- Enhance the use of tools for evaluating uncertainty about the economic outlook and the impact of monetary policy.
- Regularly consult with government agencies on current economic conditions and government responses to these.
- Improve the quality, accessibility, relevance and reliability of Reserve Bank statistics, including by setting up the core framework for the FSIS, which will integrate Reserve Bank statistics.
- Research the ways in which flexible inflation targeting may be augmented to take account of the effects of housing and asset-price cycles, leverage and prudential and fiscal policy on activity and inflation.
- Ensure that best-practice modelling and analytical methods and an appropriately wide range of data are used in generating monetary policy advice, including using the newly developed forecasting model of the New Zealand economy as the basis for producing regular forecasts.
- Continue to deepen the Bank's understanding of the inflation process in New Zealand, including price, wage and expectations formation, the impact of commodity markets, and the impact of sectoral and national debt levels.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

KEY PERFORMANCE INDICATORS

- Reserve Bank forecasts of CPI inflation should be comfortably within the target range in the second half of our forecast horizon.
- Measures of underlying inflation should generally lie within the target range.
- Unnecessary instability in output, interest rates and the exchange rate should be avoided.
- The MPS provides a basis for assessment of the Bank's performance in pursuing its price stability target as defined in the PTA.

Economy

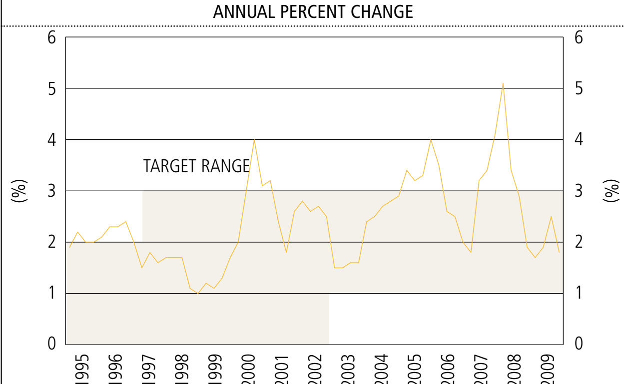
The New Zealand economy expanded an estimated 3.0 percent over the year. Growth can largely be attributed to the manufacturing and primary sectors, with households also starting to consume more. Businesses have grown in confidence, and are hiring workers once more to increase production.

However, spare capacity remains, as businesses laid off workers and reduced production during the recession. A weak construction sector has held construction cost inflation particularly low. High unemployment translated into low wage inflation pressure. This has seen CPI inflation remain at or below 2 percent for the past year.

Monetary policy remained focused on ensuring that medium-term inflation remains comfortably within the 1 to 3 percent target band. Over most of 2009-10, the Bank left the OCR unchanged at 2.5 percent, to provide stimulus to an ailing economy. Once the Bank was satisfied that the recovery was entrenched, it started to remove monetary policy stimulus, lifting the OCR by 25 basis points to 2.75 percent in June 2010.

INFLATION

ANNUAL PERCENT CHANGE



Graph 2

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

The *Monetary Policy Statement* is the full assessment and accountability document for our monetary policy key performance indicators. CPI inflation fell slightly from 1.9 percent for the year to June 2009 to 1.8 percent for the year to June 2010. Since inflation pressure had dissipated considerably, interest rates were held at a low level assisting efforts to achieve other key performance indicators, namely stability in output, financial stability and preventing inflation falling below 1 percent. With output starting to grow once more, carrying associated inflationary risks, it is appropriate to reduce monetary policy stimulus to contain medium-term inflation.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

Monetary policy advice remains our core objective. This includes providing advice on the withdrawal of monetary policy stimulus in light of current and prospective financial market conditions, and any changed economic behaviour on the part of households and firms as a result of the global financial crisis.

We have increased our forecasting capability by leveraging off the implementation of and improvements to KITT, the Bank's new primary forecasting model. We have refined our alternative models, enhancing our use of statistical modelling techniques and using more extensively the output from a variety of forecasting methods.

We continue to monitor and evaluate international thinking about how monetary policy and financial stability policy should interact, particularly the ways in which flexible inflation targeting may be augmented to take account of the effects of asset-price cycles, leverage and prudential and fiscal policy on economic activity and inflation.

During the past financial year the Bank has been very active in research forums. In December 2009, the Reserve Bank co-hosted, together with Northwestern University's Center for International Economics and Development, a conference marking the 20th anniversary of inflation targeting, and in April 2010 the Bank co-organised the Australasian Macro Workshop along with Victoria University of Wellington. Staff at the Bank's Economics department participated in both conferences, as well as in the New Zealand Econometric Study Group, the New Zealand Association of Economists Conference, and a number of conferences overseas. The Bank has continued to pursue research into both structural and statistical models of the macro-economy, and has undertaken research on housing, consumption, firm behaviour and the characterisation of interest rate yield curves. The Bank has also begun to develop a research agenda focused to a greater extent on financial stability and 'macro-prudential' policy tools.

A significant milestone in the path to improving the quality, accessibility, relevance and reliability of Reserve Bank statistics was achieved this year. The first stage of implementation of the FSIS was completed, and we expect to continually improve the scope and usability of this tool. The greater accessibility and use of data assists in providing high quality monetary policy advice.

Financial markets

DOMESTIC MARKETS
FOREIGN RESERVES MANAGEMENT

THE OBJECTIVES OF THE DOMESTIC MARKETS AND FOREIGN RESERVES MANAGEMENT FUNCTIONS ARE:

- To support the effective implementation of monetary policy.
- To assist in the efficient functioning of the New Zealand financial system.
- To manage official foreign reserves; and to provide effective support and execution for the Bank's foreign exchange market intervention policy.
- To manage the Crown's financial liquidity.
- To maintain an effective crisis intervention capability.

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

OUTCOMES

- Sufficient liquidity in the domestic banking system to meet its ongoing needs.
- Confidence in the efficient functioning of New Zealand financial markets.
- Short-term interest rates consistent with the Bank's monetary policy stance.
- Foreign reserves readily available to assist in foreign exchange intervention and crisis management where appropriate.
- Any foreign exchange market intervention conducted efficiently.

INITIATIVES AND STRATEGIES

- Assist in the formulation and implementation of bank liquidity policies and ensure that they are operational.
- Provide backup liquidity facilities that allow banks to effectively manage their own and corporates' funding needs in the face of ongoing strain in credit markets.

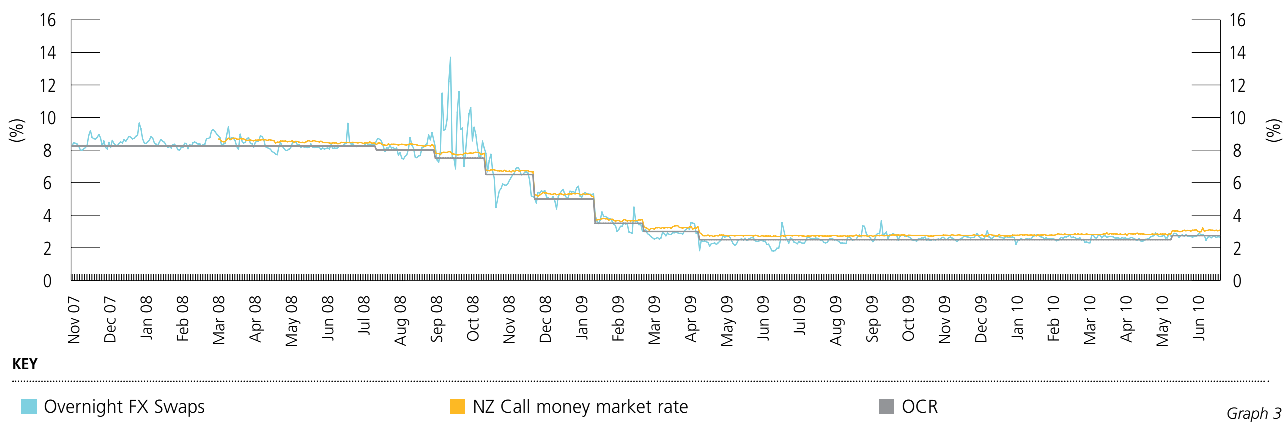
AND OUR PERFORMANCE WOULD BE MEASURED BY:

KEY PERFORMANCE INDICATORS

- Short-term wholesale interest rates should be relatively stable and maintained at levels consistent with the OCR.
- No evidence of payment failures due to shortage of cash in the banking system.
- Domestic market operations are expected over the medium term to generate a positive return for the domestic markets function, as an indicator that operations are running effectively.
- Foreign reserves held at the level agreed with the Minister.
- Foreign reserves held in a liquid and secure form, suitable for foreign exchange market intervention.
- The net return from foreign reserves management meets or exceeds the agreed benchmark.

The Reserve Bank operates regularly in the financial markets to implement monetary policy, to manage the New Zealand government's foreign reserves and to ensure an adequate level of liquidity in the banking system.

THE COST OF OVERNIGHT FUNDING VIA FX SWAPS AND OVERNIGHT CASH COMPARED TO THE OFFICIAL CASH RATE



Graph 3

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

Domestic markets

Despite ongoing turbulence in international financial markets, domestic money market conditions in 2009-10 were sufficiently stable for the Bank to begin withdrawing a number of the exceptional liquidity facilities that were required during the midst of the global financial crisis.

