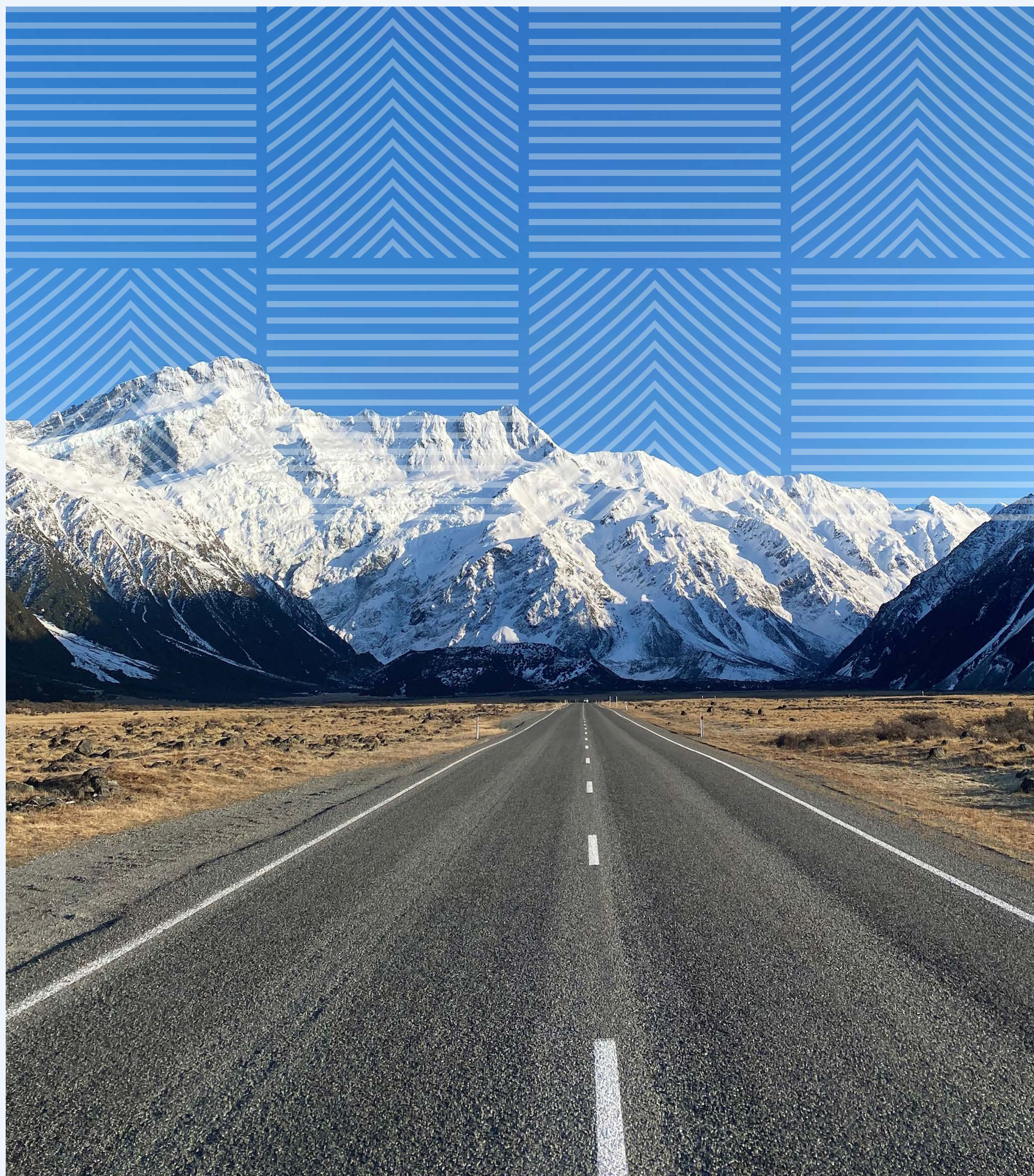
Reserve Bank of New Zealand
Te Pūtea Matua

11/2022

Financial Stability Report



Purpose of the Financial Stability Report

The *Financial Stability Report* outlines our assessment of the state of, and risks to, financial stability. The *Report* is one of our key publications, and aims to raise public awareness of developments in the financial system. It is published pursuant to section 170 of the Reserve Bank of New Zealand Act 2021, which states that the Report must:

- report on matters relating to the stability of New Zealand's financial system, and other matters associated with the Bank's prudential objective; and
- contain the information that is necessary or desirable to allow an assessment to be made of the effectiveness of the Bank's use of its powers to protect and promote the stability of New Zealand's financial system, and achieve the prudential objective.

