The Treasury

Foreign Reserves Framework Information Release

August 2023

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Key to sections of the Act under which information has been withheld:

[29] 9(2)(d) - to avoid prejudice to the substantial economic interests of New Zealand

[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

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Financial Arrangements to Support the Foreign Reserves Management and Co-ordination Framework

Date:	19 May 2023	**Report No:**	T2023/75
		File Number:	MC-1-0-6

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance**	**Agree** that it is expedient in the public interest to give an indemnity to the Reserve Bank under section 65ZD of the Public Finance Act 1989 in connection with the Foreign Reserves Framework. **Sign** the Foreign Reserves Deed of Indemnity between the Crown and the Reserve Bank. **Agree** with the Associate Minister of Finance, Hon Dr Megan Woods, to the requisite appropriation changes to provide the Reserve Bank with an additional $500 million in capital on or after 1 July 2023.	Wednesday, 31 May 2023
Hon Dr Megan Woods **Associate Minister of Finance**	**Agree** with the Minister of Finance, Hon Grant Robertson, to the requisite appropriation changes to provide the Reserve Bank with an additional $500 million in capital on or after 1 July 2023.	Wednesday, 31 May 2023

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Simon McSweeney-Harte	Graduate Analyst, Macroeconomic and Fiscal Policy	[39]	N/A (mob)	✓
Ben Gaukrodger	Manager, Macroeconomic and Fiscal Policy		N/A (mob)	

Minister's Office actions (if required)

Forward report to Hon Dr Megan Woods

Return the signed report and (Minister of Finance only) Deed of Indemnity to Treasury.

Arrange for presentation of the attached statement to the House.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Treasury Report: Financial Arrangements to Support the Foreign Reserves Management and Co-ordination Framework

Executive Summary

In December 2022, you agreed the Foreign Reserves Co-ordination and Management Framework (the Framework) with the Reserve Bank of New Zealand (the Bank) board [T2022/2709]. The Framework facilitates the Bank's ability to achieve its objectives, recognises both the Crown's and the Bank's interests and roles in relation to the management and use of foreign reserves, and provides a mechanism to identify and coordinate those interests and roles.

The Bank currently has [29], [37] in capital on its balance sheet allocated for risk due to the existing level of foreign reserves. The Bank requires an additional [29], [37] of financial backing to manage the risks of operating in accordance with the Framework, in part because the Framework sets a higher quantum of foreign reserves.

Providing the Bank with additional financial backing (through an indemnity or a capital contribution) does not create an additional cost to the Crown or directly impact net debt because the Bank is consolidated within the Crown balance sheet. The Bank does not spend the financial backing. However, the additional financial backing does enable the Bank to take on additional risk, e.g., foreign exchange risk. Losses and gains arising from these risks would flow through to the Crown.

On 28 November 2022, Cabinet agreed to provide [29], [37] of additional capital to the Bank, noting that the decision to grant an indemnity sits with you as the Minister of Finance [DEV-22-MIN-0280/CAB-22-MIN-0532 refers]. The Treasury recommends that this financial backing is provided through a combination of an additional $500 million in capital, and an indemnity given by the Crown [29], [37] Together, these financial resources would cover financial risks from holding and managing the reserves, as well as potential costs in the event of an intervention using hedged foreign reserves.

Cabinet delegated decisions on the size and structure of the capital contribution to you and the Associate Minister of Finance, Hon Dr Megan Woods [DEV-22-MIN-0280/CAB-22-MIN-0532 refers]. If you agree, capital of $500 million will be provided to the Bank by New Zealand Debt Management (NZDM) on or shortly after 1 July 2023. This capital would be sufficient to cover the Bank's risks resulting from holding and managing a higher level of foreign reserves. Given that much of this risk will be present on the Bank's balance sheet from the time they increase their foreign reserves, the Treasury believes a capital contribution is the best form of financial backing to cover this risk. As the proposed capital contribution will have no impact on net debt, it is managed outside of Budget allowances.

An indemnity would cover situations where the Bank intervenes in the foreign exchange market beyond its positive net foreign asset position where it is effectively 'short' foreign currencies. We expect this would be rare. An indemnity is preferred to an additional capital contribution as the indemnity clearly establishes a transparent link between the financial resources and the balance sheet risk it is provided for, and avoids potential implications of the Crown needing to fund a larger capital provision upfront.