The Bank has provided the banking system with a relatively stable level of settlement cash with aggregate banking system cash balances averaging around NZD 7.5 billion over the year. This has meant that cash market conditions have been fairly stable and the market cash rate has generally been close to the OCR, and the payments system has operated smoothly.

Financial market participants generally had less need for the Bank's liquidity facilities over the year as funding markets in New Zealand and offshore returned towards more normal conditions. The Bank gradually removed some of the exceptional facilities introduced to deal with the abnormal market conditions of the global financial crisis. Specific initiatives were:

- The removal of the weekly Term Auction Facility (TAF) in October 2009. The TAF was designed to provide market participants with financing for maturities up until a year, at a time when banks were unable to find such funding from the markets. Demand for the TAF dropped off through 2009, enabling the Bank to withdraw formally from providing term funding to banks.

  The Bank retained its weekly 'Tuesday OMO' which provides funding for up to a three-month maturity against all RBNZ-eligible collateral, as a backstop in the event of a sudden resurgence in funding pressures. Actual demand for the 'Tuesday OMO' has been very light, reflecting the generally more settled nature of the markets.

- The removal of the Bank's 'Term ORRF' (TORRF) in October 2009. The TORRF was an extension of the Bank's Overnight Reverse Repo Facility (ORRF), which allows banks to borrow funds at short notice on a secured overnight basis using eligible collateral. The TORRF allowed banks to borrow a potentially unlimited amount of funds for terms up to 30 days at the standard ORRF rate (50 points over the OCR). The TORRF had never been triggered at any time since its introduction.

The Bank also moved to reduce commercial bank 'tiers' in February 2010. The Bank operates a system where banks receive the OCR on balances up to a specific amount (known as that bank's 'tier'), with balances in excess of a bank's tier remunerated at 100 points below OCR. The passing of the global financial crisis had meant that banks generally had a reduced demand for settlement cash. This partly reflected reduced precautionary demand for cash as market conditions settled and also a reduction in the amount of payments banks have routinely needed to process since prior to the global financial crisis.

These initiatives have seen the size of the Bank's balance sheet decline. The removal of the TAF, combined with the gradual maturity of historic TAF loans (the last of these matured in April 2010), resulted in a decline in the assets of the Bank and a reduction in the amount of Reserve Bank bills on issue (as some TAF loans had been financed by the issue of Reserve Bank bills).

The Bank has returned to predominantly using the FX swap market to provide liquidity to the banking system. New Zealand banks typically fund a significant portion of their balance sheet in offshore markets (as these are deeper and more liquid than our own). The global financial crisis disrupted the offshore financing activities of the New Zealand banks, meaning that for a while the Bank tended to provide banks with liquidity using local collateral, instead of the foreign exchange to which banks normally had ready access. Hence, our TAF loans have been replaced with FX swaps over the course of the year, changing the composition of the assets on the Bank's balance sheet.

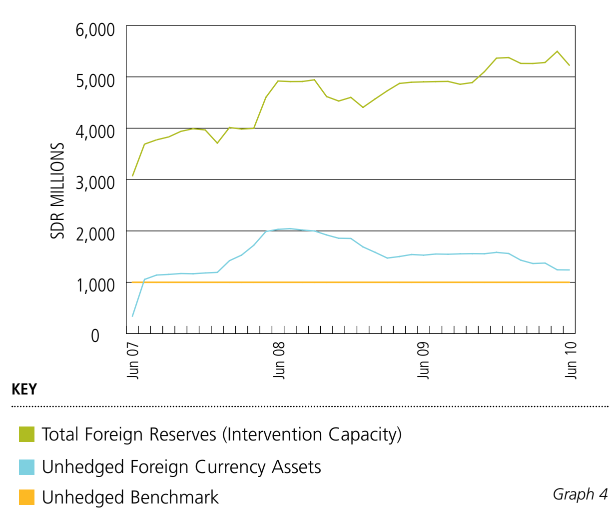
The Bank's reduced balance sheet and the removal of some crisis facilities has meant a reduced level of risk to the Bank and a lower capital requirement. The Bank reviewed its capital needs this year and concluded that a voluntary special dividend payment to the Crown of NZD 45 million was appropriate - reflecting realised earnings from previous years that had been retained as a capital buffer during the global crisis.

Foreign reserves management

The Bank's foreign currency operations have also tended to revert towards more normal levels as offshore market conditions improved over 2009-10.

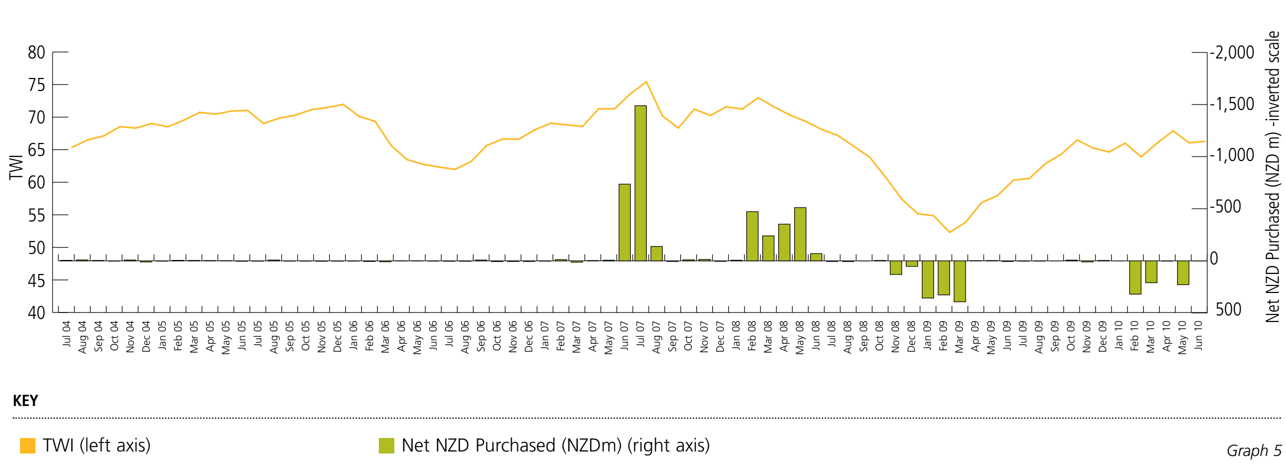
- The asset composition of our foreign currency asset portfolio has remained stable and is still dominated by liquid holdings of government securities and the short-term debt of AAA-rated near-government and supranational entities.
- The overall level of foreign reserves has remained broadly unchanged. (Graph 4).
- However, we changed the balance between hedged and un-hedged reserves over the year, moving to a greater proportion of hedged reserves.

RBNZ FOREIGN RESERVES (SDRs)



Graph 4

TWI VS RBNZ NZD TRANSACTIONS



Graph 5

- Consistent with this shift, we bought New Zealand dollars and sold un-hedged foreign reserves, thus reducing our open FX position back towards our medium-term benchmark level of SDR 1000 million (approx NZD 2200 million). (Graphs 4 and 5).
- This reflected our judgment that FX markets had improved and that the worst of the global financial crisis was likely behind us.

The Bank's foreign reserves function recorded a financial loss over the year, reflecting a couple of key factors:

- Revaluation losses on the Bank's stock of long-term foreign currency-denominated loans that finance its hedged foreign reserves. During the global financial crisis, long-term foreign currency financing became much more difficult to obtain. This meant that entities like the Bank that had prepositioned for market disruption by previously borrowing long-term FX received windfall gains as new borrowing costs rose in the more difficult financing conditions during the crisis. In 2009-10, funding conditions improved as borrowing costs fell, resulting in previous windfall gains being reversed and revaluation losses being recorded on the Bank's long-term FX loans in the current financial year.
- Revaluation losses on the Bank's stock of un-hedged reserves as the NZD exchange rate recovered from its crisis-induced depressed levels. The higher NZD exchange rate this year partially reversed some of the gains on un-hedged reserves that had resulted as the exchange rate depreciated in late 2008-early 2009.These more recent revaluation losses reflect the inherent volatility that the Bank faces on its un-hedged reserves.

In aggregate, the magnitude of the revaluation losses on foreign reserves this year is within the range of what might be expected, given the structure of the Bank's balance sheet. The Bank is adequately capitalised to manage this variability. While the Bank has recorded a loss this year relative to its internal benchmark for foreign reserves, in aggregate the Bank remains well ahead of its benchmark over the last few years.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

The Financial Markets department continued to work with the Prudential Supervision department to implement the Bank's Prudential Liquidity Policy over the year (see page 28). The Bank has continued to offer sufficient liquidity to the banking system over the year, notwithstanding the gradual removal of some exceptional measures as market conditions became more stable.

Financial system surveillance and policy

THE OBJECTIVES OF THE FINANCIAL SYSTEM SURVEILLANCE AND POLICY FUNCTION ARE:

- To register and supervise banks so as to maintain a sound and efficient financial system, and to limit damage to the financial system that could result from a bank failure.
- To regulate non-bank deposit takers, and, assuming legislation is passed, to regulate and supervise the insurance sector. This will be done in a manner that delivers a cost-effective balance between regulatory requirements and self- and market-discipline.

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

OUTCOMES

- A sound and efficient financial system in New Zealand.
- International and local confidence in New Zealand's financial system.

