Reserve Bank of New Zealand
Te Pūtea Matua

05/2022

Financial Stability Report

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This report is published pursuant to section 165A of the Reserve Bank of New Zealand Act 1989, which states that a financial stability report must:

(a) report on the soundness and efficiency of the financial system and other matters associated with the Bank's statutory prudential purposes; and

(b) contain the information necessary to allow an assessment to be made of the activities undertaken by the Bank to achieve its statutory prudential purposes under this Act and any other enactment.

In addition, under the Memorandum of Understanding between the Minister of Finance and the Governor of the Reserve Bank of New Zealand, the Reserve Bank's *Financial Stability Report* will report on matters relating to the soundness and efficiency of the financial system, including any build-up of systemic risk, and the reasons for, and impacts of, the use of macroprudential policy instruments.

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Financial Stability Report

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CHAPTER 1
Financial stability risk and policy assessment

The Financial Stability Report covers matters relating to the soundness and efficiency of the financial system. It includes an assessment of any build-up of systemic risk, and the resilience of the financial system to both the most likely scenario and potentially more severe scenarios. It also reports on regulatory and supervisory initiatives, including the use of macroprudential policy, to support financial stability.

Key points

- The New Zealand financial system remains well placed to support the economy. Banks' capital positions have increased over the past two years ahead of upcoming higher capital requirements. This strengthens the banking sector's ability to absorb losses and maintain lending in the event of a downturn.
- Global interest rates have increased as inflationary pressure has been stronger and more persistent than initially thought by central banks. By acting to anchor longer-term inflation expectations, removing monetary stimulus in the near term reduces the need for greater tightening in the future and helps to contain financial stability risks.
- House prices remain above sustainable levels despite recent declines. While a gradual adjustment to a more sustainable level is desirable for the stability of the financial system, a larger correction remains a possibility. Recent buyers with limited equity are particularly vulnerable to house price declines. Furthermore, a large fall in house prices would significantly reduce housing wealth and could lead to a contraction in consumer spending. Some recent mortgage borrowers could face difficulty servicing their debts as interest rates rise alongside higher living costs.
- Russia's invasion of Ukraine also poses risks to financial stability, especially if the conflict escalates. While our direct trade exposures are limited, commodity prices have increased, adding to the risk that long-term inflation expectations rise. If interest rates need to increase more than currently anticipated to contain inflationary pressure, this could lead to a softening in the labour market over time, which together could pose a risk to households' ability to service their mortgages.
- New Zealand's Omicron outbreak has curtailed spending. Businesses are also currently under pressure from supply chain issues, staff shortages, and higher commodity prices. Targeted fiscal support remains in place for those most affected, but underlying weaknesses in some industries may be revealed as this is removed.

- With these recent developments, the near-term risks to the financial system have increased. To address housing-related risks, we tightened loan-to-value ratio requirements in November 2021. We are also designing a framework for operationalising debt-to-income (DTI) restrictions. We intend to have the framework finalised by late 2022, so that restrictions could be introduced by mid-2023 if required. Given slowing credit growth and an increase in banks' serviceability test rates, we do not see an urgent need to impose an interim test rate floor at this stage, but we are monitoring the situation closely.

Global inflation has increased, leading to a removal of monetary stimulus

Consumer price inflation has increased in the major economies to levels not seen in several decades. Energy prices have risen amid geopolitical tensions, and in some economies labour markets have tightened. Demand for goods has put pressure on resources and supply chains, particularly given disruptions caused by COVID-19 are continuing. For example, the recent Omicron outbreak in China and resultant lockdowns have added to existing pressures on supply chains.

To support low and stable consumer price inflation in the future, central banks in most major economies have started to remove monetary support put in place during the pandemic. Wholesale interest rates have increased across all the major economies, albeit from historically low levels (figure 1.1).

The rise in New Zealand interest rates has been large relative to movements in other countries and one of the steepest rises in the past two decades, albeit from a low level. By acting to anchor longer-term inflation expectations, this increase in interest rates helps to reduce the need to further tighten monetary policy in the future. Maintaining low and stable inflation and avoiding unnecessary volatility in financial conditions is preferable for financial stability.

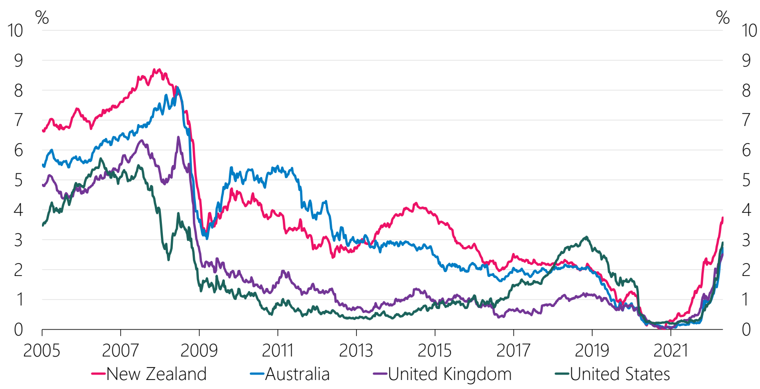
Rising interest rates are putting downward pressure on asset prices

Rising global interest rates have put downward pressure on the prices of assets such as equities and housing. In New Zealand, house prices have declined since November last year (figure 1.2). The borrowing capacity of potential buyers has reduced due to tighter loan-to-value ratio requirements, higher mortgage rates, and changes to responsible lending processes under the Credit Contracts and Consumer Finance Act (CCCFA) 2003. Previous supply imbalances are declining as well, given high levels of residential construction activity and muted population growth. Along with rising interest rates and tax policy changes affecting investors, this continues to point to current prices being unsustainable.

Figure 1.1

2-year wholesale interest rates

(swap rate, weekly average)

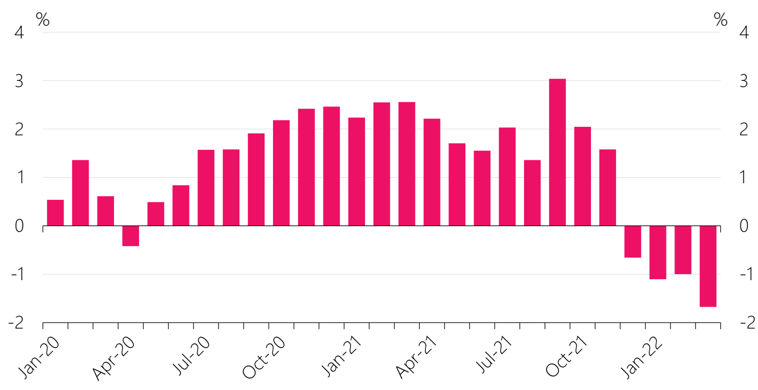


Source: Reuters.

Figure 1.2

New Zealand house price inflation

(monthly, s.a.)



Source: REINZ, RBNZ estimates.

While a gradual decline in house prices to more sustainable levels is desirable from a financial stability perspective, a sharp correction remains a plausible outcome that would have broad economic implications. Recent buyers with limited equity are particularly vulnerable to house price declines. Furthermore, a large fall in house prices would significantly reduce housing wealth and could lead to a contraction in consumer spending, especially when combined with borrowers cutting back discretionary spending due to rising interest rates and higher living costs.

Debt-servicing costs will increase significantly as current fixed-rate mortgages reprice over the coming year. Some recent mortgage borrowers are vulnerable and could face difficulty servicing their debts, but overall the threat to the financial system is limited. Banks kept test interest rates in their serviceability assessments around 6 percent during the pandemic, which remains above current mortgage rates. This provides some reassurance that buffers are in place to ensure debt serviceability continues.

29%

Domestic petrol prices are currently 29 percent above the average from the past five years

Russia's invasion of Ukraine is raising commodity prices and causing volatility in financial markets

By raising commodity prices, the Russia-Ukraine conflict is adding to already elevated consumer price inflation. There is a risk that high inflation becomes embedded in expectations and pricing behaviour, putting pressure on central banks to raise interest rates more than currently anticipated. In this environment, higher interest rates than currently anticipated could make it even harder for households to service their mortgages and lead to a softening in the labour market over time. Our 2022 stress test programme is investigating the risk for banks from higher interest rates and falling house prices, in the context of ongoing inflationary pressures and a slowing economy. Our previous stress test in 2021 showed that banks would be resilient in some scenarios where there is a large fall in house prices and high rates of unemployment.

New Zealand has little direct trade with Russia or Ukraine, so the trade impacts from existing sanctions are likely to be small. Also, with a predominance of pasture-based production, New Zealand's dairy, sheep and beef farmers are relatively less exposed than international peers to the disruptions to grain markets. However, there is much uncertainty about how the conflict will evolve, including a risk of the conflict broadening. Impacts could be particularly acute in Europe, given its geographic proximity, trade linkages and energy-dependent links to Russia. A broad slowdown in global growth, increasing trade protectionism, or further sanctions could amplify the impacts in New Zealand (see Box A for further discussion of the impacts of Russia's invasion of Ukraine in New Zealand).

With increased geopolitical risks and many central banks removing stimulus, the cost of funding for banks in foreign wholesale markets has increased from historically low levels. Banks' current wholesale funding needs are small, partly given slowing credit growth, allowing banks to access funding markets at opportune times. The Reserve Bank's *Funding for Lending Programme* (FLP) will continue to provide an alternative funding option for most of this year. Given this, banks would likely be resilient to a further tightening in funding markets in the near term, for example due to an escalation in the Russia-Ukraine conflict.

Cyber attacks are an emerging feature of geopolitical conflict. The trend towards online delivery of financial services has accelerated with the COVID-19 pandemic. Given this, and the increasing sophistication of cyberattacks, cyber risks are elevated for financial institutions and infrastructure. This highlights the importance of adequate investment in cyber resilience in the financial sector.

Businesses are facing considerable cost pressures as well as effects of the Omicron outbreak

Domestically, businesses are facing significant cost pressures, including for fuel, intermediate goods, and raw materials. Along with a tight labour market and supply chain issues, cost pressures are affecting profitability and eating into businesses' financial buffers.

In addition, cases of COVID-19 have risen rapidly in New Zealand with the Omicron outbreak. While there has not been a lockdown for this outbreak, New Zealanders have generally reduced their movements as infections have risen. This has affected retail spending, particularly in central city areas as businesses have reverted to work-from-home arrangements.

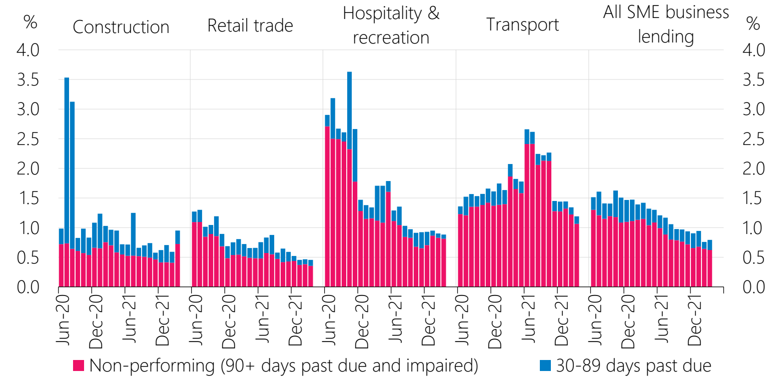
Targeted fiscal support for the most affected households and businesses has continued. However, overall fiscal support has been much more limited in this recent outbreak. As support is unwound, there may be underlying weaknesses in some business sectors. This could yet flow through to banks' asset quality, which to date has remained resilient (figure 1.3).

Similar to households, debt-servicing costs for businesses are increasing with interest rates. On its own, this may not cause financial strain given the low starting point of interest rates and general deleveraging by businesses over the past few years.

Figure 1.3

Non-performing loan ratios for selected industries

(percent of lending)



Source: RBNZ *Bank Balance Sheet survey.*

Note: Hospitality & recreation covers accommodation & food services, and arts & recreational services.

However, when combined with other cost pressures and reduced spending due to the Omicron outbreak, some businesses are likely to become stressed. In particular, we are monitoring the construction and commercial property industries, given the potential for further stress to emerge over the coming year.

Climate-related risks to the financial system continue to be explored

Climate change presents both long-term risks and opportunities to financial institutions, with the physical impacts of climate change becoming more common. As outlined in our Climate Changed 2021 and Beyond report, we plan to assess some key risks to the financial system from climate change during 2022 and 2023.

Last year we incorporated back-to-back droughts in our bank solvency stress test, and several significant storm events in our inaugural general insurance industry stress test. Two particularly relevant findings were that:

- Insurers rely on reinsurance arrangements for storms and other perils, and disruptions to these arrangements would create challenges for the insurance market in New Zealand; and
- Droughts on their own may not cause undue stress to the banking sector, but when combined with an economic downturn the number of defaults could be significant.

This year we are building on this by carrying out sensitivity analyses on banks' lending portfolios. Our initial analysis considers coastal and river flooding effects on mortgage exposures. We also intend to assess the impacts of drought and emissions pricing on agricultural exposures.

Policy assessment

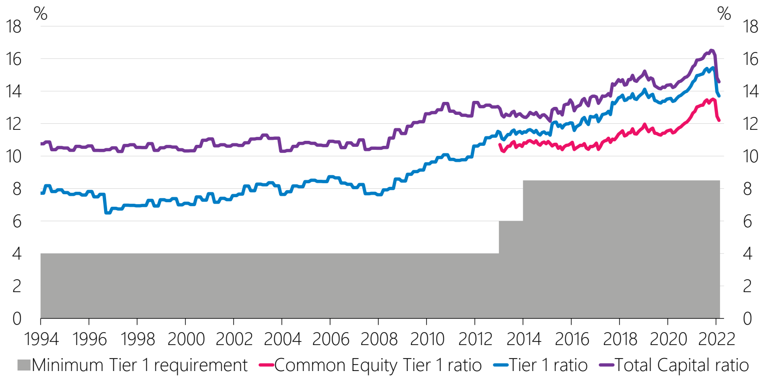
With increasing near-term risks, financial institutions need to be resilient so that they are in a strong position to keep supporting their customers and the economy.

Bank capital positions have increased as banks have remained profitable and dividend payments have been restricted. Profitability has been underpinned by low credit impairment costs, reflecting considerable fiscal support for businesses and households affected by the pandemic.

With more capital, banks have a greater ability to absorb losses and maintain lending in a downturn, as shown by our 2021 stress test results. Banks are also in a better position to meet minimum capital requirements as they progressively increase until 2028. Implementation of the Capital Review is under way. On 1 January, a floor on Internal Ratings-Based (IRB) risk weights came into effect so that banks using the IRB approach are now required to have at least 85 percent of the risk-weighted assets from the Standardised approach. As a result, overall bank capital declined as a ratio of risk-weighted assets, although capital buffers remain well above minimum requirements (figure 1.4). This has not reduced banks' overall resilience and we expect the increasing trend in capital ratios will continue during the next few years as the remaining elements of the Capital Review are implemented.

We have tightened macroprudential policy to address specific concerns around high-risk lending to recent buyers in the housing market and the sustainability of house prices. Macroprudential policies reduce the build-up of risks on borrowers and banks' balance sheets, thereby helping to mitigate the scale of economic downturns. In May last year, we tightened loan-to-value ratio (LVR) restrictions on investors to allow a maximum of 5 percent of new lending at LVRs above 60 percent. In addition, from November last year the maximum share of new lending to owner-occupiers with LVRs over 80 percent was reduced from 20 percent to 10 percent. These adjustments are limiting a build-up of homeowners at risk from a fall in house prices.

Figure 1.4
Capital ratios of locally incorporated banks



Source: Registered banks' Disclosure Statements, RBNZ *Capital Adequacy survey*.
Note: Minimum Tier 1 requirement includes a 2.5 percent conservation buffer from 2014.

Low interest rates during the COVID-19 pandemic saw debt servicing costs decline, increasing borrowing capacity and the share of new lending at high debt-to-income (DTI) ratios. Following our recent consultation, we are proceeding to design a framework for operationalising DTI restrictions. Our analysis indicates that first-home buyers would be the least impacted by a DTI restriction, with investors impacted the most as they tend to borrow at higher DTIs than other groups on average. We intend to have the framework finalised by late 2022, so that restrictions could be introduced by mid-2023 if required.

