The Treasury

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

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RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Reserve Bank of New Zealand Funding Proposal

To	Hon Grant Robertson Minister of Finance	**Date**	20 March 2020
Authorised by	Adrian Orr Governor Reserve Bank of New Zealand	**Report no**	5402
Prepared by	Nick Jeffs, Head of Performance and Corporate Relations Sophie Bishop, Adviser Planning and Performance	**Security**	

Action Sought

Action sought	Deadline
Note the Reserve Bank of New Zealand Funding Proposal for the period 1 July 2020 to 30 June 2025. **Agree** to the removal of the proposed operating expenses from the funding agreement (see paragraph 12). **Indicate** if you would like to discuss this report or require any further information.	As soon as convenient

Reserve Bank Contact for Telephone Discussion (if required)

Name	Position	Telephone
Adrian Orr	Governor	[39]
Simone Robbers	Assistant Governor, Governance, Strategy and Corporate Relations	[35]
Mike Wolyncewicz	Assistant Governor and Chief Financial Officer	[35]

Actions for the Minister's Office Staff

Return the signed report to the Reserve Bank as soon as convenient.

Note any feedback on the quality of the report.	

Reserve Bank of New Zealand Funding Proposal

Purpose

1. This memorandum attaches the Reserve Bank of New Zealand (RBNZ) Funding Proposal[1] for your consideration. It provides our rationale for the increase; the assumptions applied to reach this position; and the risks that are likely to crystallise if funding does not increase to the proposed levels. It also sets out the proposed exclusions from the funding agreement.

2. Please note the Funding Proposal and financial forecasts do not account for the evolving COVID-19 situation. The situation will require reprioritisation of activities in 2020/21 and we are uncertain what impact this could have on the Bank's forecasted operating expenses. However, now more than ever we want to ensure we are well placed for the future.

Background

3. The current Five-Year Funding Agreement for the RBNZ has been in place since July 2015 and is set to end on 30 June 2020. The Bank has prepared the attached Funding Proposal with oversight and support from the RBNZ Board and in consultation with the Treasury. The attached Funding Proposal splits into two sections:
    - Section one outlines the 'Case for change' and provides a high-level overview of the need for investment.
    - Section two, which includes Appendices 1-7, provides further detail of how the funding will be allocated across the Bank's functions.

Rationale and underlying assumptions

4. While the Funding Proposal details the broader drivers of change and the direction of the Bank over the next five year years, our proposed uplift is primarily focused on addressing critical risks to the Bank and financial system. This section sets out how this Funding Proposal was formed, including how we have:
    a. Prioritised our activities for the next five years
    b. Determined our annual average remuneration increase
    c. Considered the feasibility of our headcount growth and IT build, and
    d. Determined the exclusions from this plan.

Prioritisation of activities

5. We have applied a 'risk appetite' approach to prioritise high impact activities that enable us to meet our current mandate and scale to our anticipated future requirements. Risks that threaten the Bank's ability to discharge its mandate and addressing the most critical areas of underinvestment are the focus of our operating expenses in year one, followed by a phased investment over the remainder of the funding period.

[1] The legal Funding Agreement will be provided when the approach is agreed.

6. As we have focused on investing in the most critical areas to maintain our functions, there is little room for efficiency gains. What we have proposed is very much a moderate rather than a gold-plating approach to investment. Even with our projected increase in operating expenses we remain on the cost-effective end of the scale compared to our international peers (central banks and prudential regulators). The following areas represent a significant proportion of the funding allocation, but provide good examples of this conservative approach.

   a. **Digital Services**: Over the past five years, the Bank has not invested in technology and information systems to the extent that other central banks have and there are very little opportunities to deliver efficiency gains. With this increase in funding, we will be able to carry out risk mitigation and maintenance activities, but will also be able to progress technology solutions that are resilient, flexible and innovative.

   b. **Supervision** – While we propose significant uplift in Supervision, we continue to take a conservative approach when compared to our international peers. For example, the IMF FSAP review[2] found that supervisory resources across all sectors is insufficient, and recommended that we move towards a more intensive approach. However, we will still be taking a relatively low-intensity approach to supervision, with a continued emphasis on self and market discipline, and increases will be made at a steady pace.

   c. **Building and premises strategy** – there remain structural issues with Number 2 the Terrace, but we propose continuing to mitigate and manage them rather than find more comprehensive and costly solutions. A good example is our management of asbestos. We have controls in place to manage the risk, but the asbestos will not be removed completely due to the very significant cost of doing so. Likewise, with our expansion of our Auckland office, we have chosen more cost effective options, phased in over a period, rather than choosing a more costly option upfront.

Average remuneration increase

7. We have drawn on strong empirical evidence that average 10-year wage inflation is 3-3.5% and CPI inflation is about 2%. Wages should be growing faster than CPI (i.e. positive real wage growth) if the economy is growing (i.e. positive real GDP growth) and therefore, there is more income to be distributed between workers and owners of capital.