You made the in-principle decision to consider an indemnity further. The Treasury has now, in consultation with the Bank, drafted a proposed Deed of Indemnity which is annexed in this report. The Treasury's advice, outlined in this report, is that issuing the indemnity would be expedient in the public interest, and we recommend that you grant the indemnity under section 65ZD of the Public Finance Act 1989. The Bank is comfortable that the Deed is workable and will form part of the necessary financial arrangements for the Bank to begin operationalising the Framework.

[29], [37]

Recommended Action

We recommend that you:

Recommendations for the Minister of Finance and the Associate Minister of Finance:

a **note** that, on 28 November 2022, Cabinet delegated decisions on the necessary appropriations [29], [37] to the Minister of Finance and the Associate Minister of Finance, Hon Dr Megan Woods, to provide the Reserve Bank of New Zealand with financial backing to operationalise the Foreign Reserves Management and Co-ordination Framework

b **agree** to issue a capital contribution of $500 million to the Reserve Bank of New Zealand on or shortly after 1 July 2023 to support the Foreign Reserves Management and Co-ordination Framework

Agree/disagree *Agree/disagree*

Minister of Finance ***Associate Minister of Finance***

c **agree** to establish the following new appropriation:

Vote	Appropriation Minister	Appropriation Administrator	Title	Type	Scope
Finance	Minister of Finance	The Treasury	Capital contribution to the Reserve Bank of New Zealand	Non-departmental capital expenditure	This appropriation is limited to a capital contribution to the Reserve Bank of New Zealand to support the Foreign Reserves Management and Co-ordination Framework.

Agree/disagree *Agree/disagree*

Minister of Finance ***Associate Minister of Finance***

d **note** that the proposed contribution to the Reserve Bank of New Zealand, as described in recommendation (b) above, will have no initial impact on net debt f approve the following changes to appropriations to give effect to the policy decision in recommendation (b) above, with no impact on net debt:

	$m – increase/(decrease)				
Vote Finance Minister of Finance	**2023/24**	**2024/25**	**2025/26**	**2026/27**	**2027/28 & outyears**
Non-departmental capital expenditure: Capital contribution to the Reserve Bank of New Zealand	500.000	-	-	-	-

Approved/not approved *Approved/not approved*

Minister of Finance ***Associate Minister of Finance***

g **agree** that the proposed change to appropriations for 2023/24 above be included in the 2023/24 Supplementary Estimates and that, in the interim, the increase be met from Imprest Supply

Agree/disagree *Agree/disagree*

Minister of Finance ***Associate Minister of Finance***

Recommendations for the Minister of Finance:

h **note** that, on 28 November 2022, Cabinet agreed [DEV-22-MIN-0280/CAB-22-MIN-0532] that the Crown provide financial backing of [29], [37] to the Reserve Bank of New Zealand to support the Foreign Reserves Management and Co-ordination Framework, delegating the decision on the form of financial backing (capital and/or indemnity) to you as the Minister of Finance

i **note** that the Treasury considers the indemnity is expedient in the public interest under section 65ZD of the Public Finance Act 1989

j **agree** that it is necessary or expedient in the public interest to grant the indemnity to the Reserve Bank of New Zealand under section 65ZD of the Public Finance Act 1989 on the terms set out in the attached Deed of Indemnity

Agree/disagree

k **agree**, subject to your agreement to recommendation (i), to provide an indemnity [29], [37] to the Reserve Bank of New Zealand under Section 65ZD of the Public Finance Act 1989 as set out in the attached Deed of Indemnity to support the Foreign Reserves Management and Co-ordination Framework, with [29], [37] $500 million of financial backing to be provided in capital

Agree/disagree

l **sign** and have witnessed the attached Deed of Indemnity in order to grant the indemnity

Yes/no

m **note** that section 65ZD(3) of the Public Finance Act 1989 requires you to present a statement to the House of Representatives if the contingent liability under the indemnity is greater than $10 million, and

n **agree** to present a statement to the House of Representatives that this indemnity has been issued as soon as practicable after giving the indemnity (suggested wording is provided in Annex A).

Agree/disagree

Ben Gaukrodger
Manager, Macroeconomic and Fiscal Policy

Hon Grant Robertson
Minister of Finance

_____/_____/_______

Hon Dr Megan Woods
Associate Minister of Finance

_____/_____/_______

Treasury Report: Financial Arrangements to Support the Foreign Reserves Management and Co-ordination Framework

Purpose and structure of this report

1. This report provides all the necessary details of the financial backing the Reserve Bank of New Zealand (the Bank) requires to operationalise the Foreign Reserves Management and Coordination Framework (the Framework). The Bank has provided a corresponding report which confirms their acceptance of the proposed financial arrangements to operationalise the Framework [RB6028 refers].