Banks' test interest rates have begun to rise in line with mortgage rates, and we expect to see a slowdown in high-DTI lending over the coming months. The new CCCFA regulations, changes to the tax treatment of investment property, and tighter LVR restrictions on owner-occupiers are also having an impact on the availability of mortgage credit. We therefore do not see an urgent need to impose an interim test rate floor at this stage, but we are monitoring the situation closely and do not rule out this option if there is a resurgence of risky lending in the housing market.

Various other regulatory initiatives are continuing to future-proof the resilience of the financial system, including the drafting of the Deposit Takers Bill (see chapter 4). Many of these initiatives are addressing the findings and recommendations outlined in the IMF's 2016 Financial Sector Assessment Programme for New Zealand. Consequently, the degree and pace of regulatory change is currently high. For all its long-term benefits, this change is also creating pressure on financial sector resources. With this expected to continue over coming years, regulated entities may need to invest in additional resources.

Box A

Financial and economic impacts of Russia's invasion of Ukraine on New Zealand

This Box examines the current and potential financial and economic impacts on New Zealand from the conflict. On top of the loss in human lives, Russia's invasion of Ukraine on 24 February caused a large negative supply shock to energy and other commodities, which has increased the cost of imports for New Zealand. Higher commodity prices have raised inflation, eroding real incomes. In addition, lower household and business confidence is expected to reduce aggregate demand. The spike in uncertainty has seen risk premia rise on risky assets and a tightening in international monetary conditions.

Western countries placed sanctions on Russia, including freezing the assets of Russian individuals and corporations, banning the export of strategic goods, and freezing a significant proportion of foreign-exchange reserves of the Central Bank of Russia. For countries that have banking linkages with Russia, some sanctions are particularly relevant, namely restricting correspondent banking relationships and excluding major Russian banks from the Society for Worldwide Interbank Financial Telecommunication, or SWIFT.

SWIFT is a messaging network to confirm payments between more than 10,000 financial institutions, although payments do not flow via SWIFT.

New Zealand's direct trade and payment exposures to Russia and Ukraine are small...

The exclusion of Russian banks from SWIFT means New Zealand banks cannot use its messaging network to engage with them. However, a survey by Te Pūtea Matua indicates that New Zealand banks only transact with sanctioned banks via third parties, and customer payments to Russia have been negligible.

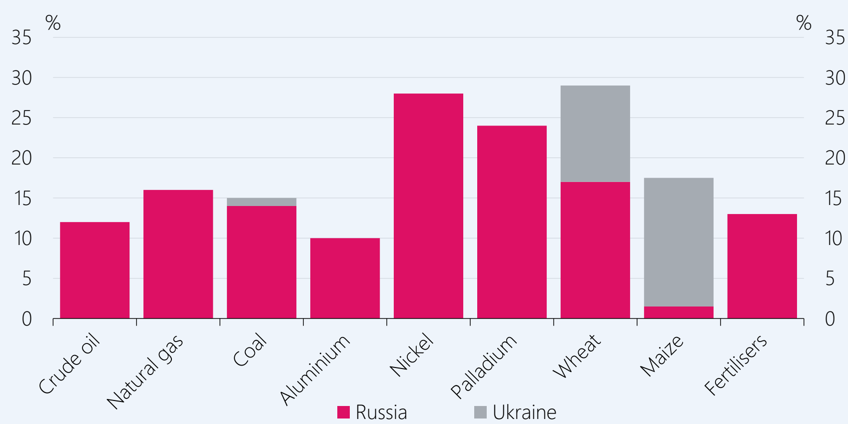
New Zealand's direct trade exposures to Russia and Ukraine are minimal. Exports to Russia comprised just 0.4 percent of total goods exports in 2021, with butter accounting for half of this, while imports from Russia were small and mostly crude oil (which has dropped to zero after the closure of the Marsden Point refinery). The Government has announced a 35 percent tariff on all imports from Russia and some export restrictions. Trade flows with Ukraine are immaterial. Recent exports to Russia have been disrupted. New Zealand's largest dairy exporter Fonterra announced it has voluntarily withdrawn from the Russian market. However, dairy prices have been resilient, and commodity exports can be redirected with limited difficulties.

Global growth forecasts have been downgraded, particularly for European countries that have relatively large trade exposures to Russia. Indirect impacts from the conflict, including higher energy prices, will weigh on real incomes and demand in New Zealand's major trading partners. This points to greater headwinds in the demand for our exports.

...but high commodity prices are affecting households and businesses

The conflict led to higher prices for a broad range of commodities owing to supply disruptions, in an environment of rising demand. Russia is a major producer of energy (crude oil and natural gas) and metals (aluminium, nickel, titanium and palladium). Both Russia and Ukraine are large producers of wheat and maize (figure A.1). Russia is also an important supplier of fertilisers. The conflict has disrupted the supply of these commodities, resulting in sharp price increases adding to general inflationary pressure. Russian energy exports have been banned by some countries. Metal-smelting activity has been dampened by high energy prices, particularly in Europe. Shipping routes through the Black Sea, a route for agricultural products, have been impeded.

Figure A.1
Russia and Ukraine share of global commodities exports



Source: Bloomberg.

Futures markets suggest that commodity prices are expected to decline over the next year, but remain elevated relative to pre-invasion levels for a number of years. Ongoing conflict-related disruptions are likely to continue to weigh on food production. More countries may look for alternatives to Russian energy. The path of commodity prices will depend on developments in the conflict sanctions, trading restrictions, and the potential for higher prices to stimulate extra supply to compensate for disruptions.

Higher commodity prices are adding to the global inflation caused by COVID-related supply shocks, increasing the risk that long-term inflation expectations rise. High headline inflation in New Zealand is already weighing on household confidence, real incomes, and consumer spending. The conflict is driving the cost of key business inputs even higher, including energy, freight and transportation, which will boost other input costs indirectly. The rising price of necessities, such as fuel, could send longer-term inflation expectations higher, which would affect wage-setting. These developments could dampen business profitability, although the magnitude of this is uncertain. There is a risk that non-performing loan ratios rise for banks' business lending, producing losses for the financial system and reducing the supply of credit to the economy.

High grain prices will affect New Zealand as a net importer of grain and cereals, and will indirectly raise the price of farm feed that is sourced mainly from Australia and Southeast Asia. However, higher food prices should also benefit agricultural exporters. New Zealand's dairy and meat stocks are predominantly pasture-fed, and should fare better than overseas grain-fed competitors.

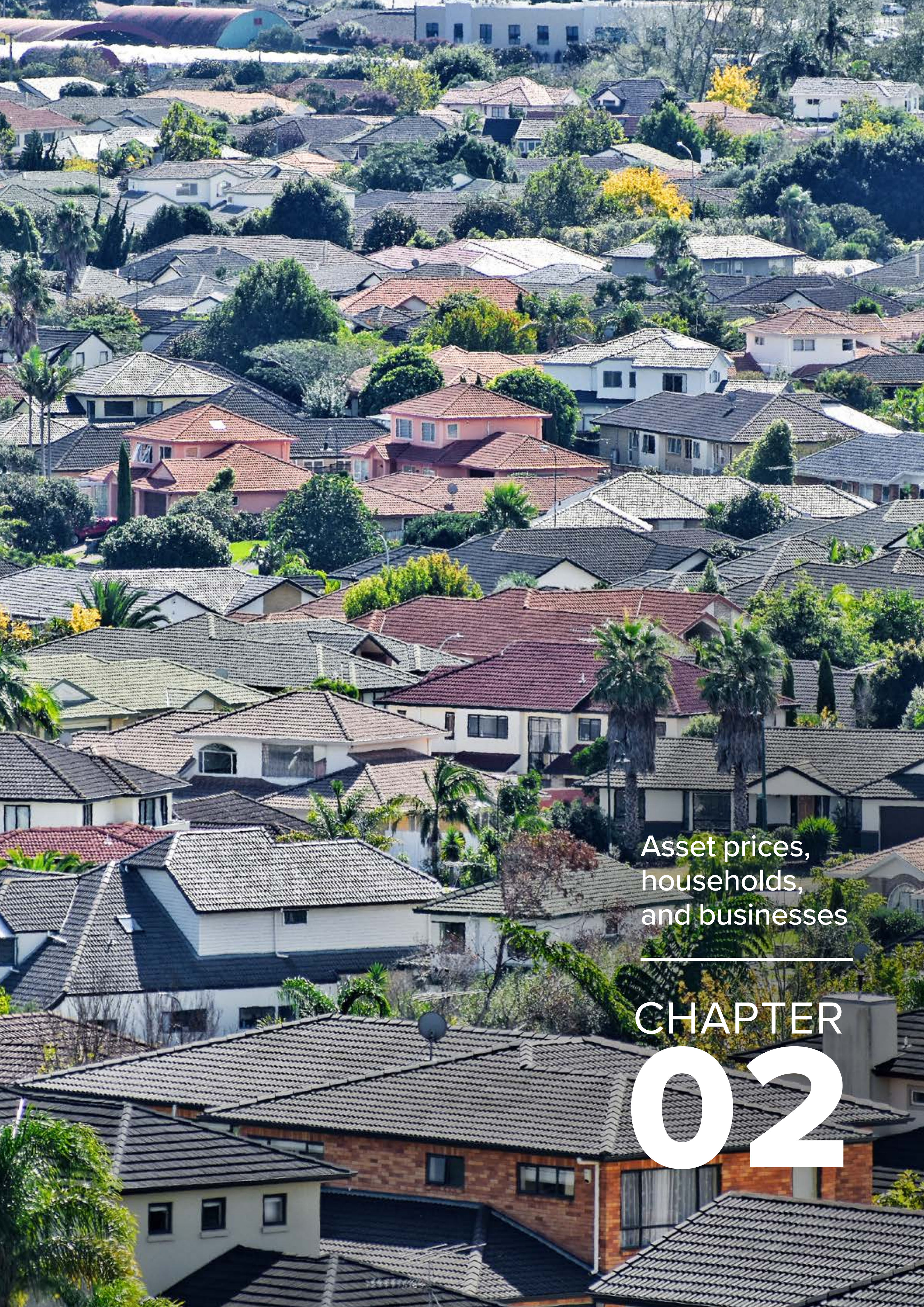
Risk to bank funding cost persists despite stabilisation in risk premium

At the start of the invasion, risk spreads widened in offshore funding markets. However, risk premia have since receded to their level prior to the invasion. Discussions with banks indicate that offshore market liquidity was temporarily tightened, but investor sentiment has since recovered, and banks are not experiencing difficulty in accessing funding. That said, overall funding costs have increased, owing to tighter current and expected future monetary policy. Reflecting large liquidity injections by central banks in recent years, funding markets have operated better than during previous stress periods, for example the Global Financial Crisis and onset of the COVID-19 pandemic. New Zealand banks have enjoyed some flexibility in responding to short-term volatility in the funding market. The share of offshore funding for locally incorporated banks is low, at 15 percent, and only one-third of this funding has a maturity of less than six months. Banks currently have strong liquidity positions.

However, market sentiment is highly sensitive to conflict-related news. An escalation in tensions could constrain banks' access to international credit markets and sharply increase offshore risk premiums. A persistent tightening in funding markets would eventually pass through to funding costs for banks domestically. These developments, if sustained, could push up debt servicing costs for New Zealanders.

Longer-term impacts of the conflict remain highly uncertain

The path of the conflict and its impact are highly uncertain. At the benign end of the spectrum, a de-escalation and easing in sanctions could reduce commodity prices. This should see the adverse impact on New Zealand ease. At the extreme end, a prolonged conflict without easing sanctions would amplify its adverse impact. There is a small but plausible risk of other countries being drawn into the conflict, whether owing to unintended incidents or deliberate intervention. US-led sanctions could also widen to other countries that are supporters or allies of Russia, and this could disrupt New Zealand's external trade more significantly. There is a risk that the invasion contributes to trade protectionism and some reversal of globalisation, which would lead to the onshoring of production, reduce labour and capital efficiency, and slow the diffusion of innovation between countries. All of this would slow potential growth rates internationally, including in New Zealand.


Asset prices, households, and businesses
CHAPTER
02

CHAPTER 2
Asset prices, households, and businesses

This chapter assesses the impact of recent global and domestic developments on the financial health of New Zealand's households and businesses. Credit risk, in the form of the banking system's lending to households and businesses, is the predominant risk affecting the resilience of New Zealand's financial system.

- Global financial conditions have tightened, as central banks respond to high consumer price inflation and rising inflation expectations amid elevated geopolitical tensions.
- New Zealand house prices have declined modestly, but remain unsustainably high given rising mortgage rates and the outlook for underlying demand and supply factors.
- In aggregate, households are resilient to a range of potential shocks, although pockets of recent buyers may face stress as debt servicing and living costs rise.
- COVID-related disruptions continue to create challenges for New Zealand's businesses.

Asset prices

Global inflation has risen to highs not seen in decades...

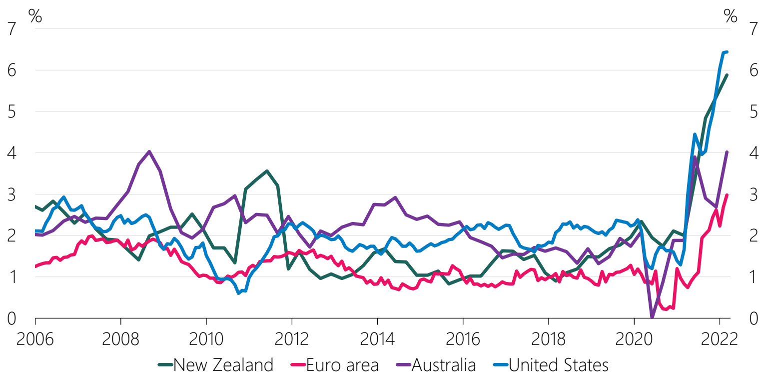
Headline inflation is at elevated levels across advanced economies, fuelling expectations of monetary policy tightening. The factors contributing to inflation include tight labour markets, supply chain pressures, and a broad increase in commodity prices owing in part to the Russia-Ukraine conflict. International financial market conditions have tightened. Financial markets are pricing in greater risk, and asset prices have declined from previous highs.

Core measures of inflation rose across most advanced economies over the second half of 2021 (figure 2.1). Solid demand as economies eased health-related restrictions contributed to the price pressure, as stimulatory fiscal and monetary policies have supported household balance sheets throughout the pandemic. Cost pressures have increased, partly driven by tight labour markets, with unemployment rates down to near pre-pandemic levels as some working-age people choose to exit the labour force. The Omicron variant continues to create near-term disruption in supply chains, as businesses adopt containment measures and some workers isolate or fall ill.

Figure 2.1

Advanced economies CPI inflation

(excluding food and energy)



Source: Haver Analytics.

Against this background, Russia's invasion of Ukraine has led to significant disruptions to commodity markets and contributed to headline inflation. Prices of major commodities reached record highs in recent months. Russia is a major exporter of energy and metals, and Ukraine is a major grain producer. Markets have also been disrupted by official sanctions and by some countries avoiding Russian exports. Box A examines the current and potential impacts of the conflict on financial stability in New Zealand.

The geopolitical factors driving elevated headline inflation may recede over time, as markets seek out alternative commodity suppliers. However, higher energy prices, especially in electricity and fuel, are likely to be embedded into higher general price levels throughout the global economy. Elevated inflation increases the risk that inflation expectations become unanchored, and that high inflation becomes embedded.

...fuelling expectations of monetary tightening

Monetary policy may need to to tighten more rapidly, to stabilise inflation expectations amid the commodities price shock. Some central banks have begun to raise policy rates and withdraw other policy measures. The Federal Reserve and the Bank of England raised their policy rates in the March quarter, and signalled a willingness to tighten aggressively as needed. In the euro area, monetary policy remains accommodative in order to support growth, but amid a growing need to control rising inflation.

Interest rates have risen from historically low levels as markets priced in a larger monetary tightening cycle (figure 1.1). The cost of new debt has increased for governments around the world, most of which borrowed aggressively in recent years to cushion the economic impact of the COVID-19 pandemic. This raises concerns over the sustainability of public debt in some countries, and leaves less fiscal room to respond to future downturns.