Our prudential objective is to protect and promote the stability of New Zealand's financial system. Financial stability means having a resilient financial system that can withstand severe but plausible shocks and provide the financial services that we all rely on. This ensures everyone in Aotearoa can safely save their money, make everyday transactions, access credit to consume and invest, and insure against risks.

The *Report* outlines our assessment of the state, resilience, and vulnerability of the financial system and its component parts. We assess how global and domestic developments are affecting the financial health of New Zealand's households and businesses, and the financial performance and resilience of our financial institutions. We also highlight longer-term risks and issues that may affect financial stability.

This analysis feeds into setting our strategy and priorities for pursuing our financial stability objectives. These priorities, and progress towards them, are also outlined in the *Report*, including actions to strengthen the regulatory framework, the use of our macro-prudential policy tools to mitigate the build-up of systemic risk, work to enhance the risk management of regulated entities, and our enforcement activities.

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11/2022

Financial Stability Report

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Financial stability risk and policy assessment

CHAPTER 01

Blue Pool, Mt. Aspiring. Photo: India Power

CHAPTER 1
Financial stability risk and policy assessment

Key points

- There are increasing downside risks to the global economic outlook. Strong and broadening inflationary pressures are leading central banks to tighten monetary policy more aggressively than had previously been anticipated. Financial markets have been increasingly volatile, and there is high uncertainty about the extent to which economic activity will slow in response to the monetary policy tightening. Financial stability risks have increased as a result.
- House prices in New Zealand continue to decline as mortgage rates rise. Nationally, prices are down 11 percent from their November 2021 peak, with larger falls in Wellington and Auckland. Negative equity and mortgage servicing arrears are not widespread at present, but will grow if prices continue to fall and as mortgages reprice to higher interest rates. Significantly higher unemployment would lead to further stresses among households, and is the biggest risk to financial stability at present.
- Rising household debt servicing costs and declining household wealth will limit consumption growth over the next year. Additionally, the current conditions in the housing market are likely to lead to a decline in new residential construction once existing development projects are completed, which would contribute to slowing economic activity. Businesses in most industries have reduced their leverage in recent years, which will limit vulnerabilities as debt servicing costs increase and demand slows.
- Despite these challenges, New Zealand's financial system is well placed to support the economy in the face of a rising interest rate environment. Banks' capital and liquidity positions are strong, and profitability and asset quality remain high. Recent stress tests demonstrate banks' resilience to scenarios involving rising unemployment and interest rates, and declining house prices.
- While the financial system as a whole is resilient, some households and businesses will come under stress from the rising interest rate environment. It is important institutions take a long-term perspective in the face of the current economic uncertainties, making prudent lending decisions and providing ongoing access to credit for the wider economy, as well as supporting customers in stress.
- We continue to strengthen our regulatory, supervisory and enforcement frameworks to support the stability of the financial system over the longer term, and are guided in this by our assessment of the risks to it and its vulnerabilities. Financial institutions need to continue to invest in their systems, governance and risk management to build their long-term resilience.

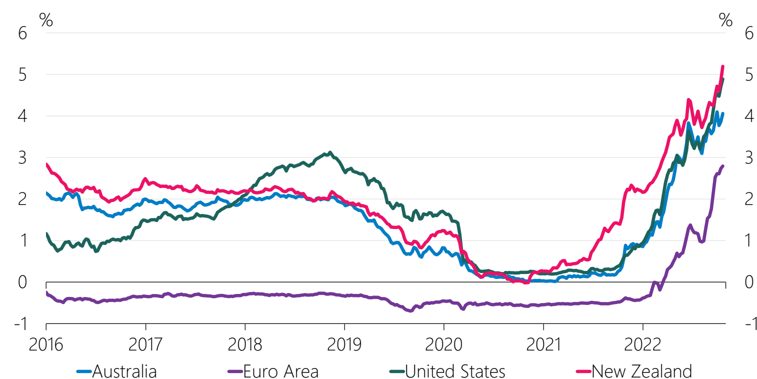
Strong and persistent inflationary pressures are requiring continued monetary tightening, as acute challenges from COVID-19 and global supply chain issues lessen