2. The Treasury's view is that the financial backing should be provided through a combination of:

   a an additional $500 million in capital (to cover fiscal risks from holding and managing the reserves, while also partly covering potential losses under a significant intervention), and

   b an indemnity given by the Crown [29], [37] (which would cover potential foreign exchange losses in the unlikely event of a significant intervention using hedged foreign reserves).

3. The first section of this report provides the background to this advice.

4. The second section of this report covers the $500 million capital contribution. If you and the Associate Minister of Finance, Hon Dr Megan Woods, agree, the capital will be provided to the Bank on or shortly after 1 July 2023.

5. The third section of this report covers the indemnity, its key terms, and how it would work in practice.

6. The final section of the report provides a detailed assessment of the public interest test for the indemnity under section 65ZD of the Public Finance Act 1989 (the Act).

7. Annexed to this report is the Deed of Indemnity and a draft Statement of Indemnity that you will need to present to the House of Representatives if you decide to give the indemnity.

Background

8. You signed the Foreign Reserves Management and Coordination Framework (the Framework) on 11 December 2022 [T2022/2709 refers]. The Framework sets the levels and composition of foreign reserves held by the Bank and sets expectations for Ministerial involvement.

9. Over the past year you have received advice from the Treasury and the Bank on:

   a the background, purpose, and key issues for the Framework [T2022/947 refers]

   b the level of reserves specified in the Framework and the approach to hedging the reserves to manage exchange rate risk [T2022/1497 refers]

   c the financial resources required to manage the risk created by the Bank holding, managing, and using the reserves, and issuing a direction relating to the Bank's capital position and financial risk management [T2022/2157 refers], and d the contents of the Framework, the processes and timeframes for establishing the required financial settings, and the issuance of a direction to the Bank relating to its capital position and financial risk management [T2022/2709].

10. The Bank's current level of foreign reserves for intervention have not been updated to reflect the growth in the New Zealand economy and global financial markets and may no longer be sufficient in some scenarios. Under the Framework, the Bank will increase its foreign reserves held for intervention purposes [29], [37] The Bank also has foreign reserves for liquidity management, [29], [37] under the Framework. The level of foreign reserves under the Framework increases New Zealand's economic resilience by providing increased capacity for the Bank to intervene to support its financial stability and monetary policy objectives.

11. The increase in foreign reserves requires the Bank to have additional financial backing from the Crown to manage the associated risk. On 28 November 2022 Cabinet agreed to your recommendations to provide a mix of capital and indemnity [29], [37] to enable the Bank to manage the financial risk of holding and using the increased reserves [DEV-22-MIN-0280/CAB-22-MIN-0532 refers].

12. As has been agreed under the Framework, the Bank will have pre-positioned financial backing to build up its foreign reserves and undertake interventions (albeit with the expectation to brief the Minister of Finance prior to intervening, where practicable). While financial stability interventions can create significant fiscal risk, pre-positioned financial backing is appropriate for instances where there is an urgency to intervene, limited or no opportunity to co-ordinate with fiscal policy, and it is very unlikely that the Minister of Finance would refuse an intervention on the basis of financial risk. Prepositioned financial backing also gives the market confidence, helping mitigate crises.

13. Foreign reserves are unhedged when the foreign currency asset (e.g., USD) is funded by a New Zealand dollar (NZD) liability. This exposes the Bank to exchange rate risk, as the value of USD may fall relative to NZD. A hedged reserve is a foreign currency asset (e.g., USD) and a foreign currency liability (e.g., to pay USD in the future at an agreed exchange rate). Hedging removes the exchange rate risk from holding the reserves. However, if the Bank intervenes with hedged reserves, it would sell the asset but would still hold the liability and subsequent exchange rate changes would result in the Bank making gains or losses.

14. [29], [37]

15. [33]

16. We expect to provide advice on [33] and the broader financial resources of the Bank in the next month.

Capital contribution of $500 million

17. On 28 November 2022, Cabinet agreed to provide [29], [37] of capital to the Bank, and delegated decisions on the size and structure of the capital contribution to you and Hon Dr Megan Woods [DEV-22-MIN-0280/CAB-22-MIN-0532 refers].