In contrast, inflation remains subdued in China, reflecting a slowdown in economic growth from 2021. Authorities have eased monetary policy to support growth, and further fiscal stimulus is expected. The country's growth outlook has softened owing to the latest Omicron outbreak in several major cities, and concerns remain around the construction and property development sectors.

Risk perceptions in global financial markets are rising

Financial market participants are adjusting to increased uncertainty. Major equity indices have declined from record high levels (figure 2.2), as rising interest rates reduced the discounted value of future earnings, and as the growth outlook weakened for major economies. Risk premiums increased temporarily and risk spreads widened in wholesale credit markets, although these moves have largely been reversed. However, risk aversion can quickly re-emerge if geopolitical tensions escalate or the global growth outlook deteriorates further.

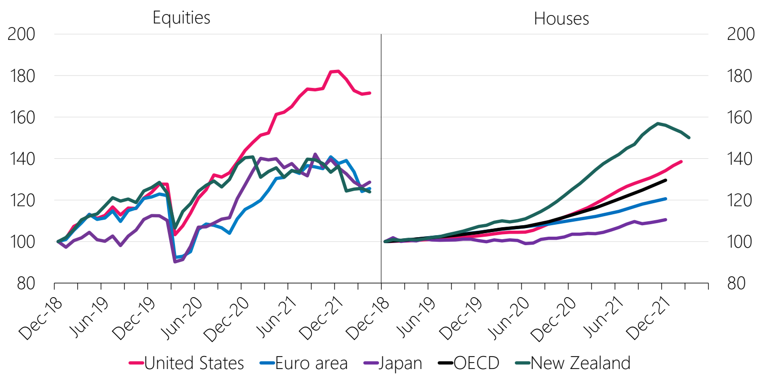
The IMF has highlighted several structural challenges for the global economy over the medium term, including geopolitical tension, energy security, and the potential fragmentation of capital markets and payment systems.[1] Central banks face a delicate trade-off between stabilising inflation expectations, which generally requires the withdrawal of monetary stimulus, and the need to safeguard the recovery and prevent a disorderly tightening of financial conditions.

New Zealand house prices have declined over 4 percent since their peak in November 2021, after having risen 48 percent over the prior two years.

New Zealand house prices remain unsustainably high despite recent falls...

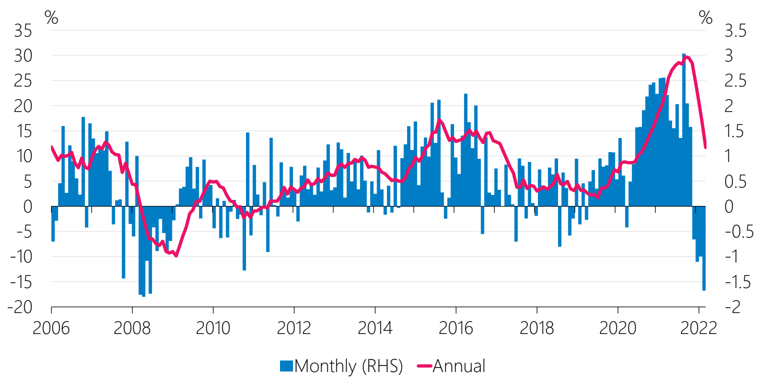
New Zealand house prices have grown rapidly since 2019, reflecting low interest rates, relatively favourable domestic economic conditions, and supply constraints, but these conditions are being unwound. Seasonally-adjusted house prices have declined 4.3 percent since November 2021 (figure 2.3), reflecting broad falls across regions. Despite a decline, the level of house prices remains unsustainable when assessed against a range of fundamentals. A steady adjustment of prices towards more sustainable levels based on fundamental demand and supply factors remains desirable for the stability of the financial system.

Figure 2.2
International equity price indices



Source: Haver Analytics, OECD.

Figure 2.3
National house price inflation
(seasonally adjusted)



Source: REINZ, RBNZ estimates.

1 See IMF Global Financial Stability Report, April 2022

...as higher interest rates and regulations dampened housing demand...

Recent developments in mortgage rates and government policy have dampened housing demand. The Monetary Policy Committee started to raise the OCR in late 2021 to control inflation and stabilise long-term inflation expectations, and wholesale interest rates have risen sharply at all maturities. Banks have passed on increasing funding costs to their mortgage customers. Interest rates on new mortgages have increased, and this will be embedded into the stock of existing mortgages as they are re-fixed (figure 2.4).

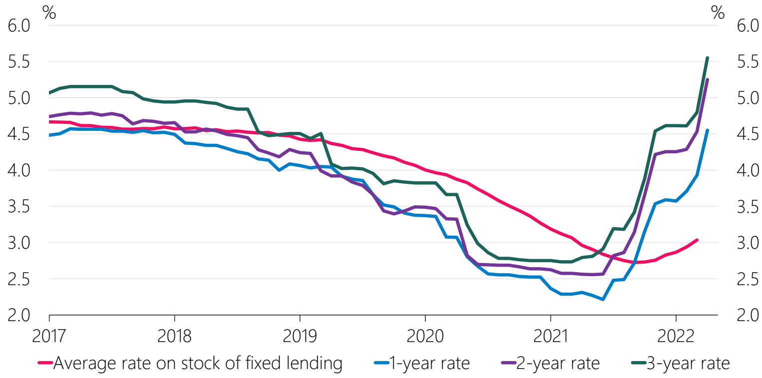
Debt servicing costs have increased as a share of household disposable incomes. Banks have increased their test rates used in their mortgage serviceability assessment, which will restrict the maximum mortgage size a homebuyer can borrow, reducing purchasing power in the housing market.

Rental yields remain historically low. As benchmark interest rates continue to increase, the relative attractiveness of rental property investment has decreased (figure 2.5). This points to increased pressure for rents to grow, or for house prices to decline, to bring rental yields in line with returns on other assets. The staggered removal of the tax deductibility of interest expenses from rental income has also reduced the effective housing investment returns for existing houses.

A number of key regulatory developments have also dampened housing demand. Changes to lending regulations under the CCCFA in late 2021 have weighed on mortgage approvals, as banks tightened their lending standards to comply with the new rules. The tightening of LVR restrictions for owner-occupiers in November was followed by a fall in mortgage demand among first-home buyers.

Figure 2.4

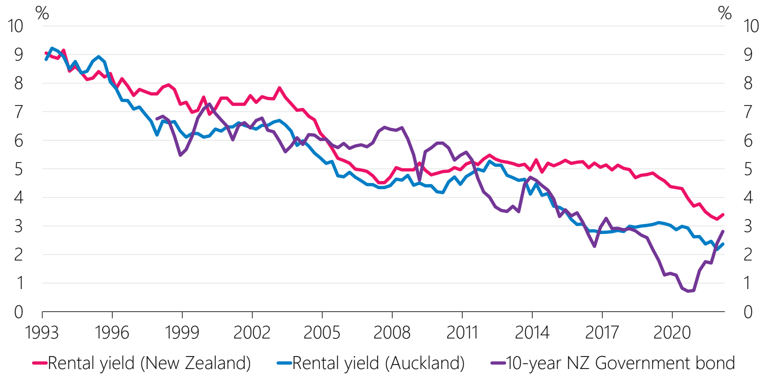
Average mortgage interest rates



Source: interest.co.nz, RBNZ *Income Statement Survey.*

Figure 2.5

Estimated pre-tax rental yields on residential property, long-term government bond rates



Source: QV, MBIE, Haver Analytics, RBNZ estimates.

Note: Pre-tax rental yields are annual gross rents on a three-bedroom house, relative to the lower-quartile sales price, less assumed annual maintenance, rates and insurance costs totalling 1.5 percent of the house value.

...and strong residential construction supports housing supply

Strong construction activity indicates that the supply imbalance that has contributed to house price inflation over recent years is easing. Population growth remains modest, with net migration being negative for the past year, and there is considerable uncertainty about the net flows as borders are opened. In addition, from August the Government's new Medium Density Residential Standard zoning regulations will increase development capacity in New Zealand's major cities, on top of previously announced changes to planning regulations.

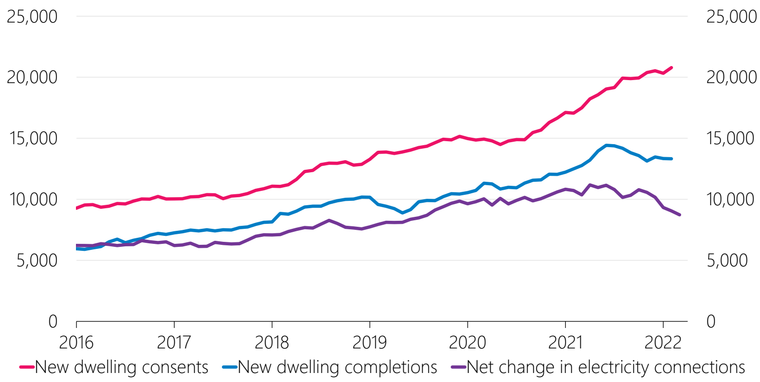
Nationwide residential building consents are at record high levels. However, new dwelling consents are not contributing as much to net housing supply as in previous building booms (figure 2.6), because a large share of consents are for infill housing, which involves demolishing older houses. COVID-related disruptions are also slowing the conversion of consents into new dwellings.

Risks around residential development projects have also increased, owing to cost escalation, supply chain disruptions, and labour shortages. Nevertheless, growth in housing supply is expected to remain strong over the next year, amid a general slowdown in demand.

Figure 2.6

New housing supply in Auckland

(12-month rolling totals)



Source: Stats NZ, Auckland Council, Electricity Authority, RBNZ estimates.

Note: New dwelling completions measures the number of new dwellings with Code Compliance Certificates issued. Net change in electricity connections is an estimate of the net change in active residential electricity connections (Installation Control Points).

Households

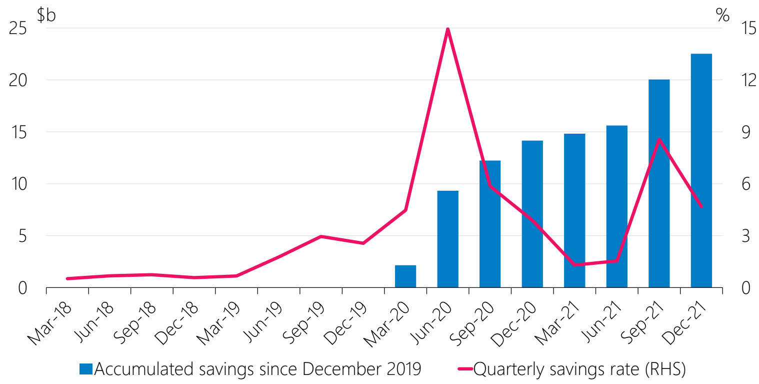
In aggregate, households' balance sheets remain strong, reflecting supportive fiscal and monetary policy throughout the pandemic, which has stabilised household incomes. LVR restrictions have helped to limit the build-up of risky household debt, in the context of rising house prices. As a result, most mortgage borrowers would be resilient to large declines in house prices. Looking ahead, rising interest rates are expected to increase households' debt servicing burden, particularly those who have recently borrowed at high debt-to-income (DTI) ratios. Debt servicing vulnerabilities do not pose a significant threat to the stability of the financial system at current mortgage rates, although some more vulnerable households could face stress from a combination of further significant increases in mortgage rates and rising living costs. Household consumption is expected to slow as monetary policy tightening continues.

Household incomes and balance sheets have continued to strengthen

The tight domestic labour market reflects the resilience of the New Zealand economy throughout the pandemic, supported by fiscal and monetary policies. Strong labour demand, closed borders, and low unemployment have supported nominal income growth, although high inflation has eroded household incomes in real terms

Figure 2.7

Household savings rate and accumulated savings



Source: Stats NZ.

more recently. Combined with time in lockdowns, limiting consumption activity, households have in aggregate accumulated a large savings buffer over the past two years (figure 2.7).

Homeowners have seen a substantial increase in their equity position, with house prices rising 45 percent in the two years to December 2021 and contributing to a significant accumulation of wealth. Total household net wealth has risen 33 percent since March 2020, with equity in housing now representing around 50 percent of total household net wealth. The decline in house prices in recent months has only marginally eroded some of the substantial increases seen over recent years.

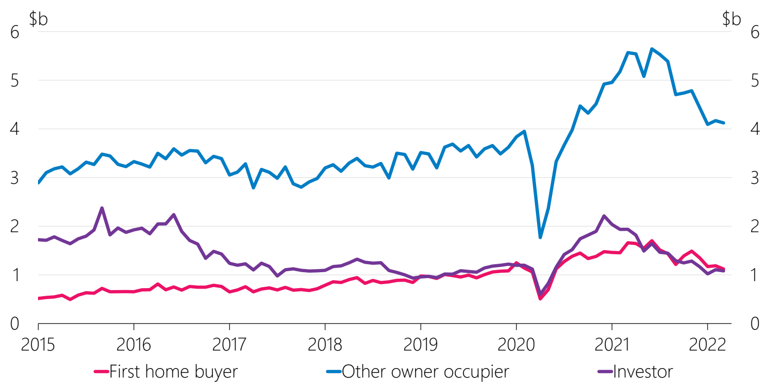
Household credit growth has begun to slow from an elevated level in recent months as interest rates have risen and house prices have cooled. The growth rate of residential mortgage lending slowed to 9 percent in the year to February, with a slowdown evident across all buyer types (figure 2.8). Other forms of consumer credit products, such as credit cards and car loans, continued to decline, falling 7 percent in the year to February.

Recent borrowers are most exposed to rising interest rates and declining house prices

While the aggregate picture for households is strong, there are some pockets of vulnerability. Recent buyers are the most vulnerable to rising interest rates or declining house prices. Newer borrowers will generally be more vulnerable than earlier borrowers, as they have repaid less principal, experienced smaller equity gains, and in recent years will have had their serviceability assessed at lower interest rates. Some first-home buyers have also had to rely on financial support such as parental guarantees to meet banks' lending requirements. The proportion of risky lending, that is lending at both a high DTI ratio and LVR, increased sharply for all three buyer groups in recent years (figure 2.9). LVR limits were tightened on owner-occupier lending from November 2021 so that now only 10 percent of lending to this group can be above an LVR of 80 percent. Higher-risk lending to first-home buyers has declined in recent months as a result of this LVR tightening.

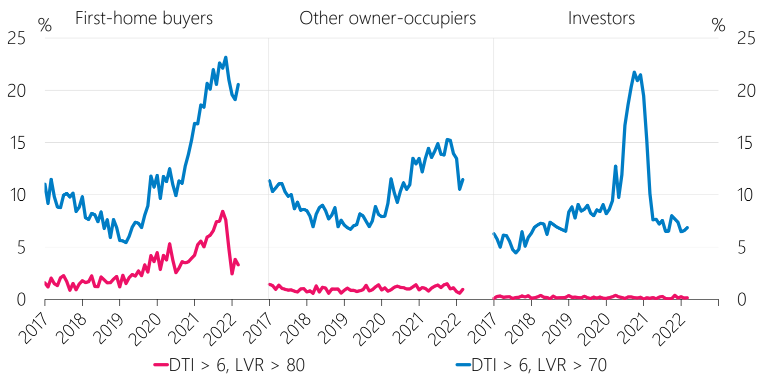
The average interest rate on the aggregate stock of mortgage lending remains low, as many borrowers fixed their mortgages when low interest rates were on offer over 2020 and early 2021, especially at shorter terms (figure 2.4). However, over half of the current stock of fixed-rate lending is due for refixing this year, with some borrowers facing potentially large increases in their debt servicing costs, particularly those who have borrowed at elevated DTI ratios. Rising living costs, which are reducing real household disposable income, may also create stress for mortgage borrowers.

Figure 2.8
New residential mortgage commitments by buyer type
(seasonally adjusted)



Source: RBNZ *LVR New commitments survey*, RBNZ estimates.

Figure 2.9
Share of high DTI and LVR new mortgages by buyer type



Source: RBNZ *DTI New commitments survey.*

Combined with the still very elevated level of house prices, the recent increases in mortgage rates mean that buyers currently entering the housing market face the prospect of significantly higher debt servicing burdens than similar buyers in prior years (figure 2.10).