INITIATIVES AND STRATEGIES

- Enhance the Bank's monitoring of risks to bank balance sheets and profitability.
- Develop, with the Treasury as required, the high-level features of durable bank and NBDT regulatory arrangements for the post-deposit guarantee environment.
- Implement new regulatory arrangements for the NBDT sector.
- Preserve and enhance the features of Basel II implementation: through-the-cycle and conservative calibration.
- Refine our crisis preparedness, focusing on practical solutions and developing trans-Tasman arrangements.
- Develop and implement the supervisory framework for the insurance sector.
- Monitor and evaluate international thinking about how monetary and financial stability policy should interact.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

KEY PERFORMANCE INDICATORS

- Banks comply with Conditions of Registration and maintain the required minimum capital ratios and liquidity requirements.
- NBDT regulations in place and NBDTs comply with the regulatory regime in line with transition requirements.
- The Treasury is notified promptly of any issues with any entities in the Deposit Guarantee Scheme.
- The Bank has in place the people, procedures and systems to implement new prudential supervision law for the insurance sector when it comes into force.
- The Bank has publicised the core features of the regulatory arrangements for banks and NBDTs on the expiry of the Deposit Guarantee Scheme.
- Measures included in the FSR provide a basis for assessment of the New Zealand financial system's stability and the performance of the surveillance function.

Financial system environment

The New Zealand financial system has continued to face turbulence from global financial markets. Market conditions improved steadily during 2009 as the global economic recovery gained momentum, especially in Asia. With credit spreads narrowing, New Zealand banks were able to issue significant amounts of longer-term debt in offshore funding markets. However, concerns about the sustainability of sovereign debt positions in a number of European countries saw market conditions in 2010 become more challenging, with a return of risk aversion.

The New Zealand economy began to recover in mid-2009, reflecting robust demand from Asia, which increasingly underpinned export prices and fuelled growth in Australia. Bank credit growth has remained subdued with tighter lending standards and efforts on the part of households and businesses to actively reduce debt. Although the banks' non-performing loans continued to increase due to the lagged effects of the recession, they appear to be close to peaking. The banks' funding positions have improved significantly with a greater proportion of funds raised from either retail or longer-term wholesale sources. Banks have continued to face demands for higher capital buffers from markets and rating agencies.

Parts of the NBDT sector continue to face challenges with the exit of many finance companies reducing credit for some activities such as property development. The expiry of the original term of the Crown's Retail Deposit Guarantee Scheme, as well as the ongoing introduction of a more stringent regulatory regime, has resulted in further consolidation in the sector.

Globally, the insurance sector has also faced a challenging environment this year, but New Zealand insurers have remained profitable.

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

Our regular *Financial Stability Reports*, which are a formal requirement under the Act, provide an assessment of the soundness and efficiency of the financial system and report on the exercise of our prudential powers. We have enhanced this document with the introduction of the cobweb diagram in 2009, a pictorial device that summarises changes in the main factors influencing the stability of the New Zealand financial system.

Financial Stability Reports over the past year have reflected our careful monitoring of banks and NBDTs, with particular emphasis on asset quality, capital, lending activity, and conditions in wholesale and retail funding markets. We have discussed important regulatory changes such as the new bank prudential liquidity policy and the ongoing implementation of the NBDT prudential regime. We have also covered the global financial reform efforts, drawing out the implications for New Zealand.

Throughout 2009-10, registered banks maintained, and usually significantly exceeded, the required minimum capital ratios and liquidity requirements that were set out in conditions of registration. Corrective action is underway to address a bank's breach of conditions of registration. There were a small number of regulatory matters that required some discussions between the Reserve Bank and the banks concerned, but these were resolved satisfactorily.

The Bank issued risk management guidelines for NBDTs in July 2009. These were followed by regulations imposing a credit rating requirement, which came into force on 1 March 2010. Regulations on capital and related-party exposures will come into force on 1 December 2010. We now require regular reporting from trustees for compliance with these requirements.

The sector has had a reasonable time to prepare for the new requirements and to deal with any transitional issues. Regulations are in place granting exemptions from credit ratings for entities with liabilities under $20 million, conduit funding entities, entities in moratorium or receivership, and entities that do not have trust deeds.

Building our own capacity to implement the insurance legislation commenced in late 2009. An insurance supervision team with the requisite skills to oversee licensing and ongoing supervision has been established.

We have continued to receive reports from entities that are covered by the current Deposit Guarantee Scheme. We are in frequent contact with the Treasury and advise them of any issues arising with any entities in the Scheme. The core features of the regime have been publicised on the Reserve Bank website, and the Scheme has been discussed in the *Financial Stability Reports.* The transition to the new extended Scheme will not have an impact on the regulatory arrangements for registered banks and NBDTs.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The Bank has been assessing the connections between monetary policy and financial stability in light of international research in this area. A key issue is whether prudential tools could play a role in supporting macro-economic stabilisation by dampening cycles in credit and asset prices. Our work to date has focused largely on the role that the new core funding liquidity requirement for banks may play in helping to dampen credit growth during an economic upswing. We have also examined the feasibility of additional macro-prudential tools such as the counter-cyclical capital buffer which is under active consideration in the major economies.

We have been taking an active interest in the international debate on bank capital and liquidity, and have submitted our views on the proposals of the Basel Committee on Banking Supervision to strengthen the resilience of the banking sector.

The increased risks in the global financial system provided impetus for intensifying our banking oversight during 2009-10. This was done by:

- escalating the level of engagement between the Reserve Bank and registered banks;
- increasing the range and frequency of the information collected from banks;
- strengthening our internal analysis and evaluation of the information received; and
- monitoring compliance with the newly introduced minimum liquidity requirements.

Further work has been undertaken to improve the large banks' modeling of credit risk for farm and housing lending. During the year, the Bank began its final calibration of amended farm lending capital requirements. Discussions were held with banks on how to improve their models of housing credit risk, and we recalibrated the amount of additional capital banks are required to hold in recognition that model improvements are required.

In the NBDT sector, new regulatory arrangements continue to be progressively introduced. Risk management guidelines, credit rating, capital, and related party regulations have been introduced, and a new liquidity policy has been agreed by Cabinet. These developments are a significant step in the implementation of the prudential regime for the NBDT sector.

The development of processes for handling the licensing of insurers is also well advanced, and frameworks are being established for the ongoing supervision of insurers once they are licensed.

The Retail Deposit Guarantee Scheme is to expire in October 2010, and the Bank has been working jointly with the Treasury on potential regulatory arrangements following the expiry, and on the development and design of the Extended Retail Deposit Guarantee Scheme.

Through the Trans-Tasman Banking Council, Australian and New Zealand agencies discussed effective coordination in the event of a banking crisis. All participants stressed the importance of close cooperation at each stage of crisis resolution, especially in respect of information sharing, early warning alerts, assessment of options, and public communications.

BOX 1

Basel III - The Reserve Bank's response to the Basel consultations[10]

The Reserve Bank has submitted comments to the Basel Committee, focusing primarily on areas where it considers that its own experience can provide valuable insight to the development of any new prudential requirements.

On capital reforms, the Reserve Bank indicated that it supported the enhanced focus on common equity and retained earnings as the predominant form of Tier 1 capital. However, the Reserve Bank does not support the introduction of the proposed leverage ratio, as it believes:

- The one-size-fits-all approach results in a poorly targeted methodology and would not be an appropriate measure for small, low-risk banks.
- The leverage ratio would undermine the value of existing risk-based measures.
- Recent experience in the New Zealand finance company sector suggests that the proposed measure could give a misleading picture of risk in some situations.

The submission also provided a number of technical observations on elements of the Basel II framework that can lead to procyclical outcomes.

With respect to the proposed liquidity framework, the Reserve Bank indicated that it supported the two proposed common standards for liquidity risk and noted that they were broadly aligned with the standards recently introduced in New Zealand.

The Reserve Bank provided the following specific comments based on its own experience:

- The proposed definition of liquid assets may be too narrow for many smaller economies, due to insufficient local currency government debt and a lack of other local currency securities meeting the stringent criteria to be deemed highly liquid.
- In such cases, the eligibility of securities in domestic central bank operations needs to be given greater recognition as a contributor to their liquidity.
- More national discretion may therefore be required in the criteria for liquid assets as well as for certain other inputs such as run-off rates, so that they reflect country-specific factors.

The Reserve Bank has published its full responses on its website.[11] Final proposals are not expected from Basel until the end of 2010, with the aim of implementation by the end of 2012.

Currency operations

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 bank notes and coins.

IN OUR 2009-12 *STATEMENT OF INTENT,* WE UNDERTOOK TO DELIVER THE FOLLOWING:

OUTCOME

- Legal tender that meets the currency needs of the public.

INITIATIVES AND STRATEGIES

- Develop and implement a new information system for the management of currency operations.
- Investigate possible enhanced security features for bank notes.
- Develop and implement a plan to improve the quality of $5 notes in circulation.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

KEY PERFORMANCE INDICATORS

- 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 biennial 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.

The Bank meets the currency needs of the public by arranging the procurement, secure storage and issue of New Zealand bank notes and coins, as well as maintaining the quality and verifying the authenticity of currency in circulation.

10 This was first published in the *Financial Stability Report*, May 2010.

11 http://www.rbnz.govt.nz/finstab/banking/

HOW WE PERFORMED – KEY PERFORMANCE INDICATORS

The value of currency in circulation grew by 0.4 percent to $3.9 billion in the year to 30 June 2010. This followed unusually high growth of 13.8 percent in the previous year, caused by the global financial crisis.

