The Treasury

Reserve Bank of New Zealand 2020-25 Funding Agreement Information Release

August 2020

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[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: RBNZ 2020-25 Funding Agreement Proposal

Date:	25 March 2020	**Report No:**	T2020/58
		File Number:	MC-1-2 (Reserve Bank Funding and Operation)

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Note** the Reserve Bank has provided a proposal for its 2020-25 funding agreement	Friday 3 April 2020
(None)	**Decide** if you agree with the proposal's direction and spending parameters, and provide any comments to Treasury officials	

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Ken Tsang	Analyst, Macroeconomic and Fiscal Policy	[39]	n/a (mob)	✓
Renee Philip	Manager, Macroeconomic and Fiscal Policy	[39]	[35]	

Minister's Office actions (if required)

Return the signed report to Treasury with any comments on the Bank's proposal **Respond** to the Bank's proposal with your decisions and comments

Note any feedback on the quality of the report	

Enclosure: No

Executive Summary

The current five-year Funding Agreement for the Reserve Bank (the Bank) has been in place since 2015 and is due to end on 30 June 2020. The Bank has now prepared its proposal for its 2020-25 Funding Agreement. This has been discussed with the Treasury and the Bank is now seeking your support. The Bank's Board has indicated its support for the proposal.

The proposal sees a substantial increase in the Bank's expenditure and investment, with the Bank considering it necessary to respond to areas of past underinvestment and address critical risks to the Bank’s ability to deliver its mandate.

Under this proposal, the Bank's operating expenses would increase to an average of $129m per year across 2020-25. The average across 2015-20 was $65m per year. This difference is primarily driven by an increase in FTE and IT system investment.

The Treasury is supportive of a significant uplift in the Bank's funding, and particularly with the Bank’s proposal to increase its financial supervisory capability. Expenditure under this proposal would continue to be relatively low compared to other central banks.

However, the Treasury cannot judge the value for money of the proposal based on its high level of detail. In discussions, the Treasury suggested that the Bank provide options and scenarios of service levels under different funding levels but the Bank considers its plans critical and cannot be scaled.

Whilst noting the operational independence of the Bank, in deciding if you agree with the proposal, you may wish to consider the size and phasing of the Bank's plans given public sector capacity constraints over recent years. However, given the scale of the downturn from COVID-19 it will be important that the Bank has sufficient resource to undertake the full range of activities required, and capacity constraints may be less of an issue in the future.

The Bank has also proposed excluding certain activities from the funding agreement framework, which it considers unpredictable and/or commercial activities. However, the Treasury considers fully removing them from the framework could reduce accountability. Phase 2 of the Reserve Bank Act Review will consider the funding agreement framework, and these exclusions could be further discussed with the Bank through that process.

If you agree with the Bank's overall proposal, we will work with the Bank to provide a final legal funding agreement document for both you and the Bank's Governor to agree and sign. The signed agreement must then be presented to the House of Representatives within 12 sitting days, and ratified before 1 July 2020.

If you disagree with the overall proposal, you should provide your comments to Treasury officials and we will work with the Bank to redraft the proposal.

Recommended Action

We recommend that you:

a. **note** that the Reserve Bank has submitted its 2020-25 funding proposal and that the current 2015-20 funding agreement ends on 1 July 2020. **We are seeking your decisions by 3 April**.

b. **note** that the Bank proposes to increase average operating expenditure to **$129m per year** across 2020-25 ($646m 5-year envelope) from an average over the 2015-20 funding period of **$65m per year** ($324m 5-year envelope).

c. **note** that the Treasury supports a significant uplift in the Bank's resourcing, particularly in its financial supervisory capability.

d. **note** that the Treasury considers there to be risks with the size and phasing of the proposed uplift in the context of existing public sector capacity constraints, however, given the impact of COVID-19, it will be important to ensure that the Bank is adequately resourced to undertake the full range of activities required.

e. **note** that the Bank considers the proposed level of spending to be the minimum required to deliver its mandate and it is unable to provide a scaled option.

f. **note** the Bank's 3% annual wage inflation assumption in the context of other agencies.

g. **note** that the Bank has excluded future potential cost areas which it considers highly uncertain, and may require additional future funding, including aspects of the Future of Cash project, and Phase 2 of the Bank Act Review (such as Depositor Protection).

h. **note** that the Bank has also proposed further exclusions from the scope of the funding agreement framework which it considers unpredictable and/or commercial activities, including litigation expenses, Security Custodian service costs, property management expenses, and payment systems.

i. **agree** to maintain the current scope of the funding agreement framework, noting that Phase 2 of the Bank Act Review is considering the funding agreement framework.