Most countries have now removed COVID-19 restrictions, and global supply chain pressures that built up at the height of the pandemic have reduced somewhat in recent months. However, Russia's invasion of Ukraine in February sparked a large increase in global commodity prices, particularly for energy, metals, and food, and they remain elevated compared to historical norms.

Figure 1.1

2-year wholesale interest rates

(swap rate, weekly average)



Source: Reuters.

These global supply shocks, when combined with the lagged effects of significant fiscal and monetary policy stimulus provided in 2020 and early 2021, have caused inflation to rise substantially across major economies, to higher levels than had been anticipated by policymakers.

After a decade of low interest rates and muted inflationary pressures, central banks are having to tighten their monetary policy settings at a faster pace than in previous tightening cycles. In doing so, they aim to ensure that high inflation does not become embedded in inflation expectations. Financial market pricing indicates a substantial monetary tightening over the next two years (figure 1.1).

Global economic growth is set to slow, with risks skewed to the downside, threatening our economic outlook

The rapid rise in interest rates over the past year presents a headwind to global economic growth. Central banks have shown a willingness to aggressively tighten monetary policy to combat strong inflationary pressures, potentially at some cost to activity and employment. Historical experience provides little indication as to the economic impact of the current tightening cycle, particularly given the public and private debt burdens that have built up across both advanced and emerging economies in the past decade. Financial markets have been increasingly volatile amid heightened economic and geopolitical uncertainties. Investor risk appetite has fallen, with market conditions deteriorating in recent months. Recent volatility highlights the risk of a disorderly tightening of financial conditions.

In Europe, policymakers are grappling with acute energy-related pressures arising from Russia's invasion of Ukraine and subsequent diplomatic and trade sanctions. Declining deliveries of natural gas from Russia since late 2021 have driven a large increase in wholesale electricity prices and household energy bills. Fiscal support measures are being implemented to soften some of the immediate impacts on households and businesses. However, by increasing input costs, ongoing high energy prices are creating headwinds for economic growth in the near term, before alternative supply arrangements are developed.

In addition, the slowdown in China's residential property development sector, and the country's adherence to a zero-COVID strategy, have contributed to slower economic growth. Financial difficulties for some developers have led authorities to tighten financial controls on the sector, which alongside reduced buyer confidence has seen a slowdown in new development. Slowing new home sales may have flow-on effects to the construction sector and cause financial difficulties amongst banks and local governments, which derive a large portion of their revenue from land development. A broader decline in China's real estate market would weigh on household consumption and economic activity more generally.

A severe downturn in any of New Zealand's major trading partners would lead to reduced demand for our exports, in turn lowering incomes of households and businesses, and leading to losses on banks' lending. A tightening in global financial conditions would also raise debt servicing costs for New Zealand households and businesses, and the government. Box B provides further information specifically about the implications of a slowdown in China for New Zealand.

Asset prices, including New Zealand house prices, are declining in the face of tighter financial conditions

The rising interest rate environment and deteriorating global economic outlook have also seen prices decline across a broad range of asset classes in recent months. In New Zealand, house prices have fallen 11 percent since their peak in November 2021, with notable divergences across regions (figure 1.2). Wellington, which experienced a relatively large increase in prices in recent years, has declined 18 percent since its peak, while Auckland has fallen by 15 percent.

Potential buyers' borrowing capacity has been reduced by rising mortgage rates, loan-to-value ratio (LVR) restrictions, and tougher serviceability assessments following changes to lender processes under the Credit Contracts and Consumer Finance Act 2003. House sales have fallen to levels seen in the aftermath of the global financial crisis (GFC), and housing lending growth has slowed considerably in recent months. The relative attraction of buying a property compared to renting or investing elsewhere has declined, given the outlook for mortgage rates, the still high level of house prices, tax policy changes, and the potential for further price falls.