The numbers of $50 bank notes in circulation increased by 1.6 million forms or by 9.1 percent in 2009-10, while the number of $20 notes fell by 4.0 million forms or by 6.7 percent These changes were caused by the increasing use of $50 notes in ATM machines.

During 2009-10 the Reserve Bank received 334 orders for currency for a total value of $1,819 million. The Bank met all these orders on schedule and in the denominations requested. This helped ensure that the public's needs for currency were met during the year.

In late 2009, the Bank undertook a 'Five Dollar Swap Programme' with two Cash-in-Transit (cash delivery) companies. The Bank issued almost 3 million new $5 notes to the two companies. Over a period of three months the two companies swapped these notes for $5 notes received from retailers and other customers. The used notes were returned to the Bank. About half were found to be unfit and were destroyed. This programme significantly reduced the number of poor quality $5 notes in circulation.

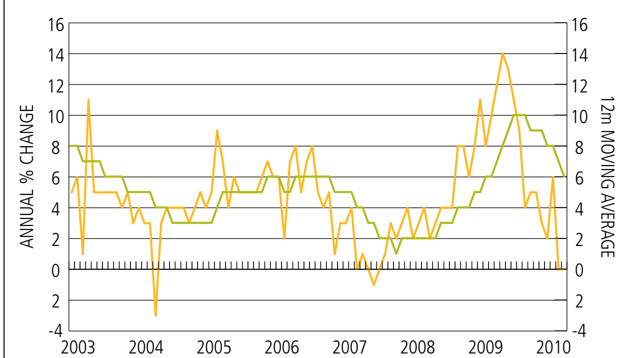
The number of counterfeit bank notes in New Zealand is very low by international standards. In 2009-10, there were about 250 counterfeits found in circulation by the Reserve Bank, security companies, banks and the Police. This represented 1.82 counterfeits per million notes in circulation. While this was an increase over the rate of 0.82 recorded in 2008-09, it was still well below the maximum of 10 specified in the key performance indicator.

HOW WE PERFORMED – INITIATIVES AND STRATEGIES

The new Currency information system is due to 'go live' in early August. The new system will automate data entry, improve the tracking of currency through note processing operations and upgrade reporting capabilities.

The Bank is undertaking a review of current and potential security features on New Zealand bank notes. It is also investigating the public's knowledge and use of these features. This is part of the Bank's ongoing strategy to keep well informed about developments in bank note technology in light of possible counterfeiting risks.

CURRENCY IN CIRCULATION



KEY

Annual percentage change (left axis)
12m moving average (right axis)

Graph 6

Depository and settlement services

THE OBJECTIVE OF THE DEPOSITORY AND SETTLEMENT SERVICES FUNCTION IS:

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

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

OUTCOME

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

INITIATIVES AND STRATEGIES

- Continue to enhance NZClear and ESAS as agreed with industry representatives.
- Establish interfaces that will facilitate inter-operability between ESAS/NZClear and other providers' payment and settlement systems, to increase efficiency and meet user needs.
- Improve business continuity planning and disaster recovery capability by arranging for Auckland office business support for payment systems.

AND OUR PERFORMANCE WOULD BE MEASURED BY:

KEY PERFORMANCE INDICATORS

- Availability of ESAS/NZClear during core hours is at least 99.95 percent.
- Customer satisfaction with operations and with system development is demonstrated through an annual customer survey.
- All risks are well managed.
- International standards for payment and settlement systems (CPSS and IOSCO) are complied with.

Settlement activity

The Bank provides specialised financial services, mainly to financial institutions. These services comprise operation of the Exchange Settlement Account System (ESAS) and operation of the NZClear securities settlement system. NZClear was formerly known as the Austraclear New Zealand system.

Most major financial institutions have a New Zealand dollar cash account with the Reserve Bank. These are known as exchange settlement accounts, and those financial institutions use those accounts, which comprise the ESAS system, to make payments to each other in real time. ESAS is a designated payment system under the Reserve Bank Act. This means that once a payment has been processed in ESAS it cannot be reversed. This provides certainty to the recipients of those payments, which is very important given that in excess of $25 billion is paid through this system each day.

One of the accountholders in ESAS is Continuous Linked Settlement Bank or 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 settlement 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 one currency but the other party fails to meet its obligation to pay the other currency.

The NZClear service allows buyers and sellers of securities to settle transactions efficiently and securely. The system provides for buyers of New Zealand dollar-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, and once those payments are made, they cannot be reversed. The Bank administers securities on behalf of members of the NZClear system, with a value totalling more than $130 billion, and each day payments with a value totalling more than $6 billion are made by members of NZClear.

ESAS and NZClear, together with CLS, provide certainty to financial institutions in processing their high-value transactions, which is particularly important during periods of financial instability.

Key developments

In December 2009, the Capital Markets Development Taskforce recommended that the Bank and NZX Limited work together, with the objective of developing a single clearing and settlement system for New Zealand capital markets, including a central counter-party settlement system. Following an extensive review, it was agreed, in a memorandum of understanding, that NZX Limited would provide a new central counter-party settlement service; that the Bank would continue to provide real-time gross settlement services by operating NZClear; and that the two systems would be interoperable.

In 2009, amendments were made to the Reserve Bank Act that allow settlement systems to apply for designation. The designation regime is administered jointly by the Securities Commission and the Prudential Supervision department of the Reserve Bank. Arrangements are in place to ensure that the Prudential Supervision department and the Bank's Financial Services Group, which provides the NZClear service, carry out their responsibilities independently of each other. NZClear has applied to be a designated settlement system and at the time of writing the application process is well advanced.

Significant systems development work has been undertaken during the last year. In November 2009, a new computer function was launched, which replaced over 40 separate functions and screens, greatly improving the usability of NZClear.

Two important interfaces were developed and are scheduled to go live in July 2010. A direct interface between NZClear and major securities registries has been developed to allow for the electronic transfer of securities between different registered owners. This will improve efficiency by reducing manual intervention and operational risk. Also, an interface with the new NZX central counterparty settlement system has been developed. This will allow institutions that are members of both systems to efficiently move securities between them.

The Bank is also working with the banking industry to build a new system to effect the settlement of retail transactions. 'Settlement Before Interchange' involves an enhancement to ESAS that will allow institutions to update their records for their customers' transactions and to settle the value of those transactions at regular intervals each day. Currently, this recordkeeping and payment occurs only once at the end of each banking day. This project is scheduled to go live in 2011-12.

A further major initiative will be the establishment of a small office in Auckland. While the Bank's key systems are already mirrored in Wellington and Auckland, an Auckland business office is required to mitigate the risk associated with all our specialist staff being located in Wellington in the event of a major physical disruption in Wellington.

Operational performance

The following table sets out key statistics for the operation of ESAS and NZClear.

The average value of transactions passing through ESAS each day has reduced markedly following the global financial crisis. Transaction volumes passing through NZClear continued to fall. These reductions are consistent with trends experienced by overseas settlement systems and financial markets more generally.

System availability has continued to improve, and at 99.93 percent was narrowly under the target of 99.95 percent availability. No major system disruptions occurred during the year.

In the annual customer survey, users of ESAS and NZClear have continued to report very high levels of satisfaction. In 2010, the satisfaction rating was 97 percent, fractionally less than in 2009 (98 percent).

On behalf of the Auditor-General, John Meehan, using the staff and resources of PricewaterhouseCoopers, undertakes external audits of the NZClear system each quarter and ESAS each year, and audit reports are reviewed by the Bank's Audit Committee. All audit opinions were unqualified. Improvements designed to enhance the management of risk associated with operating these systems are made continuously.

KEY ESAS STATISTICS

	2006	2007	2008	2009	**2010**
Average daily transaction volumes	5,472	6,081	7,024	7,156	**6,929**
Average daily transaction values	$36.6bn	$36.3bn	$38.9bn	$36.8bn	**$28.6bn**

TABLE 2

KEY NZCLEAR STATISTICS

	2006	2007	2008	2009	**2010**
Average daily transaction volumes	1,123	1,097	1,119	973	**899**
Average daily transaction values	$9.6bn	$6.6bn	$6.3bn	$6.8 bn	**$7.0 bn**

TABLE 3

KEY ESAS-NZCLEAR STATISTICS

	2006	2007	2008	2009	**2010**
ESAS-NZClear system availability during core hours	99.94%	99.92%	99.23%	99.77%	**99.93%**

TABLE 4

Human resources

THE OBJECTIVE OF HUMAN RESOURCES IS:

- To provide strategic human resource advice and support services.

IN OUR 2009-12 *STATEMENT OF INTENT,* WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- Engage and develop staff to meet the challenges of a volatile financial and economic environment.
- Support management in further developing their values-based leadership competencies.
- Continue an annual review of key-person risk within the Bank and mitigation strategies.
- Enrich the Bank's staff appraisal and personal development programme.
- Facilitate excellent management processes and decision making throughout the Bank; provide a supportive environment for staff to perform at their best; and continue to develop the skills and knowledge required.
- Ensure the Bank values of integrity, innovation and inclusion are central to all staff initiatives.
- The biennial staff satisfaction surveys will be completed in 2009 and 2011.
- Ensure staff are adequately informed to cope with an influenza pandemic, and that there is sufficient backup to ensure Bank operations are maintained.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

We recognise that the performance of the Bank in times of change is dependent on our employees doing their best work. Our hiring, development and retention strategies all strive to retain and develop the best people so that the Bank realises its greatest potential every day. Whether through team work or individual contributions, we encourage a working environment where all staff can develop their skills and knowledge, and contribute fully.