The risk of debt servicing stress or negative equity is low for most mortgage borrowers

Banks have generally kept the test rates at which they assess loan serviceability well above the actual rates that borrowers have contracted at (figure 2.11). This provides reassurance that sufficient buffers are in place as the stock of lending is repriced towards the mortgage rates now on offer in the market. However, recent borrowers with elevated debt levels relative to income would incur significant debt servicing costs if mortgage rates were to rise above these test rates. While we do not anticipate acute servicing stresses to emerge among a material proportion of mortgage borrowers, rising debt servicing costs as monetary policy tightens are expected to cause discretionary household consumption to soften.

As house prices have begun to fall in recent months, we have continued to monitor the extent of mortgage lending in negative equity. Relative to December 2021 prices, we estimate that a 30 percent fall in house prices could lead to around 10 percent of all outstanding mortgage debt to fall into negative equity (that is, the value of the borrower's property is less than the outstanding mortgage amount). LVR settings have acted to limit the risks of future negative equity for recent borrowers, while earlier borrowers have seen large gains in equity as prices have risen in recent years. Given the large increase in prices over the past two years, it would take a substantial decline in prices to see widespread negative equity.

Figure 2.10

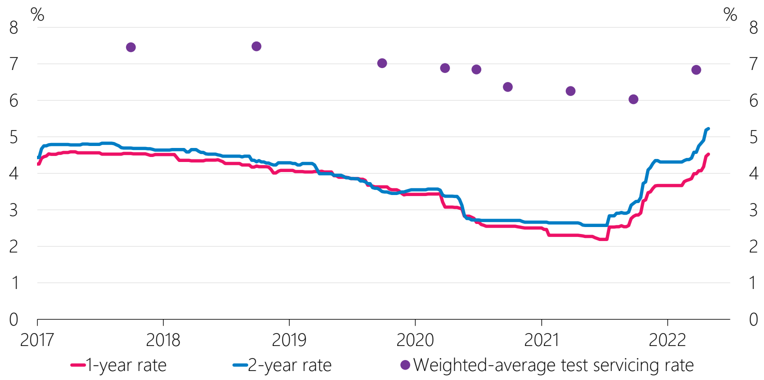
Indicative debt servicing ratio for new buyers

Source: Stats NZ, interest.co.nz, RBNZ estimates.

Note: Debt servicing costs are expressed as a share of median household disposable income and include both interest and principal repayments, based on a 30-year mortgage term using the 2 year fixed interest rate. Estimates are for buyers purchasing at the median selling price with a 20 percent deposit.

Figure 2.11

Mortgage serviceability test rates, market rates



Source: interest.co.nz, Reserve Bank.

Note: Test servicing rate is the interest rate used to assess loan serviceability by registered banks, weighted by market share.

Banks have generally kept the test rates at which they assess loan serviceability well above the actual rates that borrowers have contracted at.

Business sector

Government support helped businesses through the Delta outbreak in late 2021

Since the start of the pandemic, Government support schemes have been effective at limiting the financial losses many businesses faced due to lockdowns and changes in customer behaviour. This support continued through the Delta variant outbreak and associated lockdowns over the second half of 2021 (figure 2.12). Fiscal and monetary policy settings have supported businesses' cashflows, which has in turn contributed to a resilient labour market and strong household incomes.

The economic effects of the Delta outbreak were largely concentrated in Auckland and adjacent regions, with some wider spillovers to domestic tourism-related industries and regions. Most industries experienced a recovery in trading conditions by the end of 2021. Helped by fiscal and monetary policy, businesses' balance sheets have been resilient since the start of the pandemic, and levels of credit stress appear low even in sectors that have been more adversely affected by lockdowns, the closed border, and changing consumer behaviour (figure 2.13).

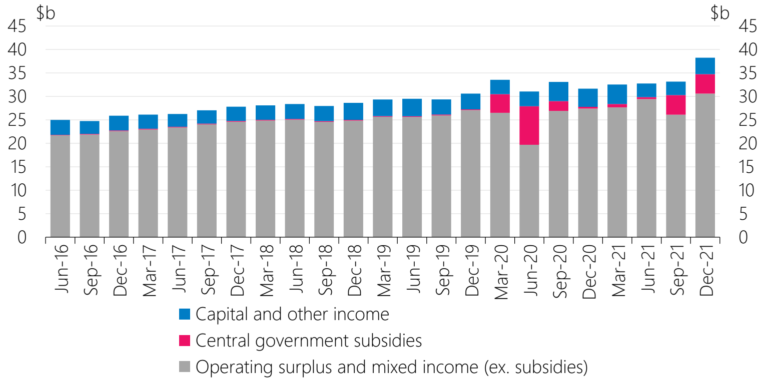
The Omicron outbreak is compounding supply chain issues and a tight labour market

A range of factors are contributing to rising cost pressures for New Zealand businesses. Supply chain and logistical disruptions that emerged at the start of the pandemic continue to affect a range of industries. International shipping capacity remains constrained, partly due to extended processing times at key global ports. After partly recovering over 2021, container movements into and out of New Zealand have declined in recent months to below pre-pandemic levels.

Figure 2.12

Quarterly non-financial business sector income

(indicative, nominal, seasonally adjusted)

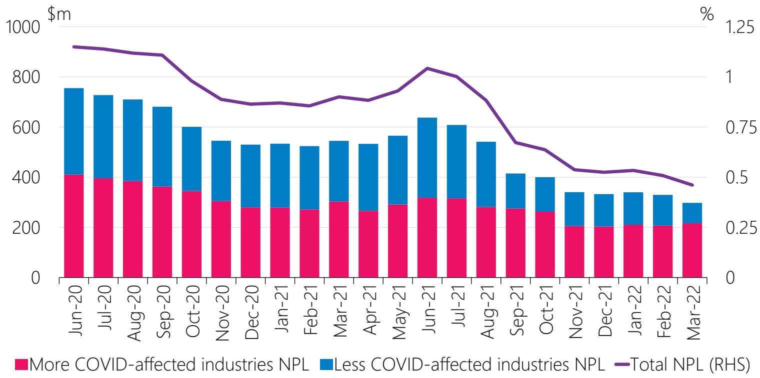


Source: Stats NZ, RBNZ estimates.

Figure 2.13

Industry breakdown of business sector non-performing loans

(excludes agriculture and commercial real estate)



Source: RBNZ *Bank Balance Sheet survey.*

Note: 'More COVID-affected industries' include construction, wholesale and retail trade, accommodation and food services, transport and storage, education and training, health and community services, culture and recreation, and personal services. 'Less COVID-affected industries' include mining, manufacturing, utilities, communications, professional, administrative and support services.

Businesses continue to report high levels of difficulty in finding labour. Global commodity price developments, particularly oil prices, are also feeding into New Zealand businesses' input costs. While businesses largely expect to be able to pass these cost pressures on to consumers, profit margins may be squeezed in some sectors in the short term, as households' discretionary spending is constrained by rising interest rates and inflation.

Against this backdrop, the outbreak of the Omicron variant over February and March saw a sharp but brief drop in business and consumer activity. While the country has moved away from using lockdowns to suppress the spread of the virus, businesses and consumers responded to the outbreak by limiting person-to-person contact, including by working from home. Business confidence fell sharply as the outbreak accelerated, reflecting both the short-term disruptions from the virus' spread and the broader environment of rapidly rising costs and acute supply and labour shortages.

The Government introduced a new support scheme for businesses facing revenue declines during the Omicron outbreak, on top of existing support schemes for workers required to isolate, but amounts paid out to businesses have been relatively limited compared to the schemes set up for prior outbreaks. It remains possible that underlying weaknesses in some industries, particularly hospitality and tourism-related businesses, may be revealed as Government support wanes. However, we expect that any impact on the financial system would be small, and near-term indicators of credit stress, such as early stage loan arrears, remain low across all industries.

Rising interest rates set to increase debt servicing costs

As monetary policy tightens in response to inflationary pressures, businesses' debt servicing costs are set to rise. Business borrowing has been relatively subdued throughout the pandemic, as support schemes have preserved businesses' cashflows (figure 2.14). As a result, across most industries businesses are entering the current tightening cycle at lower levels of leverage than before the pandemic. A return to pre-pandemic levels of interest rates is therefore not expected to result in debt serviceability stresses for most businesses.

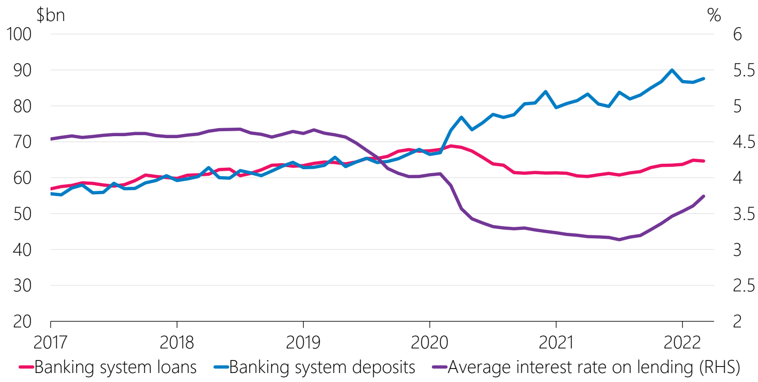
Credit supply appears normal, with demand limited by broader uncertainty

Businesses' investment intentions recovered over 2021 as capacity pressures emerged, leading to a pick-up in credit demand (figure 2.15). Merger and acquisition activity also drove higher borrowing by corporates, as businesses have taken advantage of the low interest rate environment to restructure or consolidate. Banks reported that business credit availability has remained broadly stable over the past six months, with a lift in demand for working capital by larger firms.

Figure 2.14

Banking system loans and deposits of non-financial corporates

(excludes agriculture and commercial real estate)

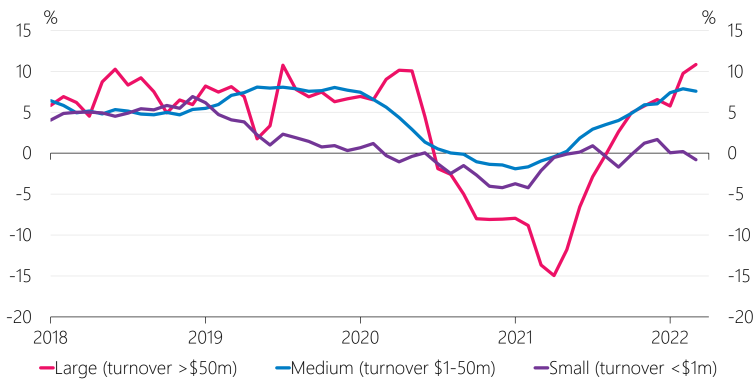


Source: RBNZ *Bank Balance Sheet survey, Income Statement Survey.*

Figure 2.15

Annual growth in bank business lending by firm size

(excludes agriculture and commercial real estate)



Source: RBNZ *Bank Balance Sheet survey.*

Commercial property sector

The commercial property sector continues to present a mixed picture, driven by COVID-related uncertainty. Strong demand and limited developable sites are supporting industrial property rents and values. On the other hand, vacancy rates for retail properties in the CBDs of the main cities are increasing, reflecting declining foot traffic. Vacancies for offices have also increased slightly, as firms reassess their occupancy needs as working from home arrangements continue to be normalised (figure 2.16).

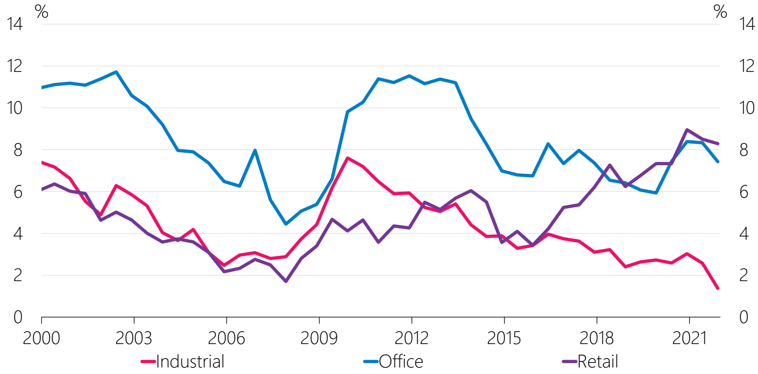
Industry contacts suggest that a 'flight to quality' dynamic is likely to result as office demand falls, with rents adjusting so that the remaining demand migrates to higher-quality and better-located buildings. This creates a risk of an overhang of untenanted, less desirable buildings. In previous commercial property cycles, this would normally result in buildings being taken out of the market and converted to alternative uses, such as international student accommodation and education facilities, although these markets are likely to take several years to recover to pre-pandemic levels. The high level of house prices may support conversion into residential accommodation. While price appreciation has been relatively limited among office properties in recent years, the decline in demand could still see some valuations for offices fall in coming years.

Banks' lending for commercial property has been robust, with investment lending having grown around 14 percent since the start of the pandemic, and development lending stabilising after a decline over 2021. Asset quality remains high, reflecting relatively tight lending standards that banks have applied to their commercial property lending in recent years. Development lending exposures remain small, at around 11 percent of total commercial property lending.

The residential development sector may present some risks in the near term, given the severe supply chain and capacity pressures facing residential construction firms.

Figure 2.16

Commercial property vacancy rates



Source: JLL.

The timing of development projects is being stretched, which may place pressure on the liquidity of some smaller developers and construction firms who are less able to work through a range of disruptions, or stockpile sufficient inventories of building materials. At this point arrears rates on bank lending to developers are historically low, and survey results indicate building firms have similar levels of overdue debtors to historic norms. However, stresses among some residential developers are starting to emerge, particularly in a context of declining house prices, rising interest rates and construction costs, and slowing housing demand.

Agricultural sector

While input prices are increasing, rising food prices are expected to be beneficial overall for New Zealand's agricultural sectors. With a predominance of pasture-based production, New Zealand's dairy, sheep and beef farmers are relatively less exposed than international peers to the disruptions to grain markets resulting from Russia's invasion of Ukraine.

Fonterra's latest forecast farmgate milk price for the 2021/22 season of $9.60 per kg of milk solids (kgMS) would represent a record payout level, although this may be slightly offset in terms of farm incomes by lower production volumes, partly due to dryer weather conditions. The current strength in dairy prices may continue into next season, with limited prospects of global milk supply growth in the near term.

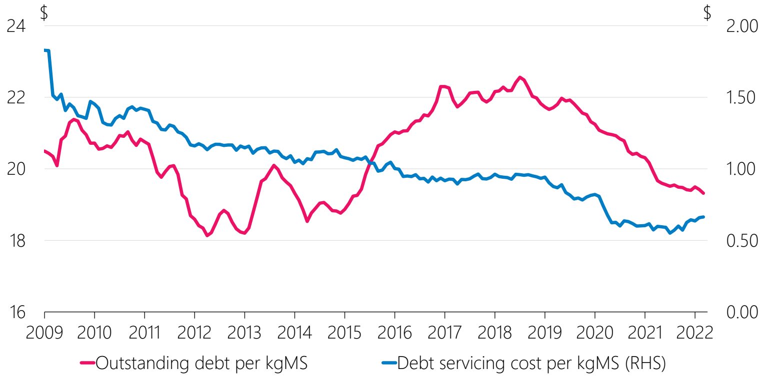
Overall, risks to the financial system from the dairy sector have diminished considerably in recent years. The dairy sector continues to use the currently favourable conditions and low interest rate environment to consolidate and reduce its leverage. On average, dairy farmers have repaid around $3 of bank debt per kgMS in recent years (figure 2.17). Total dairy sector debt has declined by around 12 percent ($5b) since its peak level in 2018, reducing debt servicing costs, and meaning farmers will be better positioned to deal with any potential future downturn in dairy prices.

Banks continue to diversify their agricultural lending portfolios away from dairy to other industries, in particular horticulture (figure 2.18). In the near term, most agricultural industries are facing similar pressures to those in other businesses, including a tight labour market, input cost inflation, and disruptions to production from the Omicron outbreak. Labour shortages are constraining production, including limiting fruit harvesting and leading to delays at meat processors. However, most of these factors are expected to be temporary. Against a broader backdrop of strong commodity prices, the continued diversification of banks' agricultural portfolios is positive for the soundness of the financial system.

