The Treasury

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

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Office of the Minister of Finance

13 May 2020

Chair

Economic Development Committee

RESERVE BANK OF NEW ZEALAND 2020-25 FUNDING AGREEMENT

Recommendations

I recommend that the Cabinet Committee:

a. **note** that, as required by the Reserve Bank of New Zealand Act 1989 (the Act), I have negotiated a five-year Funding Agreement with the Governor for the period 1 July 2020 to 30 June 2025.

b. **note** that the proposed funding profile will see an annual average uplift in the Bank's operating expenses of $46 million per year over the five-year period. Net operating expenses will increase from $79.9 million in 2019/20 to $123 million in 2020/21.

c. **note** that I have agreed to the removal of certain operating expenses from the scope of the funding agreement. The exclusions include litigation expenses, property management expenses, Security Custodian expenses, bank and broking fees, and provision of ESAS and NZClear services.

d. **note** that I intend to sign the five-year Funding Agreement (see attached) as soon as possible and have it ratified by resolution in the House before it takes effect on 1 July 2020.

Background

1. The Reserve Bank of New Zealand (The Bank) does not receive appropriations to cover its operating expenses. Instead, under the Reserve Bank of New Zealand Act (the Act), the Minister of Finance and the Governor are required to enter into a five-year funding agreement to specify the amount of the Bank's revenue that it can retain to meet net operating expenses each financial year. The current funding agreement covers the period from 2015 to 2020 and is set to end on 30 June 2020.

2. The Bank has submitted a proposed Funding Agreement for 2020 to 2025 for my approval and this has been discussed with Treasury officials. It is my intention to sign the Funding

Agreement as soon as possible and have it ratified by resolution in the House before it takes effect on 1 July 2020.

3. Under the Act, the Funding Agreement must be presented to the House within 12 sitting days of it being agreed or varied. The Funding Agreement must then be ratified in the House by resolution before it becomes effective.

The 2020-25 Funding Agreement

4. The Bank has prepared its Funding Agreement proposal with a focus on addressing critical risks to the Bank and the financial system. The Bank is currently operating with an increased risk of harms crystallising across the remit, which ultimately undermines market and consumer confidence in regulatory and financial system stability. These key areas of risk include:

    a) Continuing to support the new payment and settlement systems to ensure that banks and market participants can continue to settle payments and securities transactions as required.

    b) An inability to strengthen its regulatory approach to keep pace with international best practice for supervision, domestic legislative changes and developments in money laundering, climate risk, financial crime, cyber resilience and fintech. Without investment, the risk of failure will remain unacceptably high, and so will the risk that financial institutions do not properly meet the needs of their customers.

    c) An inability to provide sound stewardship for the cash system as the current model is not future-proofed nor fit for current purposes. Failure to deliver on the next steps of the Future of Cash project, such as vaulting plans for the long-term secure storage of cash, could lead to reputational damage, loss of stakeholder confidence, disruptions to the financial system and lack of inclusion of primary cash users.

    d) Organisation-wide operational errors or failure due to dependencies on manual processes, aging systems, and end-of-life infrastructure, across both core and support functions. This includes our ability to implement the new Financial Markets Infrastructure legislation which is a critical part of our financial system.

    e) An inability to attract, develop and retain capable people.

    f) Elevated technology and property security threats, as central banks have increasingly become targets.

    g) Property and health risks to all of the Bank's Wellington tenants can be addressed, and disrupted operations can be accommodated, to address seismic and asbestos exposure.

5. The Bank considers it necessary to respond to areas of past underinvestment and address these critical risks to its ability to deliver its mandate. If the Bank does not have sufficient funding to address these risks, the potential impact of harms crystallising will result in more severe consequences on the financial system. This funding is therefore required to provide an uplift in essential capability. This includes a substantial increase in the Bank's financial supervisory capability, as recommended by the IMF's 2017 Financial Sector Assessment Programme (FSAP) Review.

6. Furthermore, the scale of the downturn from COVID-19 means that it will be important that the Bank is sufficiently resourced to undertake the full range of activities required of it.

7. The proposed funding profile will see an annual average uplift in the Bank's operating expenses of $46 million per year over the five-year period. Net operating expenses will increase from $79.9 million in 2019/20 to $123 million in 2020/21. Therefore, the Bank expects operating expenses to total $640 million over the 2020-25 five-year period. The total over the 2015-20 period was $324 million.

8. Compared to its 2019/20 budgeted baseline of $79.9 million, the average annual uplift of $46 million in operating expenses is split across:

   a. **People ($20.7m)**: Full time employee (FTE) numbers are planned to increase from 296 FTE in 2018/19 to 468 FTE in 2024/25.

   b. **Operational ($17.9m)**: Investment focuses on modernising the Bank's technological infrastructure and investment into banking services such as settlement services and cash systems.

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

9. To maintain the effectiveness of the funding agreement framework, I have agreed to the Bank's proposal to remove certain operating expenses from the scope of the funding agreement which are difficult to predict and/or commercial in nature. The exclusions are; litigation expenses, property management expenses, Security Custodian expenses, bank and broking fees, and provisions for ESAS and NZClear services. Excluding these activities is not expected to materially impact the operating expense numbers above. A statement of expenditure under each of these items will be reported in the Bank's annual report.

10. The Treasury is supportive in a substantial uplift in the Bank's resourcing, and particularly with the Bank's intent to increase its financial supervisory capability. In assessing the Bank's proposal, the Treasury noted that capacity constraints across the public sector exist. The Bank has reassured me that its plans are feasible, that it will draw on a number of recruitment strategies to support its FTE growth, and that it will take an All of Government approach to its IT investment strategy.

Financial Implications

11. The Bank's revenues typically exceed its expenses, with any excess revenue paid back to the Crown through an annual dividend, in accordance with the dividend principles stated in the Bank's Statement of Intent.

12. Whilst agreement to this funding agreement will mean the Bank will retain more revenue for its expenses and therefore a lower dividend, the Bank's funding path is still expected to have a positive OBEGAL impact over the period of the new funding agreement. The Bank expects the annual dividend to average $120 million per year over the period of the new funding agreement (subject to fluctuations in investment income and capital requirements). Current estimates have already been built into the Budget fiscal forecasts.

Timing

13. Under the Act, the signed Funding Agreement must be tabled in the House within twelve sitting days of it being signed by myself and the Bank's Governor. I intend to finalise the Funding Agreement and present it to the House as soon as possible, so that it becomes available for other Parliamentary parties.

14. The Funding Agreement must be ratified by resolution in the House before it can take effect (i.e. before 1 July 2020). I will need a Government Notice of Motion and arrange House time for this Notice of Motion to be debated and ratified. It is my intention to seek a debate in the House for sometime in June 2020.

Consultation

15. The Treasury has been consulted and is supportive of the Bank's proposal, as is the Bank's Board.

Communications

16. The Funding Agreement will be published on the Bank's website shortly after the agreement comes into effect on 1 July 2020.

Proactive Release

17. I propose that this Cabinet paper and all other relevant material regarding the Bank's 2020-25 Funding Agreement will be proactively released within 30 business days of the funding agreement coming into effect on 1 July 2020.

Authorised for lodgement

Hon Grant Robertson

Minister of Finance

Date: 13 May 2020