The continual development and growth of leaders remains a high priority for the Bank. During the year, managers attended both individually targeted and Bank-centralised developmental training, while emerging leaders participated in programmes aimed at preparing them for management roles.

All staff were invited to attend a 'Personal Leadership - Values in Action' programme which was a follow-on from work done with managers the previous year based around the Bank Values (see inside front cover).

Practices were adopted during the year to contain a potential outbreak of the influenza strain A/H1N1 ('swine 'flu').

The existing performance review systems were evaluated and an improved online version is planned to be introduced in the coming year.

The staff satisfaction survey carried out in December 2009 found the level of staff satisfaction to be 63 percent, ahead of the public sector benchmark in 2009 and the Bank's result in 2005, which were both 60 percent.

HUMAN RESOURCE STATISTICS

	2005	2006	2007	2008	2009	**2010**
Total staff at 30 June (FTE)	218	223	221	223	237	**243**
Average years of service at 30 June	8.0	7.4	7.4	7.6	7.6	**7.9**
Annual staff turnover	9.0%	9.3%	12.3%	17.4%	9.3%	**12.5%**

TABLE 5

Remuneration

STAFF

The Reserve Bank spent $26 million on personnel in 2009-10. This included all forms of remuneration, direct expenditure on training, and redundancy payments. Table 6 shows the number of staff who received over $100,000 in total remuneration[12], in bands of $10,000.

REMUNERATION IN 2009-10

TOTAL REMUNERATION	STAFF NUMBERS 2010
$100,000 to $109,999	17
$110,000 to $119,999	14
$120,000 to $129,999	4
$130,000 to $139,999	9
$140,000 to $149,999	9
$150,000 to $159,999	12
$160,000 to $169,999	4
$170,000 to $179,999	3
$180,000 to $189,999	1
$190,000 to $199,999	4
$200,000 to $209,999	2
$210,000 to $219,999	1
$230,000 to $239,999	1
$240,000 to $249,999	1
$260,000 to $269,999	1
$270,000 to $279,999	2
$280,000 to $289,999	1
$310,000 to $319,999	1
$340,000 to $349,999	1
$400,000 to $409,999	1
$580,000 to $589,999	1
Total staff receiving $100,000 or more	**90**

TABLE 6

Non-executive directors' remuneration

Non-executive directors' remuneration consists of directors' fees in consideration for services provided to the Bank as directors. Non-executive directors receive additional remuneration due to their involvement in Board committees or as specialist advisers. 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.

NON-EXECUTIVE DIRECTORS REMUNERATION

NON-EXECUTIVE DIRECTORS	2009 $	**2010 $**
A Grimes (Chairman)	57,000	**55,500**
A Paterson	37,875	**19,814**
P Baines	27,500	**0**
C Eichbaum	23,352	**25,500**
H Fletcher (Deputy Chair)	27,500	**34,179**
J Goulter	27,500	**16,729**
S Sheldon	4,940	**27,500**
K Taylor	0	**27,500**
K Vautier	0	**10,721**
N Quigley	0	**12,054**
M Waring	15,158	**0**

TABLE 7

Insurance and indemnity arrangement

Section 179 of the Reserve Bank Act provides that every officer, employee or 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 or director of the Bank and certain other persons for any liability arising as a result of 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, and for other staff it provides insurance that extends the cover available from the Accident Compensation Corporation for work-related accidents.

12 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 or redundancy payments. The information in table 6 sets out the amount unconditionally earned during the financial year. The remuneration of the Governor is set by the Minister of Finance on the recommendation of the Board's non-executive directors, who also determine the remuneration of the Deputy Governor. 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.

Knowledge services

THE OBJECTIVE OF KNOWLEDGE SERVICES IS:

- To provide knowledge management and information technology services, direction and support.

IN OUR 2009-12 *STATEMENT OF INTENT,* WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- FSIS implementation: The core system will be built by July 2009. The second phase will ensure key business benefits are realised by completing the migration of remaining surveys, and developing new surveys for NBDTs and the insurance sector and for other external data.
- Develop systems to make our management of the information technology environment more efficient.
- Review and where appropriate upgrade older internally supported computer applications.
- Extend the Bank's knowledge management strategy by automating frequently used processes; implementing tools that allow easy sharing of information and documents across teams; and continuing digital capture of archive records and physical documents.
- Make the Bank's information, records and data management more flexible and user-friendly.
- Continue to enhance the Bank's web services.
- Continue to enhance the Bank's business continuity infrastructure, by establishing of an Auckland business support centre for critical functions and other backup computing arrangements.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

The main role of the Knowledge Services Group (KSG) is to provide core technology and information services that are secure and highly reliable. As the events of the global financial crisis intensified in 2009, KSG met increased demands on services, particularly access to market information.

During this period further work was completed to realise the value of our infrastructure and information management investments. The FSIS, developed in 2009, is now being utilised by analysts to store and analyse the Bank's time series data. A large programme of work continues in order to further develop FSIS as the core repository of data across the Bank. KSG also undertook a number of projects across the Bank. The Currency Processing System was redeveloped, work commenced on an IT security review of key financial systems, and our disaster recovery data centre was moved to new premises. We implemented a new change management system for the group and completed a major upgrade to the Bank's document management and web publishing systems. In addition, planning was completed to refresh our wide area network and backup systems. Work also continued on enhancements to our intranet and the Reserve Bank website.

BOX 2

75th Anniversary

August 2009 marked the 75th year of operation for the Reserve Bank of New Zealand. Over the years, the Bank's role has evolved to meet the needs of the times.

When founded, the Bank was partly privately owned and the main policy role was exchange rate stability. In 1935, however, a newly elected Labour government changed the basis of operations, nationalised the bank, and gave it authority to underwrite loans.

A succession of amendment acts revised and expanded the functions of the Bank over the next few years, without affecting the broader role. However, a significant revision occurred in 1964, widening the Bank's role to include government stock registry, banker to the government, operating foreign reserve controls, administering foreign exchange, conducting prudential management of the banks, and conducting monetary policy to meet a variety of targets. This included general price stability, but the Bank was also required to use monetary policy to promote growth, employment and other economic goals.

A substantial amendment in 1989 gave the Bank operational independence in monetary policy, which was to be focused on achieving and maintaining price stability. Subsequently, the Bank has become prudential regulator of NBDTs and insurance companies, and a supervisor of anti-money laundering measures by banks.

To mark the anniversary, the Bank hosted a public lecture in July 2009 by Howard Davies, Director of the London School of Economics, and formerly Chairman of the UK Financial Services Authority and Deputy Governor of the Bank of England. The webcast of his address, "The Financial Crisis - who's to blame? Problems and remedies", is available on the Bank's website (www.rbnz.govt.nz).

A temporary exhibition marking 75 years of Reserve Bank operations was also opened to the public in the Reserve Bank Museum located at the Bank's building, 2 The Terrace, Wellington.

Internal financial services

THE OBJECTIVE OF INTERNAL FINANCIAL SERVICES IS:

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

IN OUR 2009-12 *STATEMENT OF INTENT,* WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- Continue to enhance workflows, reports, and processes for financial operations and securities transactions.
- Replace the Bank's financial management information system before 2011.
- Preparation of the Bank's Five-Year Strategic Plan and Funding Agreement for the period 2010-11 to 2014-15.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

The Bank's Financial Services Group (FSG) is responsible for providing transaction processing capability for the Bank's foreign reserves and liquidity management operations. The group also provides management and financial reporting, and internal accounting services.

During 2009-10, FSG helped prepare the Bank's submission for a Funding Agreement to govern the Bank's operating expenditure for the five- year period through to 30 June 2015. A new Funding Agreement was signed by the Minister of Finance and the Governor in early June 2010, and ratified by Parliament on 20 July 2010.

The Bank's core treasury system continued to be enhanced, and from August 2010 this will be used to manage processing of the Bank's currency.

A project has begun to replace the 15-year-old financial management information system. Pilot testing of a new system has been performed and negotiations for the purchase are underway. The new system will be operational in 2011.

Communications

THE OBJECTIVE OF COMMUNICATIONS IS:

- To provide strategic advice and management for the Bank's external and internal communications and for the maintenance of its reputation and credibility.

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- Ensure the Bank's key messages are delivered and understood.
- Communicate the Bank's expanded role in the new regulatory regimes for non-bank financial institutions.
- Provide the Bank with timely information, and with strategies to address credibility risks and opportunities.
- Provide communications services for crises, including simulation exercises and the proposed Auckland business support centre.
- Enhance financial literacy, by promoting the Bank's role as prudential regulator and support for inter-agency financial literacy programmes.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

To be most effective, the Bank's messages and actions across its policy functions require broad public understanding. This has been particularly so in the Bank's responses to the global financial crisis, the economic recovery, the consideration of new macroprudential policy tools, and its expanding prudential supervision powers.

The Communications team supports the Bank's functions with communication and relationship strategies and publication management for key audiences. In addition, two members of the team also provide secretariat services to the Board.