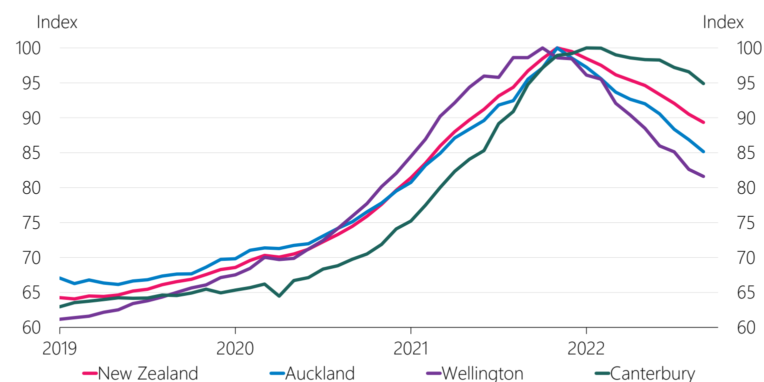
Our assessment is that New Zealand house prices remain above sustainable levels. A continued gradual decline in prices towards more sustainable levels remains desirable for long-term financial stability. However, a sharper or deeper decline remains a plausible outcome, given the strength of the run-up in prices over recent years, and the potential self-reinforcing effects from negative market sentiment.

The decline in prices means that some borrowers who purchased houses in 2021 are now in negative equity, meaning their mortgages are larger than the current market value of their property. LVR restrictions, which were reintroduced in early 2021, have helped to limit the number of households in negative equity, which remains small compared to banks' overall mortgage portfolios. However, further declines in prices would see a marked rise (figure 1.3). Negative equity among borrowers does not in itself lead to losses in the financial system. However, the default of a borrower who is in negative equity means the lender may not be able to recover the full value of their lending, for example through a mortgagee sale. A significant number of borrower defaults in an environment of widespread negative equity would lead to material financial losses for lenders.

Figure 1.2

New Zealand house prices

(seasonally adjusted, indexed to peak values)

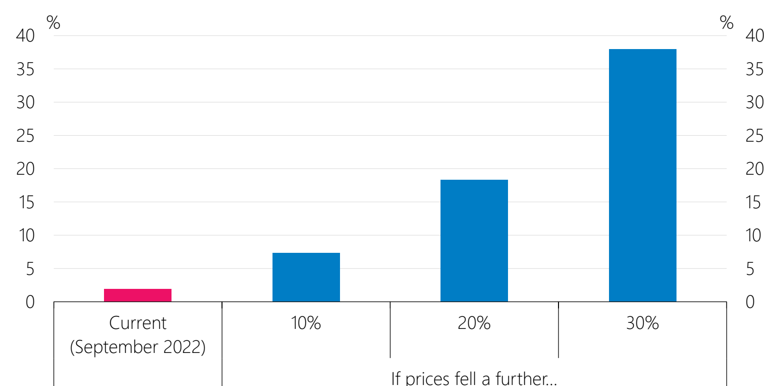


Source: REINZ, Reserve Bank estimates.

Figure 1.3

Mortgage lending in negative equity

(estimated share of current mortgage lending)



Source: REINZ, CoreLogic, Reserve Bank *LVR New Commitments survey*, *Bank Balance Sheet survey*, Reserve Bank estimates.

The downturn in the housing market will weigh on economic activity

The repricing of households' mortgages from historically low levels to current interest rates will slow the volume of consumer spending, combined with declining housing wealth as house prices retreat. Among households with mortgages, the average percentage of disposable income dedicated to debt servicing is expected to rise from a recent low of 9 percent to 20 percent, based on current mortgage rates. Repayment increases will be particularly significant for many households that first borrowed in the past two years.

The number of households in financial difficulty will grow as more fixed-rate mortgages reprice, and could increase significantly if mortgage rates rise materially above the servicing assessment rates of around 6 percent that banks applied through the pandemic period. The labour market continues to perform strongly, but a significant deterioration in labour market conditions would lead to household debt servicing stress. In these situations, lenders are likely to be able to provide relief in the form of term extensions or temporary interest-only periods for households unable to fully absorb the repayment increases they may be facing.