18. The Treasury recommends that $500 million [29], [37] financial backing be provided to the Bank in the form of capital to allow the Bank to hold its foreign reserves position. The form of financial backing recommended in this report (capital and indemnity) and the respective quanta are based on the risks associated with holding, managing and intervening with foreign reserves under the Framework. Certain risks, such as exchange rate, interest rate and counterparty risks, will be present immediately upon simply holding the increased foreign reserves and the $500 million in capital, as determined by the Bank's loss modelling work, is sufficient to cover these risks. [29], [37]

19. The $500 million capital figure has been determined by the Bank's loss modelling work, based on severe but plausible scenarios and the Treasury is comfortable with this assessment. The Bank has confirmed that $500 million is sufficient, provided that a [29], [37] indemnity is agreed.

20. The capital contribution forms a package of additional financial resources to support the overall increase in risk associated with holding increased foreign reserves. The capital contribution is the most appropriate form of financial backing to supplement the indemnity, as much of the risk associated with holding increased foreign reserves will be present on the Bank's balance sheet as soon as they increase their foreign reserves.

21. For the capital contribution to be completed, you and the Associate Minister of Finance, Hon Dr Megan Woods, need to agree to establish the new appropriation and authorise the proposed changes to appropriations to give effect to the capital contribution. As detailed in the table below, the capital is categorised as non-departmental capital expenditure and the appropriation's scope is limited to a capital contribution to the Bank to support the Framework.

Vote	**Appropriation Minister**	**Appropriation Administrator**	**Title**	**Type**	**Scope**
Finance	Minister of Finance	The Treasury	Capital contribution to the Reserve Bank of New Zealand	Non-departmental capital expenditure	This appropriation is limited to a capital contribution to the Reserve Bank of New Zealand to support the Foreign Reserves Management and Co-ordination Framework.

22. If you and Hon Dr Megan Woods agree to the capital contribution, the capital will be provided through a cash transfer from the Crown settlement account. The Bank will not be able to begin building up its unhedged foreign reserves until the capital contribution is issued, which will be on or shortly after 1 July 2023.

23. As the Bank is consolidated in the overall Crown balance sheet, the capital contribution will have no impact on net debt. However, any gains or losses the Bank makes from holding and managing higher levels of foreign reserves would flow through to net debt.

Decision to grant an indemnity [29], [37] under section 65ZD of the Public Finance Act 1989

The Public Finance Act 1989 provides you with the legal authority to grant an indemnity

24. Section 65ZD of the Act provides the Minister of Finance with the legal authority to grant an indemnity, on behalf of the Crown, if the Minister considers it necessary or expedient in the public interest to do so. The Minister may give the indemnity on any terms or conditions they see fit.

25. The Treasury recommends that you grant an indemnity to the Bank that covers [29], [37] of losses incurred by the Bank using its hedged foreign reserves to undertake an intervention in accordance with the Framework and its objectives.

26. The indemnity is preferred to the alternative of simply providing a one-off capital contribution of [29], [37] because an indemnity clearly links the financial resources to the balance sheet risk for which it is provided. Furthermore, an indemnity is suited to cover the risk associated with hedged reserves as financial backing would only be necessary if the Bank uses its hedged reserves to intervene, which is expected to be a rare occurrence.

27. The indemnity would cover losses the Bank incurs from entering into a net negative open foreign exchange position[1] for interventions under the Framework. A net negative open foreign exchange position would occur if the Bank were to sell its hedged reserves and did not hold offsetting unhedged reserves. This happens because a hedged reserve is both an asset (e.g., USD) and a liability (e.g., to pay USD in the future at an agreed exchange rate). If the Bank were to intervene with hedged reserves, they would sell the asset but still hold the liability. If the exchange rate were to subsequently change, the Bank would make gains or losses. The indemnity covers the Bank for foreign exchange losses arising in this situation.

The Deed of Indemnity included as Annex B has the following key terms:

28. Under the proposed indemnity, the Bank's losses are guaranteed, but gains are not paid back to the Crown. However, gains that put the Bank above its target capital level are typically remitted to the Crown in the annual dividend process, which you determine with regard to the Bank's recommendations, the principles set out in the Bank's statement of financial risk management, and any other relevant matters. Both realised and unrealised foreign exchange losses are covered, [29], [37] A detailed breakdown of the key terms of the indemnity is provided below:

[1] The net open foreign exchange position covers the Bank's entire foreign exchange exposure and is aggregated into New Zealand dollars. The Bank is in a net negative open foreign exchange position when the net amount in New Zealand dollars of all assets and liabilities held by the Bank that relate to its foreign reserves and are denominated in foreign currencies is negative.