Activity in the rural land market has been strong over the past year, supported by the low interest rate environment, and an increase in listings as owners reassess their holdings in the face of changing land use regulations and a rising carbon price (figure 2.19). Conversion of less productive land used for sheep and beef farming to permanent or production forestry offers attractive financial returns at the current carbon price, as afforestation is a relatively cost efficient means for New Zealand to reduce its net emissions under current technologies. The Government recently consulted on potential changes to the Emissions Trading Scheme that would disallow new permanent exotic forestry. At the margin this could further raise the carbon price and incentivise more conversion of land into production forestry.

Figure 2.17

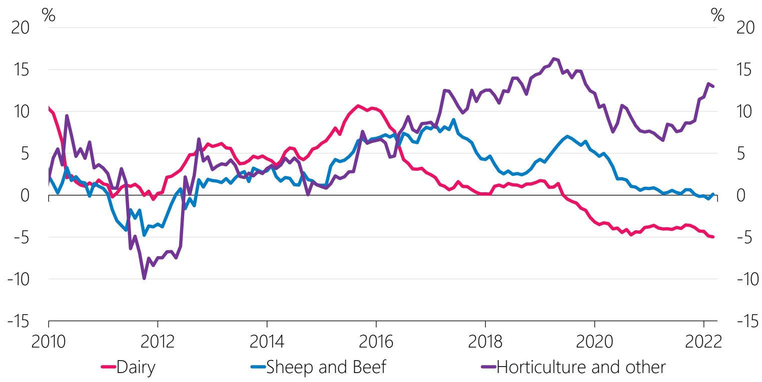
Total dairy debt and interest servicing cost per kgMS of production



Source: RBNZ *Bank Balance Sheet survey, Income Statement Survey*, registered banks' Disclosure Statements, private reporting, DCANZ, RBNZ estimates.

Figure 2.18

Annual growth in agricultural sector lending



Source: RBNZ *Bank Balance Sheet survey*, private reporting.

Figure 2.19

Market price of units in the New Zealand Emissions Trading Scheme

Source: Carbon News.

Financial sector dynamics and institutional resilience

CHAPTER

03

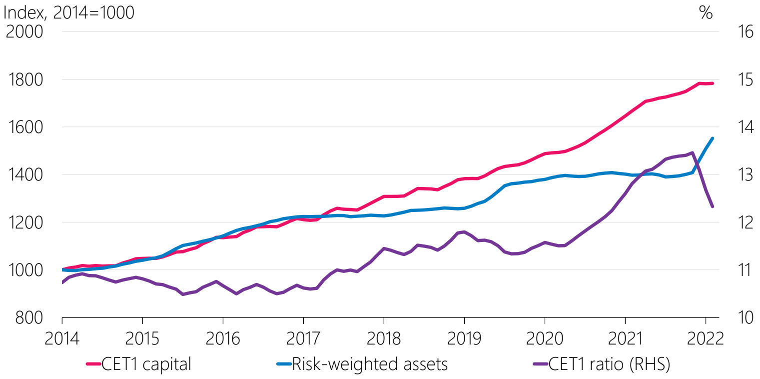
CHAPTER 3
Financial sector dynamics and institutional resilience

Financial institutions' resilience has remained strong during the past six months despite the impact of rising interest rates, geopolitical risks, and COVID-19. Registered banks' profitability has continued to recover to pre-2020 levels. Insurers have retained high levels of capital. Financial market infrastructures have operated smoothly during the COVID outbreak.

Figure 3.1

Registered banks' capital and risk-weighted assets

(3-month moving average)



Source: Registered banks' Disclosure Statements, RBNZ *Capital Adequacy survey.*

Note: Minimum Tier 1 requirement includes a 2.5 percent conservation buffer.

Registered banks

Banks' capital buffers remain high and are expected to increase further

Registered banks' capital buffers remain high and all banks are above minimum prudential requirements (figure 3.1). In January 2022, as part of the implementation of the Capital Review, a credit risk floor came into force for banks using the internal ratings-based (IRB) approach to calculate risk-weighted assets (RWA). The floor restricts credit RWA to no less than 85 percent of the level calculated under the Standardised approach. As a result, RWA increased at the start of 2022, and capital as a ratio to RWA declined. This has not reduced banks' overall resilience and we expect the increasing trend in capital ratios will continue during the next few years as the remaining elements of the Capital Review are implemented.

Registered banks also have strong liquidity positions. The liquidity policy requires banks to hold a sufficient stock of liquid assets at all times to be able to meet customer withdrawals during a period of stress. In addition, funding risk occurs when banks experience difficulty in securing funding at a reasonable price. To address this, banks are subject to a minimum core funding ratio requirement, which has returned to 75 percent from 50 percent since January 2022.

Bank funding conditions have been favourable over the last two years, partly due to monetary policy tools such as the Large Scale Asset Purchase (LSAP) Programme and the Funding for Lending Programme (FLP), which have lowered interest rates and increased liquid assets in the banking system (figure 3.2).

Monetary policy tightening has increased banks' funding costs, and will continue to do so. The Monetary Policy Committee has signalled that the removal of monetary policy stimulus will occur both through increases in the Official Cash Rate (OCR) and the gradual reduction of our bond holdings under the LSAP programme. All else equal, the latter will reduce balances held by the banks in their Exchange Settlement Account System (ESAS) accounts and reduce the level of cash in the financial system.

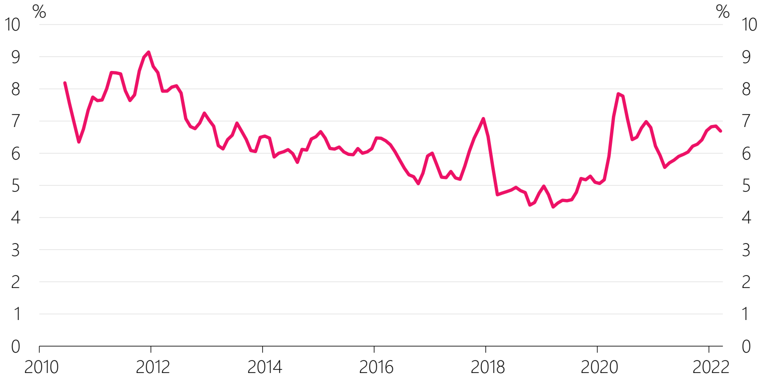
The funding gap is expected to narrow when interest rates increase

The funding gap measures the difference between lending growth and deposit growth (figure 3.3). It shows whether banks have enough new deposit funding relative to their lending growth and how much additional wholesale market funding they need, including from offshore markets. Greater reliance on offshore funding can make banks more vulnerable to disruptions in international funding markets.

Figure 3.2

One-month liquidity mismatch ratio of locally incorporated banks

(3-month moving average)

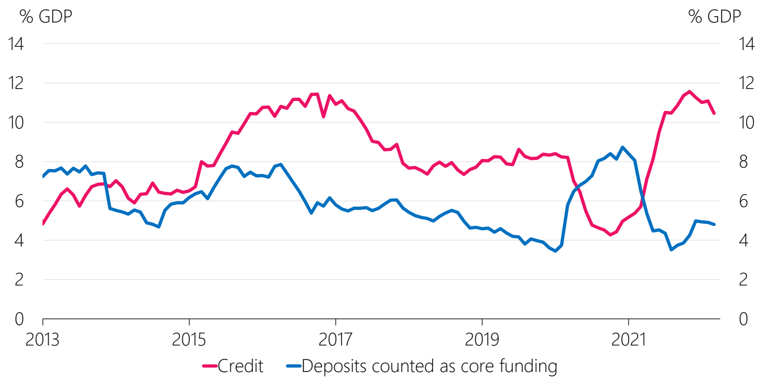


Source: RBNZ *Liquidity survey.*

Note: The mismatch ratio is a measure of a bank's liquid assets, adjusted for expected cash inflows and outflows during a one-month period of stress. It is expressed as a ratio over the bank's total funding.

Figure 3.3

Annual growth in bank credit and core deposit funding



Source: RBNZ *Bank Balance Sheet survey, Liquidity survey*, Stats NZ.

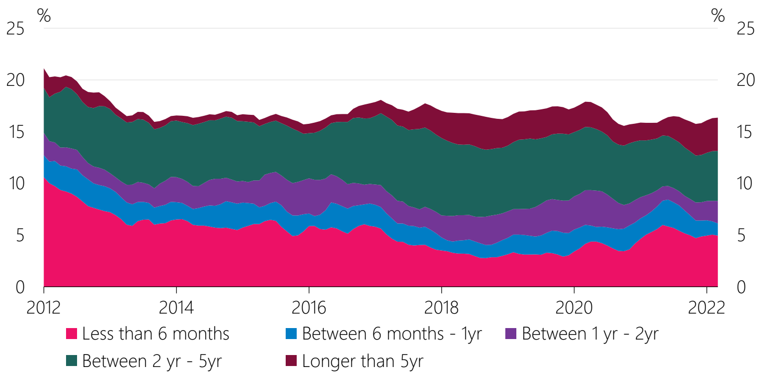
Minimum core funding ratio requirement has returned to 75 percent from 50 percent since January 2022.

The gap widened in 2021, but is expected to decline due to slowing credit demand. Higher funding costs are being passed through to higher lending rates, including for mortgages, contributing to dampening credit demand.

Liquidity in offshore markets has been negatively affected by uncertainty over the pace of monetary policy tightening by major central banks and by geopolitical tensions, leading to higher offshore risk premiums and funding costs. However, given the abundance of domestic deposit funding, banks' wholesale funding needs are currently limited. Offshore funding is currently only 16 percent of total bank funding, and the majority has at least one year until it matures, suggesting that New Zealand banks have a limited exposure to temporary increases in credit spreads (figure 3.4). As a result, banks can choose to raise funding in offshore wholesale markets at the most opportune times.

Figure 3.4

Banks' offshore funding by residual maturity as a share of total funding

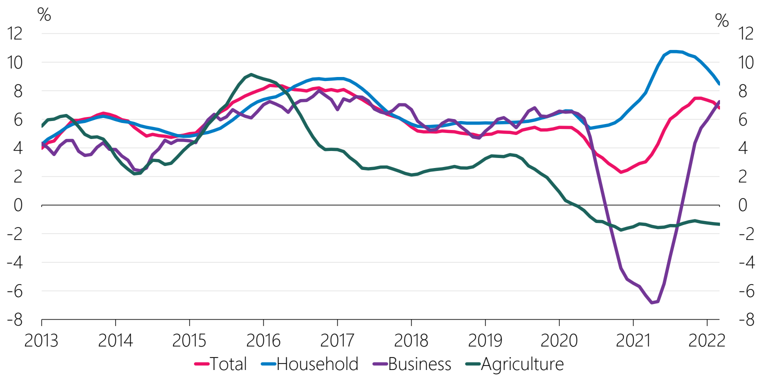


Source: RBNZ *Liquidity survey.*

Figure 3.5

Annual bank lending growth by sector

(3-month moving average)



Source: RBNZ *Bank Balance Sheet survey.*

Lending growth slows as demand eases and credit conditions tighten

Bank loan growth has moderated in recent months, although it still exceeds growth rates in previous years (figure 3.5). Lending to households has slowed from its peak in the middle of 2021. This partly reflects lower household demand for credit as housing market activity slows on the back of rising interest rates. Business sector borrowing has recovered after contracting sharply in the early stage of the pandemic. Banks have reported that this mainly reflects borrowing for working capital, property acquisition, and expansion of premises. Borrowing for other capital expenditure remains subdued. Lending to the agricultural sector continues to decline as the dairy sector continues to deleverage.

Some updates to CCCFA lending rules

As noted in Chapter 2, changes to the CCCFA have made requirements for assessing borrowers' debt servicing ability more stringent. In January 2022, an investigation into the impact of the new requirements was announced, to be led by the Ministry of Business, Innovation and Employment (MBIE), with input from other members of the Council of Financial Regulators (CoFR).[2] In March, Cabinet approved initial changes to amend the CCCFA regulations and the Responsible Lending Code to address some of the issues related to the scope and treatment of borrowers' discretionary expenses when assessing loan applications.

$118bn

Total current level of bank lending to business and commercial property sectors

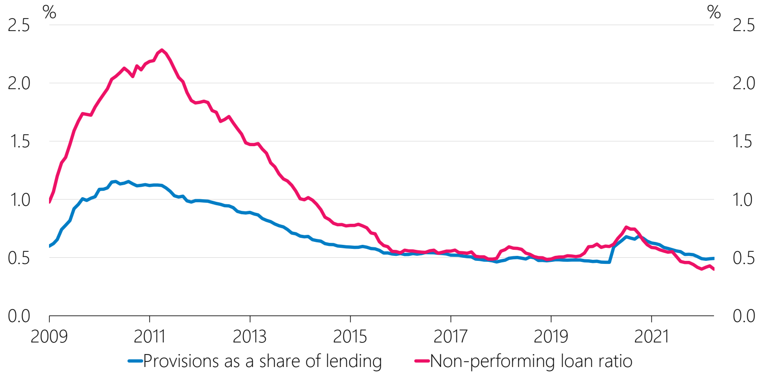
2 Members of CoFR are the Reserve Bank, Financial Markets Authority, The Treasury, MBIE and the Commerce Commission.

Improved asset quality outlook leads to rebound in profitability

Recent robust domestic economic activity has ensured that banks' asset quality remains high. Overall, non-performing loans and arrears remain at low levels. The share of housing loans on hardship programmes remains low relative to its peak during 2020. In the hospitality and retail trade sector, the share of non-performing loans and arrears is little changed since the middle of last year. Non-performing loans in the agricultural sector have declined as the dairy sector benefits from deleveraging and high dairy prices. As asset quality remains high, banks have continued to reduce loss provisioning, which increased during 2020 (figure 3.6).

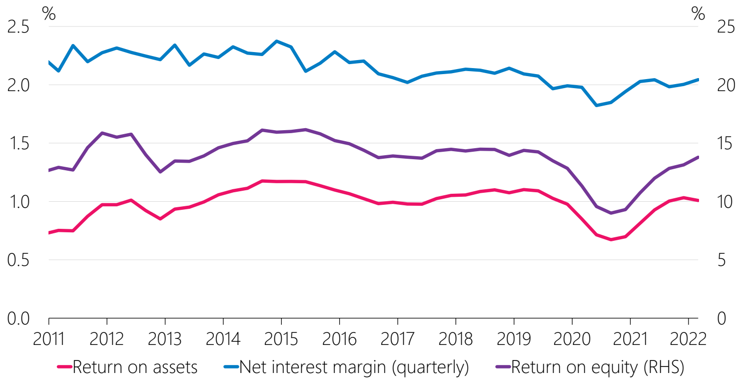
Bank profitability recovered after falling during 2020, which enabled banks to increase their capital positions, enhancing their resilience (figure 3.7). Indicators of bank profitability have remained around pre-COVID levels. The rebound in profitability reflects reductions in loss provisioning and stable net interest income. While funding costs have increased recently, this has been passed through into higher lending rates, keeping interest margins broadly stable.

Figure 3.6
Non-performing loans and provisioning



Source: RBNZ *Bank Balance Sheet survey*, private reporting.

Figure 3.7
Indicators of bank profitability
(percent of assets or equity)



Source: RBNZ *Income Statement Survey.*

Our 2022 stress test programme will assess the impact of rising interest rates and climate change on banks

The rebound in banks' profitability reflects the recent improvement in economic conditions. However, financial conditions are tightening due to rising global interest rates and related monetary stimulus withdrawal, in response to increasing consumer price inflation.

The 2022 bank solvency stress test will assess the impact of rising interest rates on the five largest banks. The severity of the scenarios used in the stress tests will be similar to the ones used in the 2021 solvency stress test. In addition, we will carry out a series of climate change sensitivity analyses to identify the vulnerability of banks' lending portfolios to a series of climate shocks. These analyses will focus on the impact of coastal and river flooding effects on mortgage exposures, and the impact of drought and emissions pricing on agricultural exposures. The outcomes will inform a full climate change stress test, which will be conducted at a later date.