Agree/disagree.

j. **note** that agreeing to recommendation (i) above will require you to disagree with recommendation (b) in the Bank's report.

k. **note** that upon agreeing the content of the funding agreement, the Bank will provide you with a final legal funding agreement copy for signing.

l. **note** that after signing, you must present the funding agreement to the House within 12 sitting days, and it must be **ratified by Parliament before 1 July 2020**.

In response to the Bank's overall proposal, we recommend that you either:

m. **agree** in full to the Bank's proposal;

OR

n. **agree** to the strategic direction and broad expenditure parameters of the Bank's funding proposal, providing Treasury officials with comments on **minor revisions**;

OR

o. **disagree** with the Bank's proposal and request a redraft, providing Treasury officials with details of **significant revisions** you want.

Renee Philip
Manager

Hon Grant Robertson
Minister of Finance

Treasury Report: RBNZ 2020-25 Funding Agreement: Draft Proposal

Purpose of Report

1. This report informs you on the Reserve Bank's 2020-25 Funding Agreement proposal. The Bank has prepared the proposal and discussed it with Treasury officials.

2. The Bank is seeking your support for the strategic direction and the broad parameters of their proposal. Once the strategic direction has been agreed, the bank will provide a final funding agreement which must be signed before the current agreement ends on 30 June 2020.

Background

The Reserve Bank's five-year Funding Agreements

3. Unlike most agencies, the Reserve Bank (the Bank) does not receive appropriations to cover operating expenses. Instead, under the Reserve Bank of New Zealand Act (the Act), the Minister and the Governor are required to enter into a five-year funding agreement to specify the amount of the Bank's income that may be used to meet operating expenses for each financial year under the agreement.

4. As the Bank does not receive appropriations, the funding agreement is a key vehicle for you to determine the Bank's expenses and ensure that the priorities of the Bank and the Government align for the next five years.

5. The funding agreement stipulates the level of annual net operating expenses permitted, with broad independence given to the Bank in how it operates within that limit. Any income the Bank earns in excess of its expenses is typically paid back to the Crown in the form of an annual dividend, in accordance with the Bank's dividend policy.

6. Capital expenditure is funded through the Bank's balance sheet and existing resources, but does impact operating expenditure in the funding agreement through depreciation.

7. Under the Act, for a funding agreement to become effective, Parliament must ratify the agreement within 12 sitting days after the agreement is agreed or varied. The Minister and the Governor can at any time, by agreement, terminate or vary the provisions of a funding agreement.

The current 2015-20 Funding Agreement

8. The current funding agreement covers the 2015-20 financial years and is set to expire on 30 June 2020.

9. Following the expansion of the Bank's role after the Global Financial Crisis, the Bank used preparation of the 2015-20 agreement as a catalyst for internally reviewing the effectiveness and efficiency of its functions. At the time, the Bank identified that a period of consolidation was appropriate, proposing efficiency savings of $24 million over five years, primarily driven by staff restructuring and a reduction in FTE by 10% (26 FTE).

10. Relative to the planned expenditure, the Bank expects to spend the full five-year funding envelope ($324 million) agreed under the current 2015-20 agreement. The Bank underspent over the first three years of the current agreement but following a shift

in the Bank's strategic direction, expenses increased over 2018/19 and are forecast to increase further over 2019/20. The increase is driven by additional resourcing in areas such as financial stability capability and IT system investment. The Bank intends to fund overspends in the latter two years with underspends in the previous three years.

11. In December 2017, the Bank noted its intention to increase its financial supervisory resourcing. The Bank stated that it could fund this increase using underspends from earlier years, but to provide certainty, the Bank requested your in-principle support to higher funding going forward. As recommended by the Treasury, you stated that any increase to the Bank's funding should be considered as part of the overall funding agreement package, but you noted that you supported the Bank funding the uplift using underspends.

The Proposed 2020-25 Funding Agreement

The Bank's funding proposal

12. The Bank's 2020-25 funding proposal extends the uplift in expenses seen over 2018/19 and 2019/20, with planned operating expenses increasing to an average of **$129m per year** across 2020-25 (**$646m 5-year envelope**). The average across the 2015-20 funding period was $65m per year ($324m 5-year envelope).