29. Section 1.1 defines a foreign-exchange intervention (FX intervention) as: *an intervention by the Reserve Bank through the sale of foreign reserves by the Bank (which, for the avoidance of doubt may be through one transaction or a series of transactions that form part of the same intervention action).*

30. Section 3.1 specifies that: *with effect on and from the date of the Deed, the Crown agrees to indemnify, in accordance with the terms and conditions of the Deed, the Bank in respect to losses incurred by the Reserve Bank following an FX intervention, provided that the relevant FX intervention occurs prior to the Framework end date and was undertaken in accordance with the Framework.*[2]

31. Section 3.2 specifies that: [29], [37]

32. Section 4.3 describes how losses are to be calculated under the indemnity.

    a Section 4.3(a) describes losses as: *net losses (if any), whether realised or unrealised, which arise as a result of dealing with foreign exchange in accordance with the Framework and as a direct result of an FX intervention that creates, or results in an increase in, the Bank's net negative open foreign exchange position. Losses are limited to those due to the then-current net negative open foreign exchange position.*

    b Section 4.3(b) states that: *losses exclude interest costs, holding costs, or other costs incurred by the Bank.*

    c Section 4.3(c) states that: *for the purposes of this Deed, net negative open foreign exchange position means a negative net foreign exchange asset position calculated as the net amount in NZD of all assets and liabilities held by the Reserve Bank that relate to its foreign reserves and are denominated in foreign currencies, in a way that is consistent with the application of accounting standards by the Reserve Bank in its published annual report.*

    d In practice, the Bank can only make a loss that needs to be indemnified if the Bank performs a foreign exchange intervention using hedged reserves *and* the New Zealand Dollar falls post intervention.

33. Section 5.1 states that: *the Crown will, in absence of manifest error by the Reserve Bank* [29], [37] *pay the full amount of the losses specified in a claim notice to the Reserve Bank within 30 business days of receipt of the claim notice, unless the Crown (acting through The Treasury) is not satisfied, acting reasonably, that there is sufficient evidence to support the claimed losses.*

    a In practice, this means the Crown will cover the Bank's losses [29], [37] provided the Bank gives the Crown (acting through the Treasury) sufficient evidence to support the claimed losses.

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[2] Section 3.1 (c) states that an indemnified event excludes foreign exchange interventions that were *undertaken by the Bank as a result of a direction of the Minister under section 134 of the Reserve Bank of New Zealand Act 2021; for the purposes of managing liquidity in the domestic financial system in accordance with paragraphs 3.5-3.6 of the Foreign Reserves Framework; and used to meet New Zealand's international commitments to the International Monetary Fund in accordance with paragraph 3.8 of the Foreign Reserves Framework.*

34. Section 6.1 details the reporting requirements under the Deed

a Section 6.1(a) states that: *after an FX intervention that results in a net negative open foreign exchange position and/or a change in the composition of an existing net negative open foreign exchange position, the Reserve Bank will provide details on the total amount of resulting gains and losses until the Reserve Bank ceases to be in a Net Negative Open Foreign Exchange Position, together with any other information as the Crown (acting through The Treasury) may reasonably require for the purposes of enabling The Treasury to forecast the Crown's potential obligations from the aforementioned FX intervention under this Deed and reflecting the Crown's obligations under this Deed in the Treasury's accounts and the Crown's accounts.*

b In practice, this means that following a foreign exchange intervention that opens the Bank up to losses, the Bank is required to provide information to the Treasury until the Bank ceases to be in a net negative open foreign exchange position that allows the Treasury to forecast the Crown's potential obligations.

35. Section 8 details the termination conditions of the indemnity.

a Section 8.1(a) states that: *the Crown's obligations under this Deed may be terminated at any time by agreement in writing between the Crown and the Reserve Bank, if the Minister of Finance elects to replace this financial backing with another form of financial backing, the Reserve Bank of New Zealand Act 2021 is amended such that this indemnity is no longer necessary, or if the Minister of Finance decides to cease indemnification under this Deed to the Reserve Bank, noting that this may necessitate a review of the Framework.*

b Section 8.1(b) states that the indemnity will automatically terminate if the Framework ends.

c Other than for the above reasons, the indemnity is irrevocable. Terminating the indemnity does not release the Crown from any liability accrued under the indemnity prior to termination.