The Bank delivered five speeches on the record and 43 news releases (four and 52 respectively in 2008-09). Many more speeches are delivered off the record so that we can explain our activities to general audiences while ensuring markets are not confused by repeated messages. We also published one brochure (one in 2008-09) and seven factsheets (eight in 2008-09) to provide wider understanding of the Bank's functions and activities.

We continued to support education initiatives, including the Bank's annual 'Monetary Policy Challenge' for senior secondary school students. Teams compete to assess economic conditions and deliver their own 'Official Cash Rate decision'. The competition was won by King's College (Auckland), ahead of St Kentigerns (Auckland) and Scots College (Wellington). Details of the competition are available at: http://www.rbnz.govt.nz/challenge.

This year we began development of an innovative teaching tool, a board game, to support our expanded regulatory role for NBDTs. This will be launched in 2010-11. This work was undertaken with assistance from Young Enterprise Trust with whom we continue to work to establish financial literacy unit standards.

Risk assessment and assurance

THE OBJECTIVE OF RISK ASSESSMENT AND ASSURANCE IS:

- To assist in the maintenance of effective and efficient risk management; to audit operations and internal control systems; and to provide legal advice.

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- Monitor the Bank's approach to risk management, utilising the enterprise-wide risk map.
- Continue a comprehensive internal audit programme to provide assurance on the Bank's control environment.
- Continue to provide quality legal advice.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

The Risk Assessment and Assurance unit continued to provide risk-related advice to managers and governors on the various issues that arose in the operation of the Bank during the year.

The year's internal audit programme was completed as planned and all issues identified were reported to the appropriate level of management.

The annual update of Bank-wide risk maps was undertaken, providing a useful opportunity for management, Governors and the Board to focus on the risks facing the Bank.

The Bank continues to make extensive use of services provided by in-house legal counsel in support of all its functions.

Property management and security

THE OBJECTIVE OF PROPERTY MANAGEMENT AND SECURITY IS:

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

IN OUR 2009-12 *STATEMENT OF INTENT*, WE UNDERTOOK TO DELIVER THE FOLLOWING:

INITIATIVES AND STRATEGIES

- Refurbish Bank accommodation as required to meet the needs of additional staff.
- Assist in locating and setting up a suitable Auckland office.
- Purchase and install a new power generator.
- Implement cost-effective measures to further enhance energy efficiency.

HOW WE PERFORMED - INITIATIVES AND STRATEGIES

The Bank maintains its own premises in Wellington and manages security operations to ensure it has secure, appropriate accommodation.

The Bank refurbished two floors of its building in 2009-10 to meet the accommodation requirements of additional staff. A comprehensive external maintenance programme has commenced.

Investigations in Auckland identified accommodation available for lease that would be suitable for daily Reserve Bank operations and for use as an out-of-Wellington business continuity site. Negotiation of a lease and set-up activities were deferred during the global financial crisis and a site is now expected to be fully established and operational in 2011.

Old and unreliable generator capacity was replaced with two new generators to provide power to the entire Reserve Bank building in the event of a failure in the main grid power supply.

Monitoring of energy usage has confirmed that savings against the baseline that was established in 2008-09 have continued and further investigations are underway to see if additional efficiency gains can be made during the summer months.

Security of the Reserve Bank building is maintained at a high level with the team involved being equipped to deal with any emergency that might arise.

The Bank's Wellington business continuity site was tested during the year, and also provided temporary office accommodation for short periods.

International activities

To further the Reserve Bank's work programme, the Reserve Bank engages and collaborates with a number of international organisations, including other central banks and multilateral organisations. The Bank continues to pursue New Zealand's interests via engagement with the International Monetary Fund (IMF). This occurs via country visits from the IMF, direct interaction with the constituency office and secondment of bank staff to the IMF.

The Bank also engages on an ongoing basis with EMEAP (Executive Meeting of East Asia and Pacific) central banks and monetary authorities. The BIS (Bank for International Settlements) continues to be an active partner for liaison on a wide range of issues including the outlook for the Asia and Pacific region. Reserve Bank staff on secondment at the BIS help further this interaction. The Reserve Bank also collaborates informally and formally with a number of central banks both within the region and across the globe.

In the South Pacific area, the Bank plays a significant role in supporting the development of financial capability through the moneyPACIFIC project. This is a financial education programme focused on making it easier for Pacific people to find out more about the cost of remittances and other financial products. It is about engaging people, building their awareness about finance, and increasing their ability to make financial decisions.

OUR FINANCIAL STATEMENTS – AN OVERVIEW

Key financial statistics for 2009-10 are:

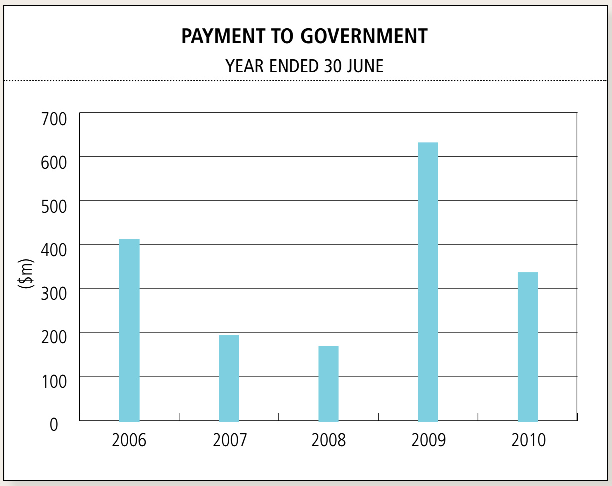
	2010 $M	2009 $M
Dividend payment to government	335	630
Net interest income	325	282
Net profit/(loss)[13]	(111)	906
Operating expenses	49.5	53.7
Net operating expenses[14]	41.2	45.7
Funding Agreement	46.9	43.3
Total assets	26,357	30,922
Foreign reserves intervention capacity	11,260	11,741
Total equity[15]	2,574	2,967

- As foreshadowed in last year's *Annual Report*, accounting results are now more volatile, given an unhedged foreign exchange position[16] and marked-to-market accounting.[17] This can be seen in the swing of net profit (loss) between 2009 and 2010.
- Nevertheless, earnings from net interest received on investments and the associated dividend payment to government continue to be sound.
- The dividend is paid from realised earnings. Unrealised gains and losses, which are included in reported performance for accounting purposes, do not normally determine the Bank's dividend.
- The reported loss for 2010 comes from a partial reversal of unrealised revaluation gains recorded in 2009 due to changes in foreign exchange and interest rates.
- Since 2007, when we commenced holding unhedged foreign reserves, the Bank has recorded an overall gain on foreign exchange, most of which has been realised in New Zealand dollars.
- Operating expenditure continues to be firmly anchored inside the five-year Funding Agreement.

13 After accounting revaluations (see footnote 17)
14 Direct comparison to Funding Agreement
15 After providing for dividends
16 Should market conditions require it, an unhedged foreign exchange position allows the Bank to sell foreign currency outright without having to later purchase or borrow foreign currency, but it also means the Bank's foreign assets and liabilities are not exactly matched (or 'hedged'). This means changes in foreign currency exchange rates might result in losses or gains.
17 Marked-to-market accounting is the practice of recording prices of financial assets and financial liabilities to reflect current market values rather than book values. The differences between market values and book values for these assets and liabilities are recorded in net profit/(loss).

Dividend payment to government is substantial

	2010 $M	2009 $M
Dividend	290	630
Voluntary dividend payment	45	0
Total payment to government	**335**	**630**



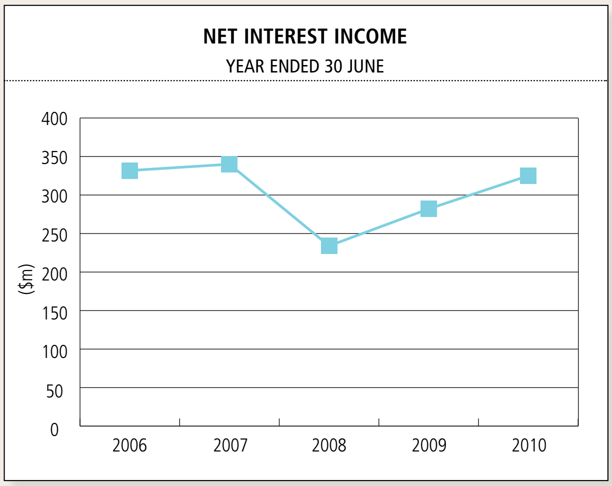
The dividend payment to government for the financial year to 30 June 2010 will be $335 million, comprising two elements: (1) a dividend of $290 million to be paid in September and (2) a voluntary dividend payment of $45 million of surplus capital made earlier in April.

This result compares with a record dividend payment of $630 million made in the 2009 financial year.

Dividends are sourced from realised earnings and may be paid even when revaluations result in a reported loss for any given year. In making a dividend recommendation, the Bank must be satisfied that it has sufficient equity for the financial risks of performing its functions.