13. The Bank considers it necessary to respond to areas of past underinvestment and address critical risks to the Bank's ability to deliver its mandate. The Bank also considers it necessary to respond to economic, political, and social changes in its operating environment and changes in public expectations of the Bank.

14. Whilst comparisons are not like-for-like, benchmarking against other central banks, the Bank's expenses are comparatively low (0.03% of GDP compared to a sample average of 0.08%), particularly as it is a 'full service' central bank with a wide range of responsibilities (see the Bank's proposal for more detail).

15. The Bank also states that it has a low number of staff per regulated entity, which partly reflects the Bank's reliance on self and market discipline in its supervisory approach. The low regulatory intensity has been highlighted as a concern by reviews such as the IMF's 2017 Financial System Assessment Programme (FSAP) review.

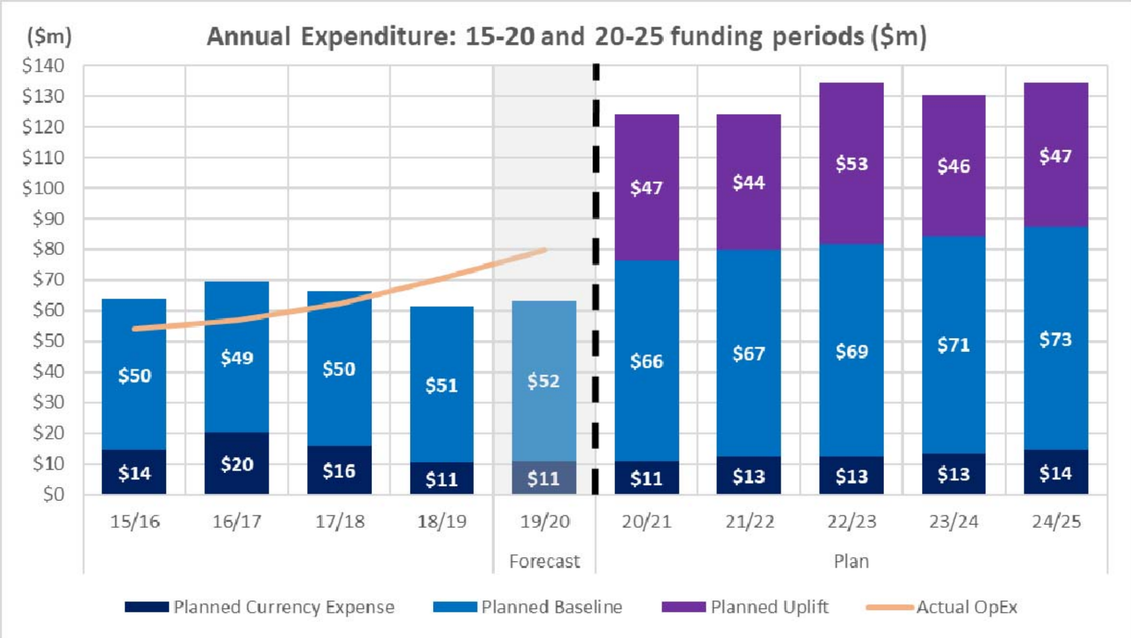
16. Compared to its 2019/20 budgeted baseline of $79.9m, the average annual uplift of $47m is split across:

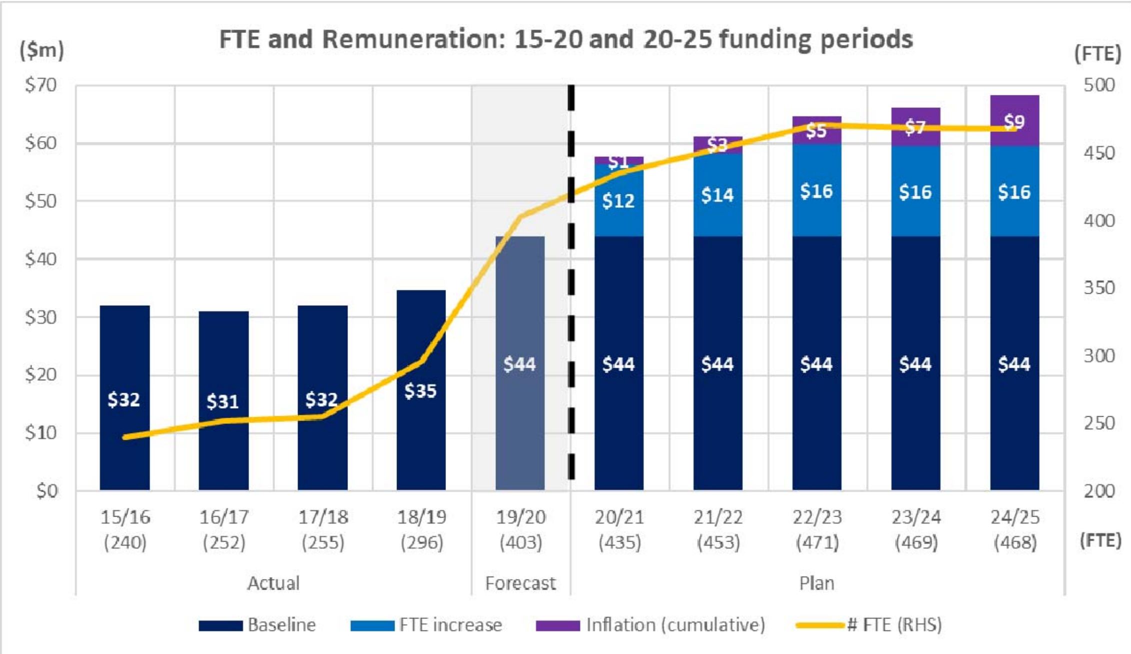
    a) **People ($20.7m)**: FTE is planned to increase by +172 from 296 in 2018/19 to 468 in 2024/25, with most of this occurring over 19/20 & 20/21.

    b) **Operational ($19.3m)**: Investment focuses on modernising the Bank's technological infrastructure (33%) and investment into banking services (26%) such as settlement services and cash systems.

    c) **Assets ($7.4m)**: Driven by depreciation of financial stability data system investments (37%) and depreciation of property & security systems investments (34%).

17. The Bank's Board has indicated its support for the proposal. Given the primary role of the Board in monitoring the Bank and its duty to *keep under constant review the use of the Bank's resources*, if you would like more information on the Board's process of review, you may wish to discuss the proposal with the Board Chair, Neil Quigley.





Treasury's assessment of the Proposal

18. **The Treasury is supportive of a substantial uplift in the Bank's resourcing, and the Bank's intention to increase its financial supervisory capability**, as recommended by the IMF's 2017 Financial Sector Assessment Program (FSAP) review that highlighted the Bank's financial supervisory capability be increased.

19. Under the Bank's proposal, expenditure would be in line with other central banks. **However, the high level of the proposal's detail means it is difficult for the Treasury to consider the value for money of the proposal.**

20. During discussions, the Treasury suggested the Bank provide options and scenarios of possible service levels under different funding levels. The Bank's view is that its plans are critical and it cannot scale its proposal. Whilst the Treasury recognises the criticality

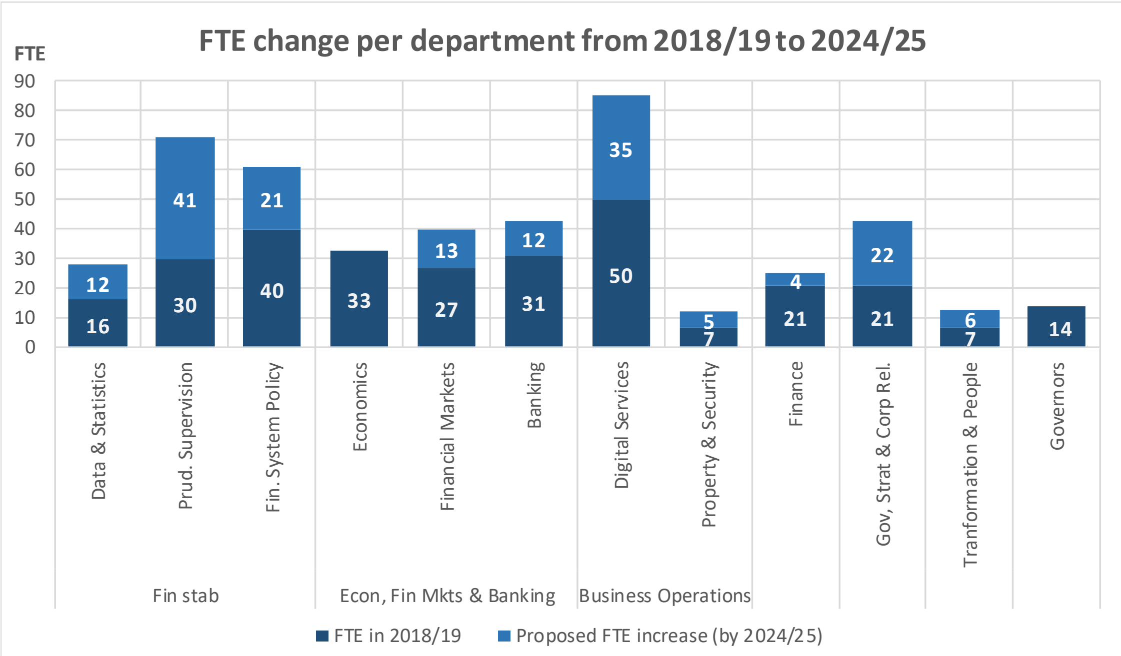
of the Bank's proposal, our preference would be that the Bank provide scenarios of outcomes under different funding levels.