36. The Framework covers interventions for both financial stability and monetary policy. It is expected that an FX intervention using hedged reserves (thus opening up the possibility of the indemnity being triggered) would typically only be performed by the Bank for the purpose of financial stability, i.e., stabilising financial markets when foreign exchange markets are dysfunctional, or the convertibility of the New Zealand Dollar for foreign currency is impaired.

37. The terms of the Deed of Indemnity are relatively asymmetrical.[3] This asymmetry is preferable to make the indemnity workable for the Bank in a similar way that providing the capital upfront would. The following terms of the indemnity give rise to an asymmetry between the Bank and the Crown:

a The indemnity is one way, meaning that the Bank's losses following an FX intervention would be guaranteed by the Crown but any gain the Bank makes following an FX intervention would not be paid to the Crown under the indemnity.

b Losses, as described in section 4.3(a) of the indemnity, include both realised and unrealised losses. This in theory allows the Bank to claim for losses on its foreign exchange positions which are not then closed, and subsequent foreign exchange movements could result in a net gain (or a smaller loss for which they have already claimed) once the position is closed.

[3] By contrast, under the Large Scale Asset Purchase (LSAP) Programme indemnity gains and losses were paid to and from the Crown.

38. It is preferable for the indemnity to be one way and to include both realised and unrealised losses as this gives confidence that the Bank can remain sufficiently capitalised and makes the indemnity operationally workable for the Bank. It is possible that the Bank would be performing an FX intervention in a crisis and the asymmetrical terms of the indemnity allow the Bank to respond adequately and avoid negative equity, ensuring market confidence.

39. The Treasury is comfortable with this asymmetry as, although in some circumstances the Bank could end up with more capital than it strictly requires, it is expected that any gain the Bank makes will be reflected in the dividend the Bank pays the Crown on an annual basis, which you determine with regard to the Bank's recommendations, the principles set out in the Bank's statement of financial risk management, and any other relevant matters. Any realised FX gains that resulted in the Bank being above its target capital would likely be paid to the Crown. [29], [37]

You must be satisfied it is in the public interest to give an indemnity on the terms set out in the Deed of Indemnity

40. The Deed of Indemnity is legally binding and, if you decide to execute it, will constitute a commitment by the Crown to indemnify the Bank as described in its terms.

41. Section 65ZD of the Act empowers you, as the Minister responsible for the administration of the Act, to grant an indemnity to a person, organisation or government if it appears to you to be 'necessary or expedient in the public interest' to do so, and to give such an indemnity on any terms and conditions that you think fit.

42. In summary, on balance, the Treasury's view is that the indemnity is expedient in the public interest for the purposes of the "public interest test" in section 65ZD of the Act and we recommend that you grant an indemnity under section 65ZD of the Act. A detailed assessment of the public interest test is provided below.

Treasury's advice is that giving the indemnity to the Bank, as outlined in the annexed Deed of Indemnity, is in the public interest

43. It is a matter for you to decide whether you are satisfied that it is necessary or expedient in the public interest to indemnify the Bank on the terms outlined in the Deed of Indemnity.

44. The following paragraphs set out factors that the Treasury considers are relevant to your assessment of the public interest test. You may decide to ignore these factors, or take into account other factors you consider relevant, and you may give weight to the factors referred to below as you deem fit. You should make an independent decision. You are not bound to accept the assessment below.

45. The Act does not define 'the public interest'. However, it is generally accepted that the public interest is broadly equivalent to the concept of the public good and can cover a wide range of values and principles relating to the public good, or what is in the best interests of society. In the context of the Act, the public interest should be viewed in a New Zealand context, that is, in the interest of the New Zealand public.

46. The Bank's financial stability objective is defined as protecting and promoting the stability of New Zealand's financial system. The Bank's economic objectives with respect to monetary policy include: (a) achieving and maintaining stability in the general level of prices over the medium term; and (b) supporting maximum sustainable employment. Parliament has recognised, through section 3(a) of the Reserve Bank of New Zealand Act 2021, that the Bank adhering to these objectives contributes to the overall purpose of the Act to "promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy". The Treasury considers that there is a clearly identifiable public interest in ensuring that the Bank is able to deliver on its financial stability and economic objectives.