Income: (1) Underlying net interest income provides a strong and stable base

	2010 $M	2009 $M
Net interest income	325	282



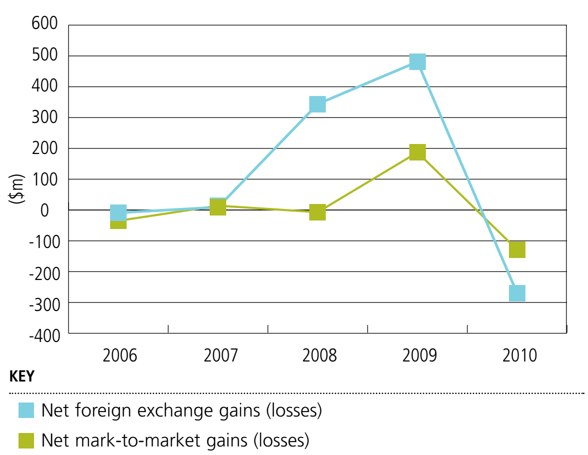
Each year, the Bank receives a large flow of net interest income from the investment of funds that result from receiving payment for notes and coins issued to banks and the investment of the Bank's equity.

During the past year, net interest income increased because the gap between New Zealand interest rates and foreign rates narrowed significantly. This meant that the cost of holding foreign assets funded by New Zealand dollars declined, and so improved net interest earned.

Income: (2) Volatile foreign exchange and interest rates cause volatility in the reported income

	2010 $M	2009 $M
Income includes:		
Foreign exchange gains (losses)	(270)	481
Gains (losses) from changes in the market value of financial instruments	(129)	187
Total	**(399)**	**668**

NET GAINS AND LOSSES FROM REVALUATIONS
YEAR ENDED 30 JUNE



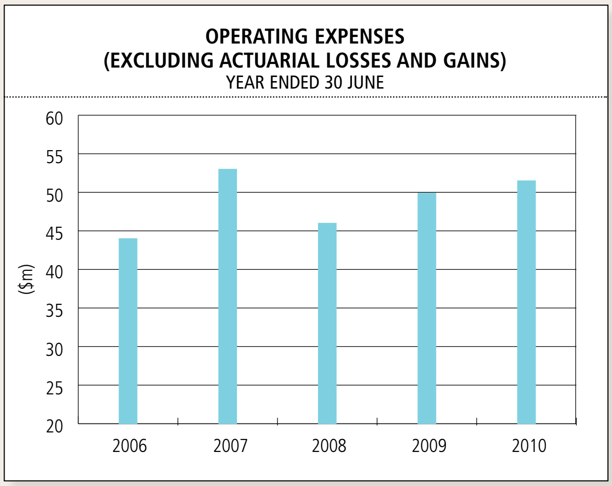
Three years ago, the Bank adopted a policy of holding some of its foreign reserves on an unhedged basis to allow the Bank to deliver a more effective response in the event of a crisis affecting the country's foreign exchange market and to smooth more extreme exchange rate movements.

The New Zealand dollar value of the Bank's unhedged reserves can change markedly from year to year. In 2009, for example, the Bank recorded very significant foreign currency revaluation gains on its unhedged reserves when the New Zealand dollar depreciated in value relative to the foreign currencies held as reserves. These revaluation gains then partly reversed in 2010 when the New Zealand dollar began to strengthen.

The Bank also holds foreign reserves on a currency-hedged basis by borrowing foreign currency for long terms so that, should the reserves be required to be sold to finance foreign exchange intervention, the Bank has time to refinance the loans before they come due for repayment. The value of the Bank's long-term foreign exchange loans can fluctuate significantly with conditions in global funding markets. In 2009, the Bank recorded large revaluation gains as it became difficult to borrow in international markets due to the financial crisis. This year, these gains have reversed as the crisis has eased.

Underlying operating expenses increase by 3.2 percent

	2010 $M	2009 $M
Staff expenses	26.2	24.3
Net currency issued expenses	3.9	5.6
Asset management expenses	8.0	7.4
Other operating expenses	13.4	12.6
Underlying operating expenses	**51.5**	**49.9**
Actuarial loss (gain) on defined benefit superannuation scheme	(2.0)	3.8
Total operating expenses	**49.5**	**53.7**



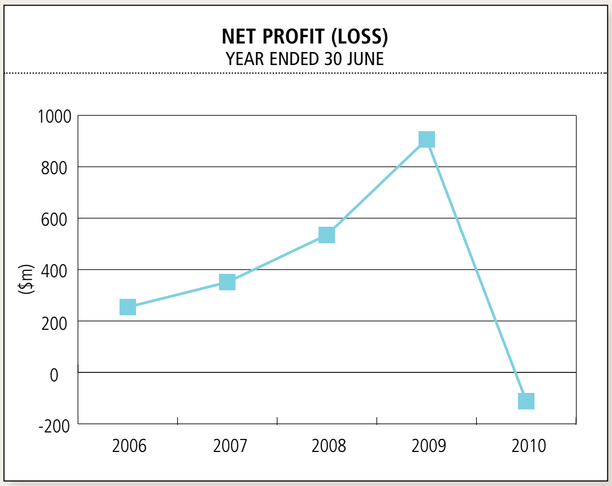
Operating expenses excluding actuarial losses and gains rose by $1.6 million from $49.9 million in 2009 to $51.5 million in 2010 as the Bank recruited additional staff for its new regulatory responsibilities for non-bank deposit takers and insurers.

The cost of issuing currency fell during 2010, as an unusually high number of bank notes were repatriated from banks.

The actuarial loss recorded for the closed defined benefit superannuation scheme in 2009 partly reversed in 2010 due to the recovery of equity markets.

Net loss recorded in 2009–10 results from unrealised currency, financial asset and liability revaluations

	2010 $M	2009 $M
Income:		
Net interest income	325	282
Foreign exchange gains (losses)	(270)	481
Gains (losses) from changes in the market value of financial instruments	(129)	187
Other investment income	5	2
Net investment income	**(69)**	**952**
Other operating income	8	8
Total income	**(61)**	**960**
Total operating expenses	**50**	**54**
Net profit (loss)	**(111)**	**906**



While the Bank's reported overall financial result for 2010 was dominated by the revaluation of unhedged foreign currency holdings and the revaluation of assets and liabilities as interest rates changed, the underlying or realised income has been sound.

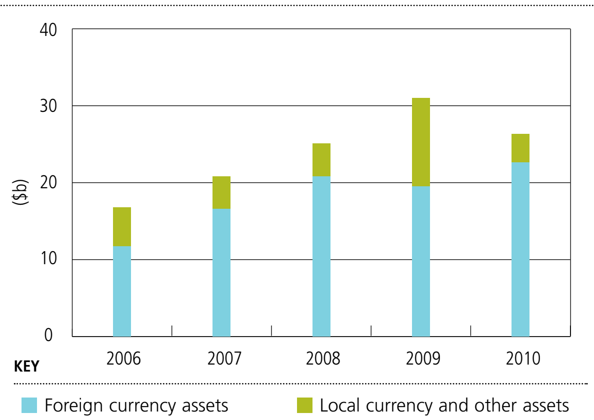
Realised gains are available for distribution, even though the Bank has reported an overall accounting loss. Realised gains were exceptionally high in 2009, as they included large gains realised in New Zealand dollars from sales of foreign currencies. Payments to the government for 2010 will be $335 million, comprising a voluntary dividend payment of $45 million made in April and a dividend of $290 million determined under the statement of dividend principles.

The Bank has held unhedged foreign reserves since June 2007. Over that time, total gains reported have been $544 million, of which realised gains comprise $446 million. There is a funding cost in holding foreign reserves because foreign currency assets generally earn less interest income than New Zealand dollar-denominated assets. Since June 2007, funding costs of $278 million have been incurred and, therefore, the net return since then has been $266 million.

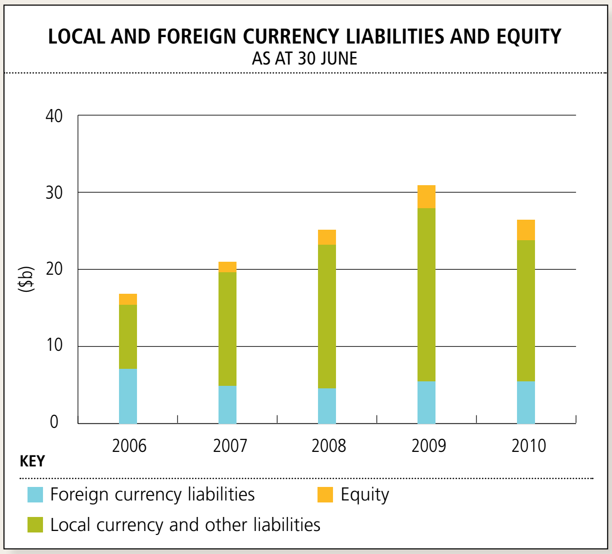
Balance sheet reduces as temporary liquidity facilities extended during the global financial crisis are repaid

	2010 $M	2009 $M
Assets:		
Foreign currency financial	22,612	19,460
Local currency financial	3,658	11,369
Other assets	87	93
Total assets	**26,357**	**30,922**
Liabilities and equity:		
Foreign currency financial	5,533	5,539
Local currency financial	13,931	17,770
Currency in circulation	3,938	3,923
Other liabilities	381	723
Equity	2,574	2,967
Total liabilities and equity	**26,357**	**30,922**