21. This section highlights particular details of the Bank's proposed service level and potential risks that you may wish to consider when deciding if you agree with the Bank's proposal.

Operating expenditure and FTE increase

22. **The Bank's proposal includes a material uplift in financial supervision capability and capacity** (+74 FTE in its financial stability group). However, it is unclear how the Bank's proposed uplift aligns with the IMF's 2017 FSAP recommendations.

23. Whilst nearly half of the +172 FTE uplift is focused on financial stability roles, there are substantial increases in the Digital Services (+35) and Governance, Strategy and Corporate Relations (+21) departments (see below).



24. **Given workforce capacity pressures across the public sector, the size and phasing of the proposed uplift could risk adversely affecting agencies competing for similar resources**, adding to existing cost pressure. This is especially the case as a large proportion of the uplift is in specialist financial stability/regulatory staff. Whilst the impact of COVID-19 is highly uncertain at this stage, it is possible that capacity constraints ease over the future due to any impact on employment.

25. Treasury analysis of Budget 2019 initiatives showed 4000 additional FTE were sought, with 2000 funded, representing a 5% increase in departmental staff levels (T2019/2621 refers). [33]

26. To recruit the planned FTE increase, the Bank intends to recruit from the private sector, recruit internationally, expand its graduate programme, and expand in Auckland.

27. You have voiced workforce capacity concerns in regards to resource bids from other agencies. Whilst not directly comparable, agencies requiring regulatory staff such as

the FMA and Commerce Commission have increased their FTE over the past few years.

28. Due to expanding regulatory remits, both the FMA and Commerce Commission have Budget 2020 cost pressure bids to fund further FTE increases. The Treasury recommended a scaled & incremental increase for both [33] noting significant uplifts could be difficult to absorb and could add to labour market pressures. Whilst discussions are ongoing and may change due to COVID-19, both have been included in the draft cost pressure package, and you decided to further scale down the FMA's request to [33] of the amount requested.

29. There may also be a risk that it is difficult to effectively implement and absorb such a swift uplift (e.g. train staff), particularly as most of the FTE and expenditure increases are phased across 2019/20 and 2020/21.

Wage inflation assumption

30. **The Bank has assumed 3% per annum wage inflation**. The Bank acknowledges this is higher than the public sector historical average, but considers it necessary to compete with the private sector for specialised staff. Anecdotally, the FMA and the Commerce Commission have noted similar considerations with the Treasury.

31. The 3% wage inflation assumption across the Bank is based on a targeted approach, with lower increases for established staff, and higher increases for more junior staff.

32. For comparison, annual salaries in the Public Service have increased by 2.6% per annum over the past ten years. Whilst annual salaries increased by 4.4% in 2019, this has been driven by collective pay agreements[1].

33. Excluding collective pay agreements, wage growth on an adjusted labour cost basis (which excludes the impact of changes in workforce composition, promotion, and performance-related increases) was 1.8% in the public sector and 2.2% in the private sector for the year to Sept 2019.

34. Whilst comparing against the private sector may be appropriate, the Bank offering higher wages could still add pressure to the wages other agencies must offer to hire similarly skilled staff. **You should therefore consider if you are comfortable with the Bank's 3% wage inflation assumption given the wider public sector context.** Whilst highly uncertain, if capacity pressures reduce because of COVID-19, future wage inflation could be lower.