The outlook for residential development has deteriorated in recent months, due to declining prices for existing houses, ongoing construction cost inflation, negative net migration, and rising interest rates. The number of new houses being sold off the plans (pre-sales) has declined considerably. Since a high level of pre-sales is a prerequisite for obtaining finance from lenders, developers are potentially facing a substantial slowdown in activity once currently committed development pipelines are completed. A slowing in residential construction would weigh on broader economic activity and employment. However, continued falls in land prices could help to restore the economic viability of future development projects, limiting the extent of the downturn in building activity.

Most businesses' balance sheets are in a strong position but a decline in economic activity would create difficulties

Input cost inflation, the tight labour market, and lingering supply chain issues in some sectors are creating a difficult operating environment for many businesses. However, overall profitability has remained healthy as most firms have been able to pass on input cost increases to customers, preserving profit margins. While interest servicing burdens will increase with the rising interest rate environment, the general deleveraging trends seen in most business sectors in recent years will lessen the strain this causes. This is particularly the case for the dairy sector, where farmers have used high milk payouts in recent years to reduce debt. To date, data on bank lending to businesses has shown limited signs of financial stress emerging, although a slowing in the economy due to declining household demand would lead to a deterioration in business incomes.

Commercial property remains a sector where pandemic-induced changes to consumer behaviour are likely to persist, but these effects on rents and vacancy rates are likely to take some time to materialise as existing leases roll off. Banks have generally had conservative lending appetites for commercial property in recent years, meaning owners have sizeable buffers to handle increases in debt servicing costs and declines in property values.

Among households with mortgages, the average percentage of disposable income dedicated to debt servicing is expected to rise from a recent low of 9 percent to 20 percent, based on current mortgage rates.

New Zealand's financial system is well positioned to handle an environment of rising interest rates and slower economic growth

Registered banks' profitability has been robust, with very low levels of non-performing loans and slight increases in their net interest margins in the past six months. Banks have retained earnings and begun to issue additional capital instruments, as they build their capital levels in anticipation of higher regulatory requirements in the next few years. Since 1 July 2022, the four domestic-systemically important banks have been subject to an additional one percentage point capital buffer requirement, which will increase to two percentage points in July 2023.

As part of our stress testing programme, the 2022 solvency stress test assessed nine locally incorporated banks' resilience to a simulated 'stagflation' scenario involving unemployment rising to 9.3 percent, 2-year fixed mortgage rates reaching 8.4 percent, and house prices falling by 47 percent from their late 2021 peak. Results from the exercise show that such a scenario would lead to substantial credit losses and some banks entering their prudential capital buffers, placing limits on dividend payments and requiring them to restore their capital positions. However, the test showed that even in the worst year of the stress, and before mitigating actions are considered, the aggregate banking system would maintain a higher Tier 1 Capital ratio than typical levels seen prior to the GFC (figure 1.4).

The banking system's liquidity and funding positions also remain strong. The end of pandemic-related support measures, namely the Large Scale Asset Purchase programme and Funding for Lending Programme, will normalise funding conditions for banks. Banks will likely seek to increase the proportion of their deposits in term accounts rather than on call, to support their liquidity positions. With mortgage lending slowing due to reduced mortgage demand, banks' reliance on wholesale funding markets is expected to be modest in the near term, insulating them to an extent from current market volatility.

Banks' high asset quality in part reflects generally conservative lending standards that they have maintained in recent years. Results from our recent *Credit Conditions Survey* indicate that banks expect to maintain cautious risk appetites for most types of lending in the near term, reflecting the uncertain economic environment.[1] To avoid a deterioration in credit conditions reinforcing an economic slowdown, it will be important for banks to maintain a long-term perspective for their customers, as was evidenced at the start of the pandemic. This will require balancing prudent lending decisions in the face of current economic uncertainties, and supporting customers in financial difficulties and the economy's ongoing access to credit.

Other parts of the financial system have been resilient through the pandemic

The non-bank deposit takers sector has been relatively stable in the past six months, with consolidation among credit unions continuing, aimed at supporting their financial viability. While non-deposit taking lenders remain a small part of the financial system, some have grown quickly in recent years and may be more exposed to credit losses than the prudentially regulated lenders if the property market downturn continues (see Box D).