LOCAL AND FOREIGN CURRENCY ASSETS
AS AT 30 JUNE



Equity base remains strong and aligned to potential financial risks



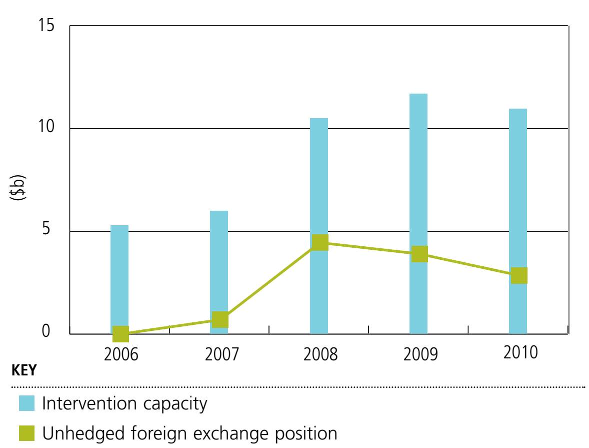
- At 30 June 2010, total assets were $26.4 billion (2009: $30.9 billion).
- As financial market conditions have improved, financial institutions have repaid their temporary liquidity facilities, reducing total assets.
- Unrealised gains on the Bank's holdings of New Zealand government securities increased from $111 million at June 2009 to $162 million at June 2010. Shifts in the value of the Bank's holdings of government securities are accounted for as a direct change in the Bank's equity and are not recorded in the Bank's net profit for the year.
- Equity is the difference between the value of the Bank's assets and its liabilities. In 2010, equity reduced by $393 million. The reasons for this were:
  - A reversal of unrealised gains reported in 2009 as the New Zealand dollar appreciated and global interest rates changed.
  - The Bank making a voluntary dividend payment to the government of $45 million in releasing surplus capital no longer needed for financial risks associated with the temporary liquidity facilities.
  - A provision for dividend payment to the government after the end of the year of $290 million, which will be made from realised earnings. The dividend will be paid in September 2010.

Unrealised gains are retained in equity and could be available for payment to government if realised or at the point when they are very likely to be realised. At 30 June 2010, equity included unrealised gains of $374 million (2009: $718 million).

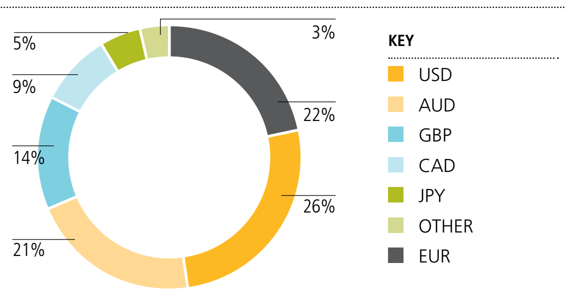
Unhedged foreign exchange position reduces as global financial crisis recedes

	2010 $M	2009 $M
Unhedged foreign exchange position	2,851	3,881

FOREIGN RESERVES INTERVENTION CAPACITY AND UNHEDGED FOREIGN EXCHANGE POSITION
AS AT 30 JUNE



CURRENCY COMPOSITION OF UNHEDGED FOREIGN EXCHANGE POSITION
AS AT 30 JUNE



The foreign reserves intervention capacity is the measure of the Bank's ability to quickly sell foreign currency and buy New Zealand dollars, should market conditions warrant such an action.

An unhedged foreign exchange position allows the Bank to sell foreign currency outright without having to later purchase or borrow foreign currency, but it also means that the Bank's foreign assets and liabilities are not exactly matched or 'hedged'. Movements in foreign currency exchange rates may therefore result in valuation losses or gains.

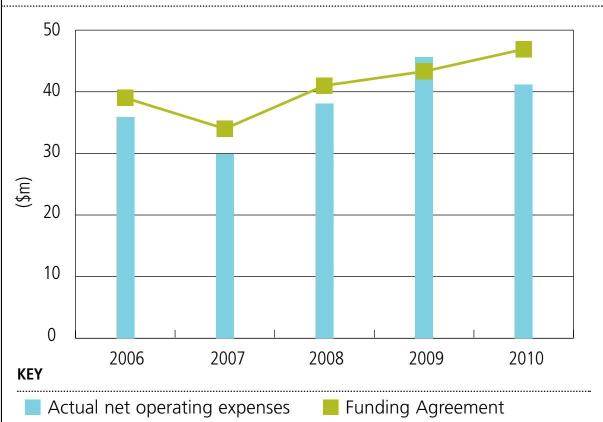
During the past year, the foreign reserves intervention capacity fell from $11.7 billion to $11.3 billion as the unhedged foreign exchange position was reduced to $2.9 billion ($3.9 billion in 2009) in response to declining international risk.

The pie chart shows the composition of foreign currencies included in the unhedged foreign exchange position.

Spending remains well anchored inside the five-year Funding Agreement

	2010 $M	2009 $M
Total operating expenses excluding actuarial loss on defined benefit superannuation scheme	51.5	49.9
Actuarial loss/(gain) on defined benefit superannuation scheme	(2.0)	3.8
Total operating expenses	**49.5**	**53.7**
Income retained under the Funding Agreement	8.3	8.0
Actual net operating expenses	**41.2**	**45.7**
Net operating expenses specified in the Funding Agreement	46.9	43.3
Funding Agreement under-expenditure (over-expenditure)	**5.7**	**(2.4)**

NET OPERATING EXPENSES
IN RELATION TO THE FUNDING AGREEMENT
(INCLUDING ACTUARIAL LOSS ON DEFINED BENEFIT SUPERANNUATION SCHEME)
YEAR ENDED 30 JUNE



- The Funding Agreement is a five-year agreement between the Minister of Finance and the Governor of the Reserve Bank to finance the Bank's operating expenses.
- The net figure is based on operating expenses less income from services such as transaction fees and rents received from the letting of office space.
- Net operating expenses were $41.2 million in 2010. This was $5.7 million below the $46.9 million level provided for in the Funding Agreement for the 2010 year.
- The main reasons for under-spending the 2010 Funding Agreement level were:
  - A decision to defer the setting up of the Bank's Auckland office until 2011.
  - The higher-than-normal return of bank notes by several banks reduced the amount of currency that needed to be issued in 2010.
  - The partial reversal of the actuarial loss on the defined benefit superannuation scheme that had been recorded in 2009.

RESERVE BANK STRATEGIC PRIORITIES FOR 2010-11

PRIORITY	EXPLANATION	DEPARTMENT
1. INVESTIGATE THE POTENTIAL FOR MACRO-PRUDENTIAL POLICY TOOLS FOR NEW ZEALAND	The global financial crisis has highlighted the interdependence of financial and macro stability. The Bank will investigate the potential for macro-prudential policy tools to assist existing monetary and prudential approaches.	FINANCIAL MARKETS ECONOMICS PRUDENTIAL SUPERVISION
2. BEGIN UNWINDING SPECIAL FINANCIAL SYSTEM SUPPORT AND MONETARY POLICY STIMULUS	The global financial crisis prompted both very rapid easing of monetary policy and financial market interventions. As conditions permit, this accommodative policy stance will be unwound. This unwinding will need to take into account the extent of policy actions undertaken and uncertainties about what will constitute 'normal conditions' in the future. The sequencing and pace of withdrawal of stimulus will be a particular focus of policy deliberations.	FINANCIAL MARKETS ECONOMICS
3. IDENTIFY ANY APPROPRIATE CHANGES TO THE BANK SUPERVISION REGIME, INCLUDING THOSE BASED ON INTERNATIONAL REGULATORY REFORMS	In the wake of the global financial crisis, a number of changes to international prudential standards and codes are expected, especially for capital and liquidity requirements. The Bank will assess evolving standards and identify any changes that assist us to promote the maintenance of a sound and efficient financial system, and to avoid damage to the financial system that might result from the failure of a registered bank.	PRUDENTIAL SUPERVISION
4. ADVANCE THE IMPLEMENTATION OF THE NEW NON-BANK DEPOSIT TAKER (NBDT) REGIME	The Reserve Bank became the prudential regulator of NBDTs in September 2008. Since then, the Bank has been developing regulations that will be progressively implemented during 2010 and 2011. In addition, it is expected that new legislation to give the Bank additional power to complete the NBDT regime, including crisis management and licensing powers for NBDTs, will be introduced to Parliament.	PRUDENTIAL SUPERVISION
5. DEVELOP AND IMPLEMENT THE NEW PRUDENTIAL REGIME FOR INSURANCE	The Insurance (Prudential Supervision) Bill, covering life, general and health insurers, is currently in Parliament and is expected to be enacted late in 2010.[18] The purpose of the legislation is to encourage the maintenance of a sound and efficient insurance sector that promotes confidence among policyholders and the general public.	PRUDENTIAL SUPERVISION
6. ENGAGE, DEVELOP AND SUPPORT STAFF TO MEET THE CHALLENGES OF THE BANK'S EVOLVING RESPONSIBILITIES	As the Bank's role evolves, the contribution of every staff member is important to the successful carrying out of the Bank's functions. Through quality feedback, appropriate training and targeted development plans, we can increase staff's individual contribution to the Bank's overall success in fulfilling its functions.	BANK-WIDE
7. IMPROVE BUSINESS CONTINUITY AND DISASTER RECOVERY CAPABILITY THROUGH THE ESTABLISHMENT OF A BUSINESS SUPPORT CENTRE IN AUCKLAND	The Bank ensures that it has systems in place to enable it to continue functioning in the event of a range of crises. It will establish a small office in Auckland to provide business continuity in payments and market functions in the event of a regional disaster in Wellington.	OPERATIONAL

18 This Bill was signed into law on 7 September 2010.