The Reserve Bank uses stress test insights to inform policy settings and the supervision of individual institutions. Institutions use stress-test results to inform their capital and liquidity strategies and the mitigating actions that can be deployed during times of stress.

We continue to promote cyber resilience in the financial sector

We continue to promote the resilience of regulated entities to cybersecurity risks. To achieve this, we work in coordination with other relevant agencies, such as the Financial Markets Authority (FMA), the National Cyber Security Centre (NCSC), and CERT NZ, with an interest and expertise in promoting and building cyber resilience.

During the past six months, interagency cyber-attack response protocols have been developed through the Council of Financial Regulators (CoFR) to enhance coordination between relevant agencies and support industry in their own response efforts.[3] In addition, a cybersecurity standard will be developed for designated financial market infrastructures under the Financial Markets Infrastructures Act. This standard will be principles-based and focused on governance and risk management, rather than technical aspects of cybersecurity.

We will soon begin consultation on cyber data collection. The consultation is focused on cyber incident reporting, broader organisational cyber capabilities, and governance and risk management practices.

We will carry out a series of climate change sensitivity analyses to identify the vulnerability of banks' lending portfolios to a series of climate shocks.

3 Quarterly Statement by the Council of Financial Regulators – November 2021 | Kaunihera Kaiwhakarite Ahumoni – Council of Financial Regulators (cofr.govt.nz)

Table 3.1

Key metrics for registered banks

Metric	Value (%, end of March)					Regulatory minimum (%)	Comment
	2018	2019	2020	2021	2022[2]		
Tier 1 capital ratio	13.4	13.6	13.4	15.0	13.7*	8.5**	Tier 1 capital levels have increased over the past 12 months, as banks have retained earnings.
Mismatch ratio (one month)[1]	4.7	4.3	5.9	5.6	6.7	0	Mismatch ratios remain elevated, reflecting the high level of settlement balances in the system.
Core funding ratio	88.4	87.8	88.3	86.8	89.5	75	Banks' core funding ratios are high, reflecting the large amounts of deposits in the banking system.
Annual return on assets (after tax)	1.05	1.10	0.86	0.82	1.04		Banks' return on assets has returned to pre-COVID levels.
Annual return on equity (after tax)	14.2	14.3	11.3	10.8	13.1		Banks' return on equity has recovered after declining during 2020.
Net interest margin (quarterly, annualised)	2.13	2.09	1.98	2.03	2.04		Net interest margins have stabilised around their long-term levels, following declines in lending and funding rates over 2020.
Non-performing loans ratio	0.56	0.49	0.62	0.57	0.39		Non-performing loans have returned to pre-COVID levels as the economy recovered.
Annual credit impairment expense (% of average loans)	0.06	0.06	0.22	0.09	-0.02		Banks are writing back provisions made in the early stages of the pandemic, as credit losses have been lower than expected.
Cost-to-income ratio	41.4	39.5	44.5	44.5	40.9		Operating expenses have been relatively stable over the past 12 months.

Source: RBNZ *Capital Adequacy survey, Liquidity survey, Income Statement Survey, Bank Balance Sheet survey*.

1 Mismatch ratio (one month) is presented as a three-month moving average to remove short-term volatility.

2 We have corrected some of the figures in the March 2022 column after publication, due to an error being identified.

* Tier 1 capital ratio of 2022 is up to February.

** Includes the capital conservation buffer of 2.5 percent of risk-weighted assets, which banks must maintain to avoid dividend restrictions.

Non-bank deposit takers (NBDTs)

There are currently 18 NBDTs operating in New Zealand. The stock of total lending by NBDTs is around $2.8 billion, compared to more than $500 billion in lending outstanding for banks. Most lending by NBDTs is for housing and consumer loans. While NBDTs comprise a small share of the financial system, in some instances they provide banking services and loans to customers unable to access these facilities from banks.

Requirements of the new DTA remain a key focus for NBDTs

The regulatory framework for NBDTs will change when the new Deposit Takers Act (DTA) comes into force. Banks and NBDTs will be covered by a single regulatory regime under the new Act. Having a single regime will reduce complexity and ensure banks and NBDTs carrying out similar activities are treated consistently. This should enable NBDTs to compete more effectively with banks. Having a single regime will also be consistent with the introduction of the Deposit Compensation Scheme covering both banks and NBDTs. We will ensure that we recognise the diversity within the NBDT sector and take a proportional approach to how the new regime is applied.

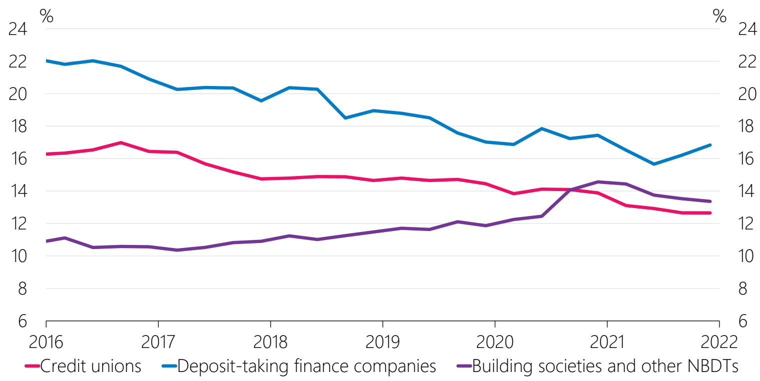
In December 2021, we launched a consultation on the exposure draft of the DTA. Further consultation is planned on the regulations and prudential standards required under the new regulatory regime. These are expected to address the current uncertainty about the DTA's impact on the NBDT sector. In general, the introduction of the Deposit Compensation Scheme is likely to lead to stronger prudential standards over time for NBDTs.

Asset quality and profitability vary across the sector

The share of asset impairment and non-performing loans is highest in the credit union sub-sector. Asset quality is higher in building societies and finance companies, given the higher proportion of housing lending. Returns on assets are lower in credit unions than in building societies and finance companies. Overall, each of the NBDT subsectors has large capital buffers to absorb losses (figure 3.8), although there is variation across individual entities. NBDTs have generally remained resilient to the impact of COVID-19, although the impact on individual entities depends on their location and geographical exposure.

Having a single regime will enable NBDTs to compete more effectively with banks.

Figure 3.8
NBDT capital ratios



Source: RBNZ *Non-Bank Deposit Takers survey.*

Table 3.2[1]

Key metrics for NBDTs

Metric	Segment	Mar 2019	Mar 2020	Mar 2021	Feb 2022
Total assets ($m)	Finance Companies[2]	254	227	270	332
	Credit Unions	1140	1122	1138	1100
	Building Societies and Other[3]	1,190	1,273	1,377	1,531
Capital ratio (%)	Finance Companies	14.3	16.4	16.6	16.5
	Credit Unions	14.8	13.8	13.1	12.6
	Building Societies and Other	11.7	12.2	14.4	13.5
Non-performing loan ratio (%)	Finance Companies	5.9	8.0	2.9	0.9
	Credit Unions	2.8	2.7	3.1	3.4
	Building Societies and Other	0.1	0.1	0.0	0.3
Return on assets, before tax (%)	Finance Companies	1.7	2.1	1.6	2.3
	Credit Unions	-0.2	-0.3	0.3	0.3
	Building Societies and Other	0.9	0.9	1.1	1.4
Number of operating entities	Finance Companies	7	6	6	6
	Credit Unions	12	9	8	8
	Building Societies and Other	4	4	4	4

Source: RBNZ *Non-Bank Deposit Takers survey.*

1 We have corrected some of the figures in Table 3.2 after publication, due to an error being identified.

2 Data for finance companies exclude FE Investments Limited from March 2020, when it entered receivership.

3 Other NBDTs includes Christian Savings Limited.

Insurers

Insurers in New Zealand provide a valuable risk-management function for both individuals and businesses by spreading risks. The risk of large, potentially ruinous financial losses is substantially reduced by purchasing insurance.

Insurers have retained capital during the period of economic uncertainty

Even though the worst-case economic scenarios envisaged earlier in the pandemic have not materialised in New Zealand, our expectation is that insurers have appropriate contingencies in place to mitigate significant stresses on their businesses and protect the interests of policyholders. Overall, the New Zealand insurance sector remains resilient despite the many ongoing uncertainties.

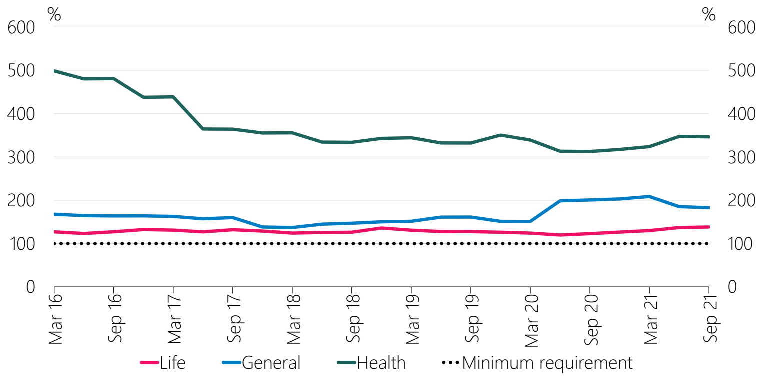
Overall, the solvency capital ratio of the general insurance sector decreased during 2021, but is still higher than it was prior to 2020 (figure 3.9). This reflects capital being retained in 2020 and a cautious approach to capital management once dividend payments resumed in 2021. The solvency ratio for the life insurance sector increased during 2021. The solvency ratio for the health insurance sector continues to fluctuate around previous levels.

COVID-related uncertainties are likely to remain in the short term

Overall, the New Zealand insurance sector remains resilient and has coped well with COVID-related issues. However, the Omicron variant is infecting a substantial proportion of New Zealanders, with a rise in deaths and longer-term health conditions (long COVID). Therefore, claim impacts on life and health insurers may increase. For health insurance, the deferral of both elective surgery and routine health screening during the pandemic may ultimately lead to increased claim numbers as a result of the missed identification and treatment of health issues.

Figure 3.9

Insurer solvency ratios



Source: RBNZ *Insurer Solvency Return*.

Higher inflation could lead to more under-insurance

Increasing inflation is flowing through to higher general insurance claim costs, and in turn leading to premium increases. Residential construction costs have been rising faster than consumer price inflation. As most property insurance has moved from replacement cover to a sum insured basis, at least for earthquakes, households and businesses should regularly review their sum insured, or in the event of a total loss they will need to self-fund a portion of the costs to rebuild or replace their damaged properties.

High rates of corporate activity in insurance markets...

We have observed a continued high rate of corporate activity in the New Zealand insurance markets. This includes market entry and exit, mergers and acquisition, and sales of portions of insurers' books. These types of corporate activities often increase risks to the insurers involved as management and board focus is diverted from normal business activities to the corporate activity. In some instances they can also spill over to be higher risks for other insurers in the relevant markets, due to changes in market dynamics including competition for new or renewing business.

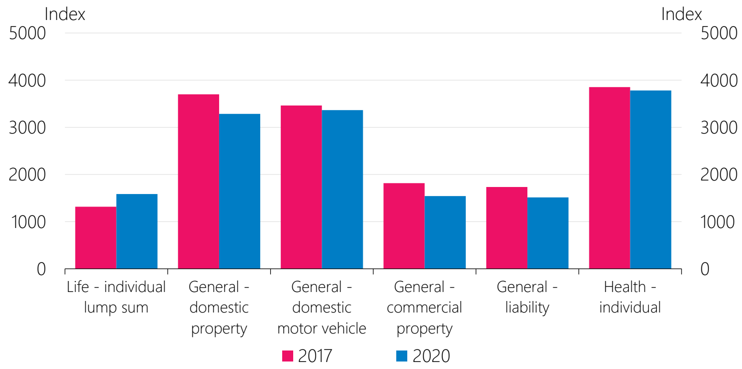
...and life insurance market has become more concentrated

In New Zealand, the life insurance market has always been less concentrated than property and motor insurance, or health insurance. However, in the past several years there has been a consolidation as most banks have divested, or are in the process of divesting, their life insurance subsidiaries. Despite the recent changes, life insurance remains less concentrated than general or health insurance (figure 3.10).

Figure 3.10

Concentration in the insurance sector

(Herfindahl indices for sub-sectors, gross earned premium basis)



Source: RBNZ *Quarterly Insurer survey*, RBNZ estimates.

Note: The Herfindahl index measures the degree of concentration in industries or sectors. Data for 2020 do not include Fidelity's acquisition of Westpac Life or other transactions that are currently in progress.

General insurers account for the largest part of New Zealand's insurance sector, with around 59 percent of total gross premium revenues, life insurers around 29 percent, and health insurers around 12 percent.

Table 3.3

Key metrics for New Zealand's insurance sector

Metric	Value (%)				Regulatory minimum (%)	Comment
	Sep 2018	Sep 2019	Sep 2020	Sep 2021		
General insurers						
Solvency ratio	147	161	201	183	100	Solvency ratios increased significantly in early 2020 when insurers ceased paying dividends and retained capital.
Profit margin	-3.0	13.1	13.2	10.3		Profit margins have been stable in recent years.
Expense ratio	13.7	13.4	12.9	13.5		Expenses returned to pre-COVID levels.
Life insurers						
Solvency ratio	126	128	123	138	100	Solvency ratios have steadily increased since the end of 2020.
Profit margin	13.8	16.6	15.1	12.4		Profit margins materially decreased during the year ended September 2021.
Expense ratio	20.9	21.3	22.7	24.5		Non-commission expenses have been increasing.
Health insurers						
Solvency ratio	334	332	313	346	100	Health insurers generally have stronger capital buffers than general insurers, reflecting the fact that many are mutual companies with restricted access to capital.
Profit margin	1.6	1.5	4.2	3.7		Profit margins are low for health insurers, again reflecting the fact that many are mutual companies that lack profit-motivated parent-firms or shareholders.
Expense ratio	11.4	11.0	11.6	12.4		Expenses have increased in the year ended September 2021.

Source: RBNZ *Insurer Solvency Return, Quarterly Insurer Return*.

Note: Profit and expense figures are from the Quarterly Insurer Return for the year to September 2021. These cover just under 90 percent of the insurance sector by premium. Profit margin is profit after tax divided by gross premium revenue; note that this measure overstates profitability for mature traditional life insurers with large balance sheets and low levels of premium. Expense ratio is non-commission expenses divided by gross premium (expressed as a percentage). Solvency figures are from the Insurer Solvency Return to September 2021 for all insurers.

Financial Market Infrastructures (FMIs)

FMIs are the systems that allow financial transactions to take place. Their importance to the stable operation of the financial system makes it crucial that they operate with minimum risk, perform consistently, and are proactively regulated.

FMIs have remained resilient during the COVID outbreak

FMI operators have continued to operate smoothly in recent months, including by activating business continuity plans. FMIs continue to show resilience during the changing environment caused by the pandemic, with no significant incidents lately. A key priority for the Reserve Bank, as the operator of the ESAS and NZClear systems, is to ensure the systems are run efficiently and safely in the current environment.[4]

Sanctions on Russia affect payment systems, but have likely limited direct impact on the New Zealand economy

As mentioned in Box A, Russia's invasion of Ukraine has led to wide-ranging financial sanctions, including the exclusion of major Russian banks from SWIFT. Messages sent through SWIFT initiate and confirm payments between financial entities. This can affect New Zealand exports and imports if payment flows are difficult to facilitate. New Zealand banks have indicated there are limited bilateral relationships with the sanctioned banks, and therefore the direct impact on the New Zealand economy of the Russian banks' exclusion from SWIFT is likely be relatively minor.

Mastercard, Visa and American Express have announced that in response to Russia's actions, they will suspend operations in Russia. Cards issued by Russian banks will not work outside the country and cards issued outside Russia have ceased to operate in Russian shops or ATMs. People in New Zealand with credit cards issued by a Russian bank will be unable to use it in New Zealand, and people in Russia who want to pay with a credit card issued outside Russia by one of those companies will be unable to pay. We continue to monitor developments in the conflict and how these could affect New Zealanders and payment operators.