Figure 1.4
Banking system capital and 2022 stress test projections

Source: RBNZ *Capital Adequacy survey, Disclosure Statements,* Reserve Bank.

1 See https://www.rbnz.govt.nz/statistics/series/lending-and-monetary/credit-conditions

New Zealand insurers have retained capital through the pandemic period, supporting solvency ratios during a period of economic uncertainty. High inflation is leading to increased claim expenses and premium increases, which could also increase under-insurance. Insurers and customers need to regularly review their property sums insured to ensure they provide the desired level of protection.

New Zealand's Financial Market Infrastructures have continued to operate effectively despite the challenges of the pandemic.

Structural and long-term developments continue to be important for the financial system

While the near-term outlook for financial stability is dominated by the worsening global economic outlook, the rising interest rate environment, and soft housing market, financial institutions also need to keep a focus on other operational and longer-term challenges. The threat of cyber attacks continues to require vigilance and investment in systems' resilience, particularly in light of rising geopolitical tensions in recent years. Sound and effective governance is critical for institutions' long-term resilience, and is the focus of a thematic review we are jointly undertaking with the Financial Markets Authority.

Climate change will present challenges and opportunities for institutions, with insurers already facing increased weather-related claims in recent years. We are also working with banks to assess flooding risks to their mortgage portfolios caused by climate change (see Box C).

LVR settings remain appropriate for now

We recently reviewed our LVR settings and assessed the current speed limits in place on high-LVR lending as remaining appropriate for the time being. An easing in the speed limits would be considered if they were judged to be creating excessively tight lending conditions at a point when we were confident that house prices were around or below sustainable levels.

We are also continuing to consider how limits on high debt-to-income (DTI) mortgage lending could operate, and are consulting on a regulatory framework with the aim of making final decisions in early 2023. We do not see an immediate need to introduce high DTI limits, given the current conditions in the housing market and recent tightening banks have made to their serviceability assessments. However, DTI limits will be an important tool for managing any future build-up of financial stability risks.

Policy developments

We are continuing to strengthen the regulatory framework and build the resilience of the financial system for the longer term, and are prioritising work on major legislative reforms and other key initiatives. Alongside the implementation of higher bank capital requirements, work continues on a strengthened prudential regime for all deposit-taking institutions. The Deposit Takers Bill, recently introduced into Parliament, will consolidate the prudential regulation of banks and non-bank deposit takers (NBDTs) into a single regime. The Bill is set to strengthen the Reserve Bank's supervisory toolkit, and introduce a depositor compensation scheme that would guarantee depositors' funds up to $100,000 in the case of an entity failing.

Our review of insurance regulation continues assessing potential improvements to the Insurance (Prudential Supervision) Act (2010), which governs our supervision of insurers, and the solvency standards applying to insurers. We have recently released the Interim Solvency Standard 2023, to ensure that the solvency standard is compatible with new accounting rules. We are now beginning a second phase of the solvency standards review to assess the calibration of the level of capital insurers need to maintain against different risks. We are continuing with implementation aspects of the Financial Market Infrastructures Act 2021. In September we released a draft of proposed standards under the Act for consultation.

In addition, our policy programme will be shaped in the coming years by the introduction of a Financial Policy Remit (see Box A).

Box A

The Financial Policy Remit and the Reserve Bank

On 1 July 2022 the new Reserve Bank Act came into force. Among other changes, the new Act reconstituted the Reserve Bank Board and gave it overall responsibility for our strategic direction, functions, and operations, and ultimate accountability for the delivery of our outcomes. Among the collective duties of the Board, it is required to take account of the Financial Policy Remit.[2]

The remit is issued by the Minister of Finance and specifies matters the Government considers the Reserve Bank should have regard to in achieving its financial stability objective and performing its functions as a prudential regulator and supervisor. The remit is the counterpart to the Monetary Policy Remit, through which the Minister of Finance issues the Monetary Policy Committee with operational objectives and other considerations to have regard to for monetary policy.

What does the remit cover?