8. Our modelling assumes a 3% average remuneration increase year-on-year applied across the Bank. However, this would be based on a targeted approach, for example a modest increase for established staff performing satisfactorily, higher increases for graduates and junior analysts on a steep progression path, and appropriate performance based rewards for the most highly performing staff.

Feasibility of our headcount growth and IT build

9. We are well aware of the competitive labour market we are operating in for staff, particularly in our key areas of uplift: supervision and digital services. While the financial services industry is our main competition, we are aware that some public sector agencies are also in the market to recruit similar types of people. For that reason, we are committed

[2] Financial Stability Assessment Programme, 2017

to working with others across Government to minimise competing against one another for the same skills.

10. We will draw on a number of recruitment strategies. These include seeking specialist expertise from the international market, collaborating with other agencies, fast tracking the development of existing staff members, expanding our graduate programme and retraining staff into roles that require different skillsets. With our expansion in Auckland, we will also be looking to recruit in that market rather than relying on filling positions in Wellington.

11. Our approach to digital transformation is consistent with wider all-of-government IT strategy and principles. We will continue to leverage All of Government capabilities and collaborate with agencies to harness efficiencies in technology and data sharing.

Proposed exclusions from the funding agreement

12. Certain operating expenses, such as actuarial gains and losses on the Bank Staff Superannuation and Provident Fund, have been excluded from past funding agreements on the basis that they are unpredictable, outside the Bank's control and potentially of a size that could crowd out other activities. Actuarial gains and losses are reported separately in the Bank's Annual Report. We have proposed the exclusion of further potential operating expenses (and operating income) from the funding agreement that are unpredictable and undermine the effectiveness of the agreement, including:

    a. Litigation expenses

    b. Net property management expenses

    c. Security custodian expenses and bank fees, and

    d. ESAS and NZClear.

The rationale for the proposed exclusions are provided in Appendix 7 of the Funding Proposal. The five-year forecasts in the Funding Proposal include these expenses and the following table shows the impact on the Bank's net operating expenses if excluded:

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)**

Risks to the Bank and the financial system

13. 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. This section provides an outline of the key risks across the Bank's mandate and the potential impact on the Bank and the wider financial system if we do not have sufficient funding to mitigate the risks or achieve our purpose.

14. We are currently operating with significant risks across our mandate, and ultimately the financial system. Our 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 our 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, 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 our 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. This includes being able to build our performance management and development frameworks and refresh our employee value proposition.

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

    g. Property and health risks to all of the Bank's Wellington tenants and operations face disruptions including, but not limited to, seismic events and seismic-caused asbestos exposure in the Bank's Wellington premises.

15. If we cannot address our key risks, the potential impact of harms crystallising will result in more severe consequences on the financial system. At a reduced funding level we do not consider we can deliver on our core mandate nor prepare the Bank adequately for our suite of new legislation. For this reason, we have ruled out a lower cost funding package as this would only provide a marginal increased benefit above the status quo. Such investment would be limited to providing maintenance on aging systems and "patch-work"

solutions. The Bank would not be in a position to future-proof our operations, deliver efficiency gains and provide optimal returns to the Crown.

The numbers at glance

16. Our proposal requires an increase in net operating expenses from $79.9m[3] in 2019/20 to $124m in 2020/21[4]. Over the five-year funding period, the annual average uplift in operating expenses is $47m. Of this uplift:

    a. Investing in our people accounts for 44% of the additional expenses with headcount increasing by 172 FTE.

    b. Investing in our operations accounts for 40% of the additional expenses and covers major projects such as the Future of Cash and Digital Services delivery.

    c. Investing in our assets accounts for 16% of the additional expenses[5], which covers property and security, IT software and hardware.

Recommendation

1. It is recommended that you:

    a) Note the Reserve Bank of New Zealand Funding Proposal for the period 1 July 2020 to 30 June 2025.

    b) Agree to the removal of the proposed operating expenses from the funding agreement (see paragraph 12). Agreed.

    c) Indicate if you would like to discuss this report or require any further information. No.

Hon Grant Robertson
Minister of Finance

6 / 4 /2020

Adrian Orr
Governor
Reserve Bank of New Zealand

20/03/2020

3 The budgeted net operating expenses for 2019/20 is $79.9m, against a funding agreement amount of $63.2m. The additional budgeted expenditure is sourced from underspending of the funding agreement in the preceding four years.

[4] Net operating expenses are made up of baseline expenses (operating expenses plus net currency issue, less operating income), a contingency provision and an annual average uplift of $47m. We have broken the uplift down into our three key focus areas: people, operations, and assets throughout the document.

[5] Annual depreciation expenses, some of which go beyond the 2020-2025 funding period. The assets are funded by the Bank's balance sheet.