We continue to monitor developments in the conflict and how these could affect New Zealanders and payment operators.

Developments in the payments landscape offer significant enhancements

The New Zealand payments industry continues to prepare for the migration to ISO 20022 for cross-border payments. This standard creates a common language for global payments messaging, with a growing number of jurisdictions either having started to use it, or will use it soon. The standard can also carry richer data, which enables more detailed and better structured payment information. This in turn makes it easier for businesses to detect fraud. To ensure a smooth implementation of ISO 20022 in November, industry steering groups meet regularly and participants and ESAS operator are starting to test required system changes. The industry has also committed to a three-year period where both the existing and new messaging standards will be in use.

4 The Exchange Settlement Account System (ESAS) is the system that allows transactions between financial institutions to be settled. NZClear is the system for clearing and settlement of high-value debt securities and equity transactions.

Payments NZ advances initiatives to prepare the payments landscape for the future

SBI 365 is a major industry project driven by Payments NZ (PNZ) to enable banks to make payments on 365 days per year and will likely come into place in 2023. This will allow New Zealanders to make and receive electronic transactions every day of the year, as opposed to only during the traditional five-day business week. Consequently, the project is a key piece ensuring that payment systems are efficient and innovative.

In line with its modernisation plan, PNZ recently completed a market-gathering exercise on real-time payments capabilities for New Zealand. Based on the responses, PNZ is assessing options for a real-time payments system in New Zealand.

The joint regulators have finalised the regulatory framework and will proceed to assess systemic importance

After the passing of the FMI Act in May 2021, the FMA and we are jointly acting as the 'regulator' in the new regime. In January, the two agencies published the results of their July 2021 consultation on implementing the new Act. The consultation has resulted in a refined approach to developing legally binding standards for designated FMIs and a finalised framework to identify systemically important FMIs. Future workstreams of FMI Act implementation include assessing the systemic importance of currently designated FMIs and finalising the standards for designated FMIs.[5]

SBI 365 is a major industry project driven by Payments NZ to enable banks to make payments on 365 days per year and will likely come into place in 2023.

5 See Chapter 4 – *Regulatory Initiatives*.

Box B

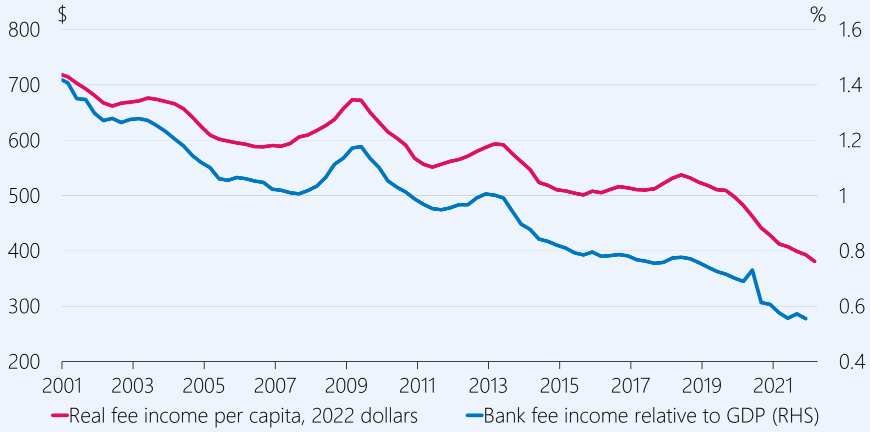
Bank fees and financial system efficiency

Financial system efficiency refers to how well the system helps to direct the economy's scarce resources to their most productive purposes (allocative efficiency), how well the system responds to changing technologies and consumer preferences (dynamic efficiency), and the extent to which the system provides services at a reasonable cost (technical efficiency).[6] As one lens on the technical efficiency of New Zealand's financial system, this Box examines recent trends in registered banks' lending and service fee charges.

New Zealand's banks tend to operate relatively straightforward business models, focused on intermediating credit between savers and borrowers. As a result, most of the banks' income is derived either from net interest income (the difference between what they earn on their lending, and the cost of their funding, such as deposits) and fee income charged to cover the cost of a range of services provided. These include fees for account maintenance, interchange payments, money transfers, and lending facilities.

Figure B.1

Annual bank fees per capita and relative to GDP



Source: Stats NZ, registered banks' Disclosure Statements, RBNZ *Income Statement Survey*, S&P Capital IQ, RBNZ estimates.

Note: Fee income from 2014 onwards is sourced from the *Income Statement Survey*. Prior to 2014 fee income for all registered banks is an estimate based on annual reports of the major New Zealand banks.

Figure B.2

Banking system net fee and commission income by country

(percent of average assets, year to September 2021)

Source: APRA, ECB Statistical Data Warehouse, RBNZ *Income Statement Survey*, RBNZ estimates.

Fee income has become a relatively less important part of banks' revenues over time, falling from around 28 percent of total income in 2001 to around 13 percent today. Adjusted for inflation, per capita bank fees are around 40 percent lower today than 20 years ago (figure B.1). A cross-country comparison also suggests that New Zealand banks' fee income is relatively low (figure B.2).

6 For further discussion of the concept of financial system efficiency, see Bloor and Hunt (2009), *Understanding financial system efficiency in New Zealand*, https://www.rbnz.govt.nz/research-and-publications/reserve-bank-bulletin/2011/rbb2011-74-02-03

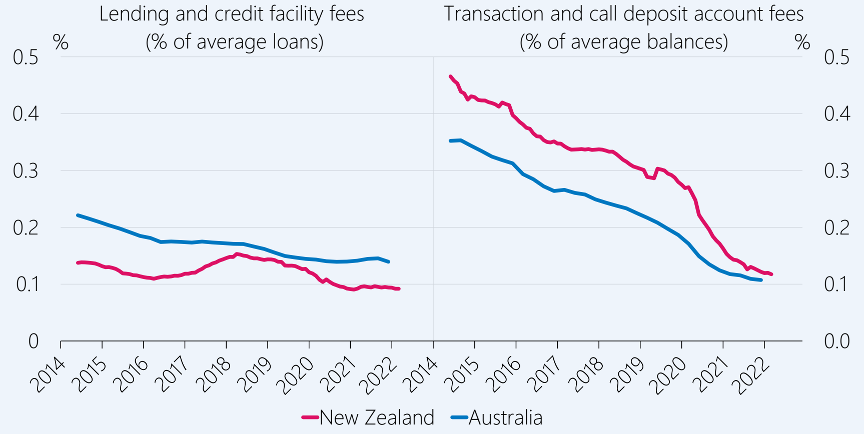
New Zealand banks' fees have also trended downwards when viewed at a product level. Fees for lending and credit facilities (such as application, overdraft, and default fees) and for transaction and deposit accounts (such as account maintenance and manual transaction fees) have declined relative to the total value of these products. This mirrors trends seen in Australia (figure B.3).

To a large extent, the declining value of bank fees in New Zealand reflects ongoing declines in banks' operating costs due to the digitalisation of banking and economies of scale. For example, all major banks now offer free personal transaction accounts, with no fees charged for most electronic transactions. Amendments to consumer laws in 2015 have also limited lenders' ability to charge credit and default fees on consumer lending beyond what is reasonably necessary to recover their costs.

Offsetting a general downward trend in fees, consumers' greater use of scheme debit and credit cards (Visa and Mastercard) issued by banks had led to a growth in banks' income from this source in recent years (figure B.4). EFTPOS transactions are free in New Zealand, while payments using scheme cards involve interchange fees, which are charged per transaction and generally paid to card-issuing banks and borne by merchants.

Figure B.3

Annual fees on lending and deposit products

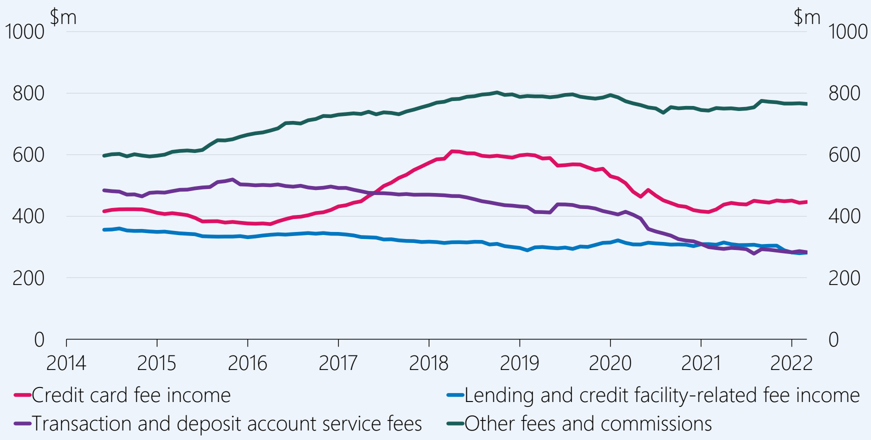


Source: APRA, RBNZ *Income Statement Survey*, RBNZ estimates.

Figure B.4

Registered banks' fee income by type

(annual revenues)



Source: RBNZ *Income Statement Survey*.

Banks have lowered their interchange rates somewhat in recent years, and in some cases temporarily waived fees for contactless payments to support the country's response to COVID-19. However, interchange fees in New Zealand remain high compared to peer countries, and legislation to introduce a new regulatory framework and limits on interchange fees is currently before Parliament.[7]

Reflecting an ongoing trend of digitalisation and operating cost efficiencies, fee income has become a relatively less important part of New Zealand banks' business models in recent decades. New Zealand households and businesses are paying significantly less in bank fees than in prior decades, and future changes to the regulation of retail payment systems look set to continue this trend.

7 See the MBIE website for further information on the proposed regulation of the retail payment system https://www.mbie.govt.nz/business-and-employment/business/competition-regulation-and-policy/retail-payment-systems/

Regulatory initiatives

CHAPTER 04

CHAPTER 4
Regulatory initiatives

At present, we are considering feedback on the Deposit Takers Bill. Alongside this we are enhancing our policy framework with other consultations and a thematic review. This chapter provides updates on these initiatives and more, highlighting in particular four new initiatives since our previous *Report*.

New regulatory initiatives

Governance thematic review

In collaboration with the Financial Markets Authority (FMA), we are conducting a cross-sector thematic review of governance of regulated entities. The review focuses on boards of regulated entities, given their role as the ultimate governing body. The review seeks to examine the policies and operational practices of boards to understand the mechanisms in place that allow them to govern effectively and provide oversight. It will assist us in developing and maintaining industry knowledge of board practices and their adherence to expectations set out in the respective RBNZ and FMA governance guidelines.

The sample for the review consists of 32 regulated entities from across the banking, insurance, non-bank deposit taking and investment management sectors. Sampled entities have been informed of their selection to participate in the review.

The review will follow a similar approach to prior thematic reviews, which will include an offsite and onsite phase. We expect to complete the review over a 12-month timeframe.

On conclusion, we will provide feedback to sampled entities and jointly publish a thematic report, on a no-name basis.

The next step for the review is the offsite phase, which will involve documentation reviews and preparation for onsite visits.

Debt servicing restrictions

In November 2021, we published a consultation paper seeking feedback on the merits and potential design of two types of debt servicing restrictions (DSRs). One option is restrictions on debt-to-income (DTI) ratios, which impose a cap on debt as a multiple of income. Another option is a floor on the test interest rates used by banks. Test interest rates are used in banks' serviceability assessments, which examine the ability of borrowers to continue repaying their loans if interest rates rise.

The DSR consultation closed in February 2022, and we recently released a summary of the submissions received, along with our response. Following consideration of the submissions, we intend to proceed with designing a framework for operationalising DTI restrictions, in consultation with the industry and other stakeholders. We intend to have the framework finalised by late 2022, so that restrictions could be introduced by mid-2023 if required.

Banks' test interest rates have begun to rise in line with market rates, and we expect to see a slowdown in high-DTI lending over the coming months. The new CCCFA regulations, changes to the tax treatment of investment property, and tighter LVR restrictions on owner-occupiers are also having an impact on the availability of mortgage credit. We therefore do not see an urgent need to impose an interim test rate floor at this stage, but we are monitoring the situation closely and do not rule out this option if risks to the financial system warrant it.

Liquidity policy review

We are undertaking a comprehensive review of our liquidity policy (BS13). Although we believe our existing liquidity policy remains broadly fit for purpose, it has not been reviewed since it was implemented in 2010. Since that time, an international liquidity framework has been developed and implemented overseas. There have also been a number of significant developments domestically that support the case for reviewing the policy now, including our recent liquidity thematic review and stress tests as well as the COVID-19 pandemic experience.

In addition, we plan to consider whether our liquidity policy should also capture banks that are operating in New Zealand as branches, and, in due course, how it should apply to a broader set of deposit takers under the upcoming Deposit Takers Act.

We released the first consultation paper for this review earlier this year, with the comment period closing in mid-April. This paper set out the proposed issues and scope for the review, and contained the principles we propose be used to guide the review and our decision-making.

We intend to issue at least three more consultation papers as part of the review, with the entire review spanning approximately three years. The second and third consultation papers will seek feedback on a number of fundamental issues related to our liquidity policy, with a fourth consultation paper expected to contain the proposed final liquidity policy.

New standards for Financial Market Infrastructures (FMIs)

The Financial Market Infrastructures Act 2021 (the FMI Act) came into effect in May 2021. This new legislation follows on from the IMF's 2016 Financial Sector Assessment Programme recommendation to modernise the FMI regulatory regime in New Zealand. The FMI Act establishes a comprehensive prudential and conduct framework for FMIs that are systemically important or FMIs that want to opt-in to access legal protections around netting, settlement and the enforcement of system rules. The FMI Act also establishes a crisis management regime for designated FMIs and includes information-gathering powers in respect of all FMIs for risk-monitoring purposes.

The IMF recommended that New Zealand adopt the relevant international standards, the Principles for Financial Market Infrastructures (PFMI). The FMI Act gives us and the FMA (or the Reserve Bank alone for payment systems) the power to issue binding standards on a wide range of prudential and conduct matters, and allows us to embed the PFMI into binding standards appropriate in New Zealand.

Work is progressing to implement the FMI Act. We are currently developing standards that are largely based on the PFMI, with additional requirements that go beyond the PFMI in key areas to support the financial system in New Zealand. We will consult on these standards in the second half of this year.

Update on previously reported regulatory initiatives

Deposit Takers Bill

Between 2018 and 2021 a joint team of Reserve Bank and Treasury staff conducted the second phase of a review of the Reserve Bank of New Zealand Act 1989. The review saw the introduction of two major reforms – the Reserve Bank of New Zealand Act 2021 and the Deposit Takers Bill. The former modernised the Reserve Bank's governance, reporting and accountability requirements. The latter aims to promote financial stability by establishing a framework for regulating and supervising deposit-taking entities. The Deposit Takers Bill will introduce a deposit compensation scheme to protect depositors from loss up to $100,000 per depositor, per institution.

Based on Cabinet decisions on the Deposit Takers Bill, we released the draft of this Bill in December 2021 for public comment. The consultation is now closed and a summary of public comments will be published before the Bill is introduced into Parliament. We are considering the public comments and working to obtain agreement on final changes. To meet implementation timelines, the Deposit Takers Bill is expected to be introduced to the House for its first reading around July 2022.

The Deposit Takers Bill will introduce a deposit compensation scheme to protect depositors from loss up to $100,000 per depositor, per institution.

Review of policy for branches of overseas banks

We are conducting a review of policy settings for registered branches of overseas banks, as they apply both to current registered branches and future applicants. Unlike banks that are incorporated in New Zealand, branches are part of a bank that is incorporated overseas. As a result, branches are not subject to many of the requirements that apply to banks incorporated in New Zealand.

We are currently considering responses to the first consultation, which set out the current branch policy, the problem definition of the review, assessment principles, and some high-level policy questions and options. A second consultation paper is expected to be published in July and will seek feedback on our proposed approach.

Insurance reviews

We are continuing to conduct two reviews of insurance regulation. They are a review of the Insurance (Prudential Supervision) Act 2010 (IPSA), and a review of solvency standards, which are rules issued under IPSA, imposing minimum capital requirements on insurers.

The IPSA review will involve several public consultations, and legislative changes are not expected until after 2024.