Capital expenditure & IT investment

35. **The Bank's plans include $58.6m of capital expenditure**. Capital expenditure is funded through the Bank's balance sheet, but through depreciation, has an average annual impact on expenses of $7.4m over the 5-year funding period (total of $35.4m) with the remainder depreciating after 2025. Planned capital expenditure across the 2015-20 funding agreement was $16.8m.

36. The $58.6m of capital expenditure is split across the following areas:

    a) **IT software** ($34.9m): $12m towards a new *financial supervisory system*, and $10m to replace the Bank's Financial Sector Information System (FSIS) data system.

    b) **Property & hardware** ($19.7m): $7.6m expanding the Bank's Auckland office.

[1] Figures are from the SSC's Workforce data and are affected by changes in workforce composition and promotion and performance-related increases.

c) **IT Hardware** ($4.1m): primarily to refresh IT hardware (e.g. laptops).

37. The Treasury recognises that the Bank needs an uplift in capital investment, particularly for software and data systems. However, similar to our consideration of capacity pressures in the public sector labour market, there exists widespread demand for IT systems procurement in the public sector and any significant procurement by the Bank could add to existing pressure.

38. The Bank is aware of the Government's Digital, Data and ICT Investment principles that were developed for Budget 2019 and updated for Budget 2020. The Bank has stated it would collaborate with other agencies and take an all-of-government approach to its IT investment.

39. The capital plans also include $7.6m of investment into the Bank's Auckland office. The Auckland office currently houses 30 FTE and focuses on core business functions and business continuity. The Bank intends to expand its presence in Auckland to strengthen its ties with its Auckland stakeholders, as well as improve the Bank's operational resilience. The Auckland office will cover all areas of the Bank, and will include business support functions.

Future potential cost areas which may require additional funding

40. **The Bank's proposal excludes potential future costs that the Bank considers highly uncertain and difficult to forecast** (see Annex 1 for a full list).

41. If any of the excluded areas results in **a significant unplanned expense** over 2020-25, the Bank may need, with agreement between yourself and the Bank's Governor, a variation in its funding agreement to **obtain additional funding**. You may wish to note that the proposal, particularly;

    a) **Excludes**; Elevated enforcement-litigation capability, **Depositor Protection**, upgraded physical cash storage and distribution assets (Future of Cash), UMP operating costs;

    b) **Partially includes**; Crisis resolution capacity, establishing a regulatory regime for financial market infrastructures;

    c) **Includes**: More intensive supervision, development of business models and vaulting plans (Future of Cash), and research on unconventional monetary policy (UMP) tools.

42. Whilst uncertain, it is likely the Bank will need to build capability and invest resourcing in some of these areas prior to final decisions being made. A near-term example is **Depositor Protection**. Even if it is determined that the Bank will not administer the scheme, it will need to be involved in the design of the scheme given its relationship to the regulatory perimeter determining the entities the Bank is responsible for.

Exclusions to the funding agreement framework

43. **The Bank has further proposed excluding certain expenses from the scope of the funding agreement framework** that it considers unpredictable and/or commercial in nature. This includes litigation expenses, Security Custodian service costs, property management expenses, and payment systems (NZClear and ESAS). The Bank estimates removing these would reduce annual operating expenditure in their proposal by **$1.1 - $1.4m** (payment systems services are revenue generators). Annex 2 provides the Bank's justification and estimated financial impact.

44. Whilst the proposed exclusions are not expected to have a material financial impact (but are uncertain), the Treasury considers fully removing them from the framework of the agreement could reduce accountability.

45. Based on discussions with the Phase 2 Review Team, our recommendation is that activities are not fully excluded from the funding agreement, noting that:

    a) There may be a case for ring-fencing commercial activities (property management and payment / settlement systems);

    b) Whilst we do not want to adversely constrain the Bank undertaking regulatory legal action in its financial supervisory role, any unexpectedly large litigation expenses can be provided for through a future variation in the agreement;

    c) We do not see a strong case to exclude Security Custodian Costs in particular. Whilst the Bank states that this expense is directly incurred in connection with its financial transactions, other expenses at the Bank also likely fall under this category.

46. The funding agreement framework is being considered as part of the Phase 2 Review and these exclusions could be further discussed with the Bank through that process.