47. The Bank holds foreign reserves to meet its statutory objectives and functions under the Reserve Bank of New Zealand Act 2021. Sufficient reserves allow for interventions in the event of a crisis, and having that capability provides market confidence. The Bank's current level of foreign reserves for intervention have not been updated to reflect the growth in the New Zealand economy and global financial markets and may no longer be sufficient in some scenarios. Under the Framework, the Bank's foreign reserves for interventions will increase to [29], [37] To allow the Bank to meet its financial stability and economic objectives, the Bank would require additional financial backing to manage the additional risks.

48. Cabinet agreed on 28 November 2022 that the Bank should be provided [29], [37] of financial backing to operationalise the Framework, which could be provided through an indemnity and capital contribution [DEV-22-MIN-0280/CAB-22-MIN-0532 refers]. An indemnity provides the financial backing required by the Bank to use its foreign reserves for intervention purposes as set out in the Framework. A capital injection of [29], [37] from the Crown to the Bank would also provide the required financial backing but the indemnity provides transparency as to the use of capital and clearly links the financial resources to the balance sheet risk for which it is provided.

49. To the extent the Crown indemnity (as set out in the attached Deed of Indemnity) is required to enable the Bank to operationalise the Framework, the indemnity can fairly be described as securing outcomes that benefit the public interest.

Necessary or expedient

50. The Bank needs additional financial backing before they would be willing to hold, and intervene with, the foreign reserves. This additional financial backing would enable the Bank to manage the risk of losses associated with operationalising the framework. Without additional financial backing, losses could result in the Bank entering a negative capital position, which could have reputational effects. [33]

51. Under the Framework, the Bank will hold a combination of hedged and unhedged foreign reserves to balance the costs and risks associated with both portfolios. [29], [37] but it would require financial backing in the event the Bank uses its hedged foreign reserves to intervene in the market and makes a significant loss.

[4] The Bank also has foreign reserves for domestic liquidity management purposes, [29], [37] under the Framework.

52. Given the above, the Bank has indicated that it would not be able to increase its foreign reserve holdings to the level set out in the Framework and use these additional foreign reserves for an intervention without Crown financial backing. As also discussed above, we consider that a mix of capital and an indemnity is the most appropriate form of financial backing.

53. In the circumstances, officials consider that the more appropriate threshold under section 65ZD would be the “expedient” threshold rather than the “necessary” threshold.

Risks and mitigations

54. In addition to the usual risks associated with indemnifying an organisation, the following risks to the Crown are present under the terms of the Deed of Indemnity:

- **No time limit on the indemnity:** As there is no time limit on the indemnity, the Crown’s liability under the indemnity will be permanent, unless terminated in specified circumstances. The Framework will be reviewed by the Bank and the Treasury at least every five years, and we would expect to review the financial backing arrangements every five years as well.

- **The indemnity is asymmetrical:** As detailed in the previous section, the indemnity is asymmetrical and does not require the Bank to remit foreign exchange gains to the Crown. This would also be the case were capital provided. The risk is offset by the expectation that any gain the Bank makes would be reflected in the dividend the Bank pays the Crown on an annual basis, which is further explained below.

55. The risks to the Crown under the terms of the Deed of Indemnity are mitigated through:

- [29], [37]

- **Annual dividend:** Under the Reserve Bank Act 2021, the Minister of Finance must determine the amount that the Bank must pay to the Crown as an annual dividend for the financial year having regard to the recommendation of the Bank, the principles set out in the statement of financial risk management, and any other relevant matters. Any realised FX gains that resulted in the Bank being above its target capital would likely be paid to the Crown.

- **Reporting requirements of the indemnity:** The Deed of Indemnity includes reporting requirements on the Bank to enable the Treasury to forecast the Crown’s potential obligations following a foreign exchange intervention and to reflect the Crown’s obligation under the Deed of Indemnity in the Treasury’s accounts and the Crown’s accounts. Furthermore, the Framework requires the Bank to provide reporting on the foreign reserves, including the level and composition, as well as regular progress and performance reporting.

- **Monitoring and reporting under the Framework:** Under the Framework the Bank is required to provide regular progress and performance reporting and signal any developing issues and emerging risks or opportunities, where appropriate. The Bank will provide reporting on the foreign reserves, including the level and composition.