We recently published the third consultation under the IPSA review, on enforcement and distress management. Previous consultations have covered the scope of the Act and overseas insurers, and policyholder security. The third consultation considers:

- Introducing a wider range of offences and enforcement options in the Act so that we can respond more proportionately to non-compliance;
- Expanding our ability to obtain information, including through on-site inspections and a breach-reporting system; and
- Reforms to the governance of our role in distress management.

For the solvency standards review, an exposure draft of the proposed interim solvency standard was published in July 2021. This interim standard incorporates changes to the structure of the standards and means that solvency rules will work effectively with incoming rules for insurance accounting (IFRS 17). We are currently revising the standard based on feedback.

A final version will be published in late September and will come into force in January 2023. Once the standard is finalised, we will be calibrating the amount of capital insurers are required to maintain against different risks.

Implementation of the Capital Review

In December 2019, we announced final decisions on the comprehensive review of the capital adequacy framework for locally incorporated banks (the Capital Review). Banks' conditions of registration were updated on 1 October 2021 to bring the new Banking Prudential Requirements relating to capital into force.

A number of aspects of the December 2019 decisions took effect from 1 January 2022:

- An 85 percent output floor for calculations of risk-weighted assets (RWA) for banks accredited to use the Internal Ratings-Based (IRB) approach; and
- Banks accredited to use the IRB approach must use the Standardised approach for Sovereign and Bank exposures.

Both of these changes have the effect of increasing the size of RWA, therefore reducing the capital ratio for a given amount of capital.

The largest impact arises from the output floor. This applies to banks that use their own models to estimate RWA. From 1 January 2022, these banks must also calculate the RWA outcome if they had used the Standardised model instead of their own models. The bank must then use either their modelled outcome for their RWA, or 85 percent of the Standardised outcome, whichever is the highest.

The implementation of the output floor narrows the gap between outcomes for the same exposures between banks accredited to use IRB models and those using the Standardised approach.

One key element related to estimates of RWA is yet to be put in place, namely 'dual reporting'. Banks accredited to use internal models will be required to report both their modelled and Standardised equivalent RWA for credit risk. Dual reporting will begin for disclosure statements with a reporting date of 30 September 2022.

We published a consultation paper about the detailed coverage of dual reporting early in February and the consultation closed on 3 May 2022. Decisions about the final shape of dual reporting will be made in the coming months.

In the past couple of months we have also published a technical paper on capital instruments for banks structured as mutual entities. This covers options for the design of a capital instrument that would qualify as Common Equity Tier 1 capital for mutual entities.

Other Capital Review decisions will also take effect during 2022. The most significant of these is the increase in the Prudential Capital Buffer (PCB) that banks need to have in addition to the minimum capital requirement. On 1 July 2022, a 1 percent buffer will apply to Domestic Systemically Important Banks (D-SIBs), increasing the PCB for these banks to 3.5 percent.

At the moment all banks need to have a PCB of 2.5 percent, in addition to minimum total capital requirements of 8 percent. This means they must have a capital ratio of at least 10.5 percent. For D-SIBs this will be 11.5 percent from 1 July 2022 and will increase to 18 percent by the time the Capital Review decisions have been fully implemented in 2028. This will increase the stability of the New Zealand financial system.

The future of money and cash

The Reserve Bank has proposed to take on a stewardship role to ensure that money and cash remain fit for purpose in New Zealand (Box C). The work programme is currently focused on articulating the role of the Steward, exploring the possibilities of a new digital form of central bank money and considering options to redesign the cash system. Public feedback on the issues was broad and informative for our work plan, and further public engagement will follow.

Box C

Public views on the future of money

Insights from feedback to the Future of Money issues papers

In September 2021, the Reserve Bank released the Future of Money Stewardship – (*Te Moni Anamata – Kaitiakitanga*) issues paper. This paper expanded from previous consultations on the future of cash by broadening discussions on the future of New Zealand's money. The issues paper set out the importance of central bank money as a value anchor for the financial system (thereby supporting stability) and for achieving financial and social inclusion. The issues paper also proposed the Reserve Bank should take a broader and more holistic stewardship role over New Zealand's money.

In an effort to progress work on policy options for securing the roles of central bank money identified in the Stewardship issues paper, the Reserve Bank released two further issues papers: Future of Money – Central Bank Digital Currency (CBDC) (*Te Moni Anamata – Aparangi ā Te Pūtea Matua*) to explore ideas for a digital form of central bank money; and Future of Money – Cash System Redesign (*Te Moni Anamata – He Whakahou i te Pūnaha Moni*), which considers options for redesigning the cash system to ensure it is fit for purpose.

Public feedback on the three issues papers was broad and informative for our work plan. While a detailed summary of the submissions will be published separately, three insights emerged and are outlined below.

The public are highly engaged in the future of money issues

The level and content of the responses to the three issues papers revealed that New Zealanders care deeply about the future of their money, particularly cash. We received over 6000 responses from the public and stakeholders. Most of the responses were received in response to the CBDC issues paper, but the nature of the feedback spanned the content of all three. Over 90 percent of the responses from the public were received via online survey in a short period following interest on social media. In addition, detailed submissions from stakeholders and members of the public provided substantive feedback.

Cash remains very important to New Zealand

The nature of the responses confirmed that many New Zealanders support our work on ensuring the future of cash despite its long-term decline. Some respondents considered access to cash as a basic human right, stating they value the privacy it provides and its tangibility, as well as being an alternative for those with a low level of trust in banks or the government.

Many respondents pointed out that cash facilitates the social and cultural life of New Zealanders. These themes confirmed findings from the 2019 Future of Cash consultation and 2021 deliberative workshops.

The privacy and autonomy afforded by cash was a repeated theme in responses to the CBDC issues paper. This reinforced the proposal for a CBDC to be 'cash-like' in the sense that people are able to freely and privately use and hold cash, and that it can be used as a back-up payment in personal emergencies. Therefore, future work will, in the first instance, focus on a privacy-centric CBDC that also helps us achieve inclusion goals.

The majority of responses supported having a well-functioning cash system and flagged the urgency with which actions should be taken to redesign the cash system. Members of the public, community representative organisations, merchants and cash industry participants supported prescribing minimum standards for commercial bank-provided services and equipping the Reserve Bank with new tools to direct banks to provide cash services at low cost. Respondents also expressed support for mandating the acceptance of cash by merchants and government entities, but concerns about unintended consequences were raised by banks and merchants.

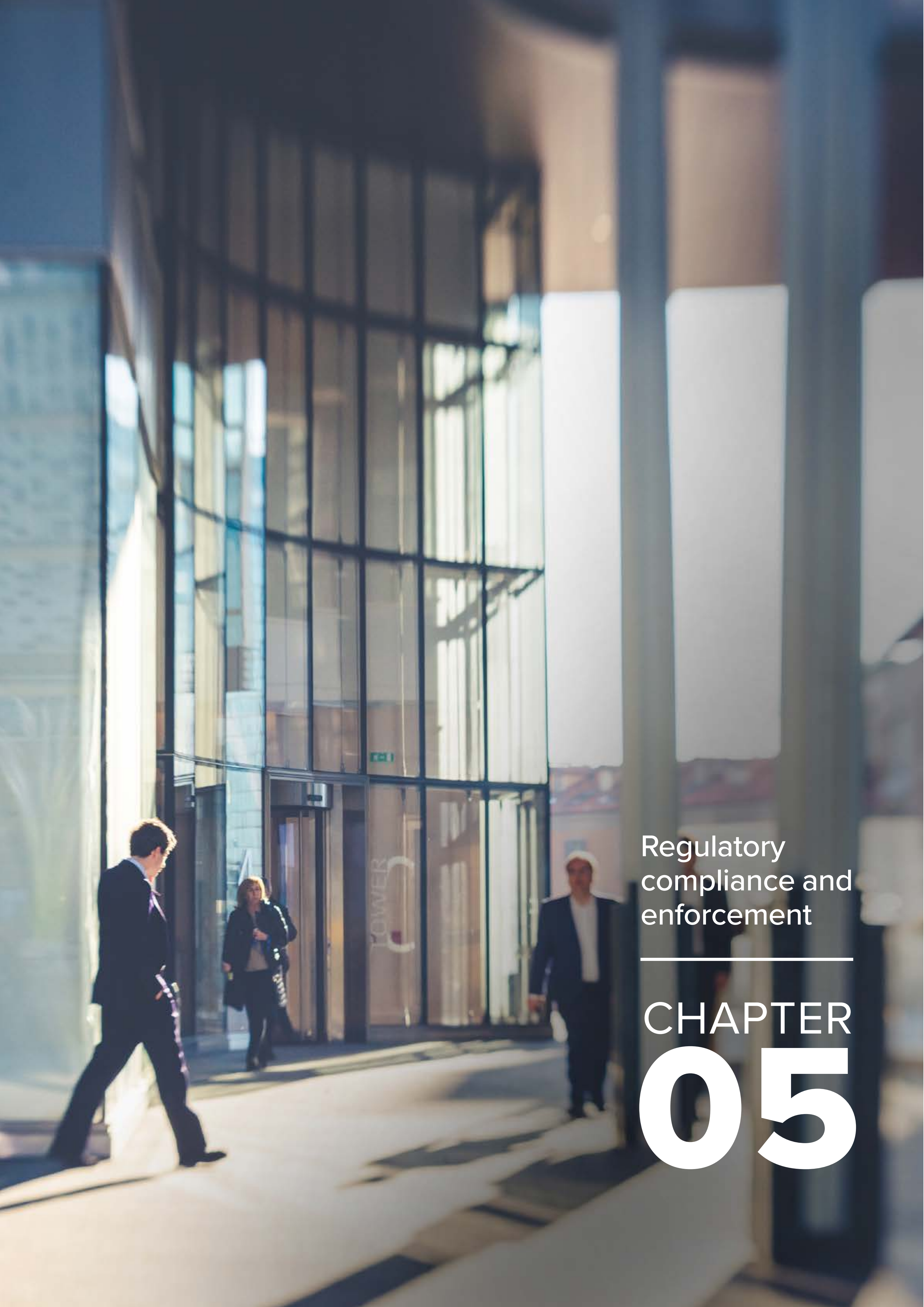
We must continue a multi-stage approach

The feedback to the papers also reinforced our need to take a multi-stage approach in addressing the Future of Money issues. More detail and further consultation was requested on the concept and responsibilities of stewardship, on the design and arrangement of a CBDC, and on cash system options.

On stewardship, most respondents supported the proposed objectives, role, responsibilities and approach. However, many requested further clarity around the Reserve Bank's vision for the future of money and payments and on how stewardship will operate in practice. We plan to develop a framework for measuring and monitoring the needs of the public for cash, reporting on how we are tracking against the stewardship objectives and outcomes, and establishing expectations of how we act as Steward with stakeholders and partners.

Among the respondents who understood that the Reserve Bank was not contemplating replacing cash with a CBDC, enthusiasm was evident. There was general agreement on most of the opportunities, challenges and risks outlined in the paper. However, details on its design and distribution arrangements were requested. Opposition to a CBDC arose due to the lack of perceived need for a CBDC, or the potential risks created by its introduction such as breaching transactional privacy or cyber-attacks. We plan to test whether and how the various design principles for a CBDC, including privacy, can be ensured and engage in further consultation with industry and the public to advise our work.

Although banks supported the proposed criteria to assess the cash system, they suggested that a clearer problem definition, and a joint money and payments strategic vision, are essential.



Regulatory compliance and enforcement

CHAPTER 05

CHAPTER 5 Regulatory compliance and enforcement

In the event of identified non-compliance, we have the discretion to take action and to decide what form this might take. This helps to ensure that financial institutions comply with the relevant legislation and regulatory frameworks. This chapter provides information on recent non-compliance, and the activities we have undertaken to achieve our statutory objectives.

Areas of non-compliance

The number of instances of identified non-compliance by regulated entities was broadly stable over the past six months, relative to the period covered by the previous *Report*. Reporting and disclosure issues continued to be common across both the banking and insurance sectors, comprising over a quarter of the compliance issues identified.

For licensed insurers, the majority of compliance issues identified related to governance processes, including the CEO certification requirements. The Reserve Bank and FMA cross-sector thematic review of governance, discussed in Chapter 4, is likely to identify further instances of non-compliance, as it explores how boards and directors adhere to regulatory expectations on key governance areas.

For registered banks, most instances of identified non-compliance were liquidity-related, as banks continued to work through the findings from the thematic review of banks' compliance with the liquidity policy.

As noted in the previous *Report*, the thematic review identified a range of systems, controls, and risk management weaknesses, and instances of non-compliance with the policy. The findings from this review have led to the first entries published in the material breach register on our website.[8] This register collates material breaches by banks in one place and aligns with our aim to be an open, transparent regulator. We continue to monitor banks' remediation of these issues.

Requirements to report on prescribed transactions continued to be the primary area of non-compliance with anti-money laundering and countering the financing of terrorism (AML/CFT) requirements. Reporting entities are required to obtain information about the originator of a transaction, and ensure that information accompanies a wire transfer. Reporting entities must also report prescribed transactions to the New Zealand Police's Financial Intelligence Unit. Prescribed transactions are international wire transfers of $1,000 or more, and domestic cash transactions of $10,000 or more.

8 https://www.rbnz.govt.nz/regulation-and-supervision/banks/disclosure-of-historical-breaches-of-key-prudential-requirements

Responding to non-compliance

We aim to have an escalating regulatory response to identified non-compliance. We set out below an overview of some recent actions we have taken since the last *Report* to address non-compliance by regulated entities.

Independent report on WNZL's risk governance

In March 2021, we requested two independent reports from Westpac New Zealand Limited (WNZL) under section 95 of the Reserve Bank of New Zealand Act 1989. This followed the identification of issues with WNZL's compliance with our liquidity requirements, and concerns about the risk governance processes and practices applied by the WNZL Board and executive management.

In November 2021, the first report on WNZL's risk governance was published. This highlighted material shortcomings in the Board's oversight, and found that there had been historic underinvestment in WNZL's management capabilities.

As a result of the report, we will be closely monitoring WNZL's remediation of its risk governance in line with the report's recommendations, to ensure their efforts are effective.

The second report that we requested will assess the effectiveness of the actions WNZL has taken to improve the management of their liquidity risks, and the culture surrounding it. A summary of this report will be published once finalised.

Independent report on ANZ's implementation of governance recommendations

In June 2019 we requested a report on ANZ Bank New Zealand Limited's (ANZ) Director Attestation and Assurance framework, also under section 95.

ANZ engaged Deloitte to prepare the report, which found that ANZ's directors' attestation and assurance framework required improvement to become fully effective. Deloitte recommended a number of actions that directors must ensure are taken to improve effectiveness.

In December 2019, we issued a further section 95 notice to ANZ, requiring an external party to confirm that ANZ had implemented all of the recommendations.

We received this report from Deloitte in December 2021. In relation to the work undertaken, we consider ANZ has taken appropriate steps to address the recommendations from the section 95 report. However, some elements are still being embedded, and we will continue to monitor ANZ's progress over the coming year.

Investigations and enforcement action

We are empowered to investigate non-compliance with our prudential legislation and the AML/CFT Act, and take enforcement action where it is appropriate to do so.

All of our current investigations relate to non-compliance with obligations under the AML/CFT Act by registered banks that may be exhibiting inadequate AML/CFT procedures, policies or controls.

The non-compliance relates to wire transfer identity requirements and/or the prescribed transaction reporting requirements under the AML/CFT Act. Current investigations relate to failure to ensure originator information accompanies wire transfers, failure to report prescribed transactions within the statutory timeframe, and failure to accurately report required information.

There have been no formal enforcement actions since the last *Report*.

Enforcement framework

We are currently developing our enforcement framework, which is intended to allow regulated entities, the public, and other stakeholders to better understand and engage with our enforcement investigation and decision-making processes.

In October 2021 we published a consultation document on the first part of the framework – the Enforcement Principles and Criteria (P&C). The response to the feedback from the consultation and the new P&C will be published on our website.

The P&C are intended to provide a lens through which enforcement issues are considered. Along with the Relationship Charter, the P&C also guide our approach to communicating enforcement decisions.