Next steps

47. The Bank is seeking your in-principle agreement to the strategic direction and broad expenditure parameters of its proposal. To provide time to incorporate any comments and for next steps, **we are seeking your decisions by 3 April.**

48. Whilst noting the operational independence of the Bank, we suggest that in deciding whether you agree with the Bank's proposal that you consider the size & phasing of the planned uplift in the context of both workforce and IT procurement capacity constraints in the public sector. You should also consider your comfort with the Bank's 3% annual wage inflation assumption within the context of the public sector.

49. **If you agree to the Bank's proposal in full**, you should respond to the Bank noting your support. The Bank will then provide a final legal funding agreement document for both you and the Bank's Governor to sign.

50. **If you would like minor revisions, but agree with the proposal's strategic direction and broad expenditure parameters**, please provide comments to Treasury officials and we will work with the Bank to consider minor revisions, and provide a final legal funding agreement document for signing.

51. **If you disagree with the Bank's proposal and would like substantial revisions** to the proposal, please provide comments to Treasury officials and the Treasury will work with the Bank to provide you with a revised proposal.

52. Following agreement between the Minister and the Bank, the Minister must present the agreement to the House of Representatives within 12 sitting days of signing the legal funding agreement document. The House **does not need to debate this within 12 sitting days**, as long as the agreement is ratified by Parliament **before 1 July 2020**.

Annex 1: Operating Environment Changes and Implications for the Funding Agreement (Table 3 in the funding proposal)

Drivers of change	Area of potential cost implications for the Bank	Included
Future of Cash project	Development of business model and vaulting plans	yes
	Upgraded physical property and system assets to provide optimal cash storage and distribution	no
	Architecture to support cash movements between commercial banks	no
Phase 2 of the Reserve Bank Act Review and our future mandate	Revised fee structure for Board members	yes
	Increase in number of Board members	no
	Compliance with additional statutory requirements for institution	yes
	More intensive supervision	yes
	Income from new levies on supervised entities	no
	Elevated enforcement-litigation	no
	Crisis resolution capacity enhanced	partial
	Establish and operate a senior executive accountability regime	no
	Depositor protection: establishment of insurance regime and early policy and legal work	no
	Depositor protection: developing and servicing operations for the scheme	no
Systems and assets	Replacement of Findur (core treasury system). The approach and timing of a system replacement is unknown.	no
	Insurance of No 2 the Terrace building	yes
	Greening of No 2 the Terrace building	no
Future focused strategies	Research to underpin unconventional monetary policy tools	yes
	Operating costs (establishing instruments and legal, audit and governance costs) for unconventional monetary policy	no
	Initial work to develop a new South Pacific remittance model	yes
	Implementation costs for contribution to the South Pacific remittance model	no
	Establishing a regulatory regime for Financial market infrastructures	partial

Annex 2: Proposed exclusions to the funding agreement framework (Appendix 7 in the funding proposal)

Type	Justification for exclusion
Litigation expenses	• Unpredictable • Potentially large • Lodgement of legal challenge by an external party, requiring legal defence, being outside the Bank's control
Net property management (landlord) expenses	• Non-core commercial activity • Significant risk to unpredictable events requiring costly remediation/staff relocation (we will include in the funding agreement a market rental charge and the property income and costs being disclosed in the *Annual Report*)
Security Custodian expenses and bank fees	• Incurred directly in connection with the Bank's financial market transactions and better reported as an offset against investment income (excluded from the funding agreement). Very volatile costs as the balance sheet expands and contracts. These costs will be separately reported on in the *Annual Report*.
NZClear and ESAS	• NZClear is a contestable service run as a commercial operation generating net profit of about $1.9 million per annum • Revenues and costs can fluctuate in line with transaction volumes and also rapid changes to technology. Revenues and costs will be separately reported on in the *Annual Report*. • ESAS is strongly connected with NZClear. (ESAS operates at zero net cost as fees received from members offset operating expenses)

Impact of exclusions on 5-year forecast	Forecast				
	2020/21 $m	2021/22 $m	2022/23 $m	2023/24 $m	2024/25 $m
Litigation expenses	-	-	-	-	-
Net property management (landlord) expenses	(1.5)	(1.9)	(1.8)	(1.8)	(1.7)
Security custodian expenses and bank fees	(1.4)	(1.4)	(1.5)	(1.5)	(1.5)
NZClear and ESAS	1.9	1.9	1.9	1.9	1.9
Total	**(1.1)**	**(1.4)**	**(1.4)**	**(1.4)**	**(1.3)**