The current remit outlines the Government's desired outcomes of a strong, efficient, and inclusive financial system, with a low incidence of failure of entities regulated by the Reserve Bank. Within an appetite of a low incidence of failure, a competitive financial system is encouraged, to ensure ongoing financial efficiency and inclusion.

The Government considers the Reserve Bank should have regard to:

- the costs imposed by regulation and that they are proportionate to their risks and benefits;
- encouraging new investment and innovation that raise the economy's productive potential; and
- encouraging financial resources to be allocated in a way that maximises sustainable long-term economic growth.

The Government also considers it desirable for the Reserve Bank to have regard to the Government's wider policy objectives in relation to:

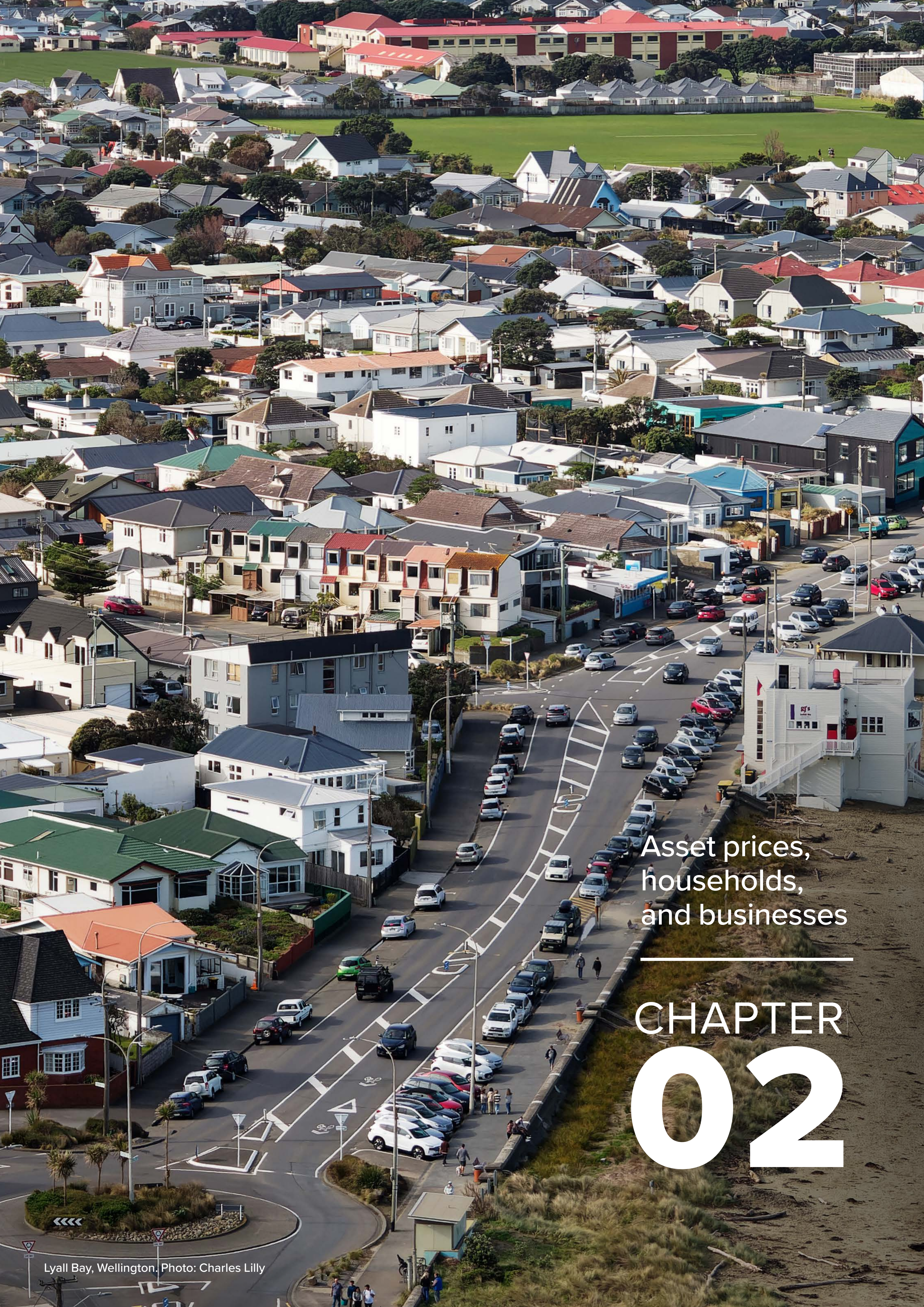
- sustainable house prices;
- building resilience and facilitating adaption to climate change;
- improving financial inclusion; and
- improving cyber resilience.