- **The composition of foreign reserves under the Framework:** [29], [37]

- **The foreign exchange interventions covered by the indemnity are expected to be rare:** Foreign exchange interventions for financial stability (stabilising financial markets when foreign exchange markets are dysfunctional, or the convertibility of NZD for foreign currency is impaired) that would yield losses under the indemnity are expected to be rare.[7] Financial stability interventions would typically only take place during a crisis. Interventions are not common and are not intended to maintain a fixed level of exchange rate. In practice, the cost to the Crown only occurs when the Bank performs a foreign exchange intervention *and* the New Zealand Dollar falls post intervention. The probability of realisation is thus considered remote.

- **Alternatives bear more risk:** The purpose of holding hedged reserves is to mitigate the risk of exchange rate fluctuations. However, performing a foreign exchange intervention using hedged reserves creates a risk. The alternative would be for the Bank to hold 100% unhedged reserves, but holding 100% unhedged reserves would unnecessarily expose the Bank to exchange rate fluctuations and comes at a cost (resulting from interest differentials). The risk created by the possibility of using hedged reserves for foreign exchange intervention is considered less than the risk of holding 100% unhedged reserves.

- **The Bank operates within particular accountability arrangements:** The Bank is different from most indemnified organisations because it is a part of the Crown and operates within particular accountability arrangements. These arrangements include but are not limited to producing statutory accountability documents, appearing annually before the Finance and Expenditure Committee, being subject to audits from the Office of the Auditor-General, and the regular monitoring activities the Treasury undertakes as the monitor appointed under the Reserve Bank of New Zealand Act 2021. The Reserve Bank of New Zealand Act 2021 also requires the Bank's board to ensure that the Bank operates in a financially responsible manner and prudently manages its assets and liabilities.

Benefits

56. The principal benefit of providing the indemnity is that the Bank will be able to begin operationalising the Framework [29], [37] Allowing the Bank to operationalise the framework better enables the Bank to fulfil its financial stability and economic objectives (which is expected to have positive flow-on effects for the wider economy and the public interest).

No better alternatives to an indemnity

57. As noted above, without financial backing the Bank would not operationalise the Framework. Other than the Crown, there is no other entity within New Zealand that would be able – or willing – to indemnify the Bank for the amounts required.

[29], [37]

[7] Generally, we would expect monetary policy interventions to be more likely but with a lower likelihood of losses compared to financial stability interventions.

58. The only reasonable alternative to an indemnity would be to provide the financial backing through a one-off capital contribution of [29], [37] However, the indemnity has the advantage of being a non-fungible [29], [37] financial resources for the policy objective rather than simply increasing the Bank's overall capital position. For this reason, alongside the remote probability of financial loss eventuating, officials consider the indemnity to be the best available option.

Assessment of risks and benefits against the public interest threshold

59. In light of the above, officials consider that:

a there is a public interest in giving an indemnity to the Bank on the terms set out in the Deed of Indemnity

b the benefits of the proposed indemnity appear to outweigh those risks when mitigations are taken into account, and

c although a capital injection presents an alternative to the indemnity, the indemnity clearly establishes a transparent link between the financial resources and the balance sheet risk it is provided for, and avoids potential implications of the Crown needing to fund a larger capital provision upfront.

60. Accordingly, on balance, the Treasury is of the view that the indemnity appears to be expedient in the public interest and we recommend that you grant the indemnity under section 65ZD of the Act.

Next steps

61. If you agree that it is necessary or expedient in the public interest to give the indemnity, you will need to:

a sign the attached Deed of Indemnity, and

b present a statement to the House that the indemnity has been given as the contingent liability exceeds $10 million, in accordance with section 65ZD(3) of the Act. A draft statement is appended for your consideration. Your office can liaise with the Office of the Clerk of the House about the necessary arrangements for presenting the statement to the House.

62. For the capital contribution to be completed, you and the Associate Minister of Finance, Hon Dr Megan Woods, need to agree to establish the new appropriation and authorise the proposed changes to appropriations to give effect to the capital contribution. Once approved, New Zealand Debt Management will begin working on the transaction, which will take place on or shortly after 1 July 2023.

63. [29], [37]

64. [33]

Annex A – Draft Statement of Indemnity given under section 65ZD of the Public Finance Act 1989

On [date] I, Grant Robertson, Minister of Finance, on behalf of the Crown, gave an indemnity to the Reserve Bank of New Zealand in relation to the Foreign Reserves Co-ordination and Management Framework dated [date].

Dated at this day of 20

Grant Robertson
Minister of Finance

Annex B – Foreign Reserves Deed of Indemnity