How does the Reserve Bank have regard to the remit?

With the new Reserve Bank Board now in place, we take into account the remit in four key ways.

- When setting our strategic intentions, we consider the remit in developing the priorities outlined in our Statement of Intent.
- In reviewing, developing, and implementing prudential policy, we consider the remit through the analysis of our policy proposals on the factors noted in the remit.
- In performing our supervisory functions, the remit is taken into account when considering the burden imposed by specific actions.
- And finally, in monitoring our performance, we report on how our activities may have affected the factors identified in the remit.

2 See https://www.rbnz.govt.nz/about-us/responsibility-and-accountability/our-financial-policy-remit.



Asset prices, households, and businesses

CHAPTER 02

Lyall Bay, Wellington. Photo: Charles Lilly

CHAPTER 2
Asset prices, households, and businesses

The overall financial health of New Zealand households and businesses is sound, but looking ahead there are vulnerabilities. The global economic outlook is deteriorating as central banks tighten monetary policy to reduce inflation. There is uncertainty about the extent to which economic activity will slow. Domestically, some recent mortgage borrowers are at risk of debt servicing stress and negative equity as interest rates rise and house prices fall. Businesses have benefited from strong demand and have improved their balance sheets, but household spending is expected to weaken, and this could pose challenges for some industries. After a period of buoyant demand, prospects for the residential construction sector are deteriorating owing to the housing market downturn.

International conditions and asset prices

Headline inflation is elevated, partly as geopolitical disruptions lift commodity prices

While most countries have now removed COVID-19 restrictions, and global supply chain pressures that built up at the height of the pandemic have abated somewhat in recent months, inflation is elevated. Labour markets are extremely tight, leading to high wage inflation as firms compete aggressively for workers. Periodic lockdowns in China have continued to restrict global manufacturing output.

The continuation of the war in Ukraine has led to ongoing volatility and uncertainty in key commodity markets. The outbreak of the war contributed to a sharp increase in commodity prices earlier in the year, especially in energy and food. While some of these commodity price pressures have abated, wholesale electricity prices in Europe have risen ahead of winter, following Russia's curtailing of natural gas supply and reduced generation from other sources. Global oil supply has been disrupted owing partly to sanctions on Russia, fuelling high oil prices for many countries. Some major oil producers intend to cut production, presenting upside risks to prices.

Monetary policy has tightened rapidly to stabilise inflation

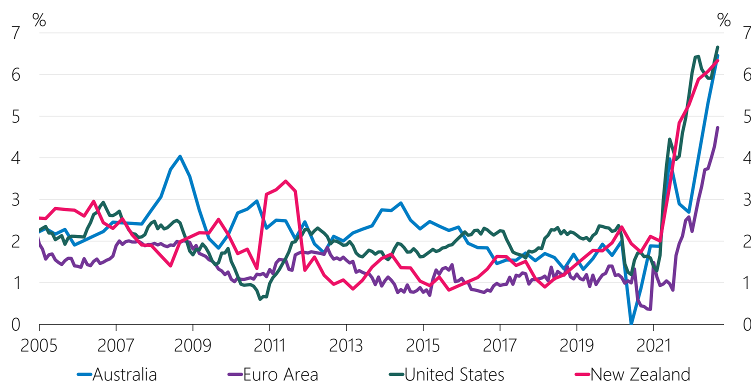
The recent drivers of high headline inflation are partly commodity-based shocks that monetary policy cannot necessarily affect. However, evidence of broader-based inflationary pressures building in many advanced economies is pushing central banks to swiftly tighten their monetary policy stances. This response aims to ensure that inflation expectations remain anchored and high inflation does not become entrenched (figure 2.1). Interest rates have risen sharply from historically low levels, as financial markets have priced in a larger monetary tightening cycle than six months ago.

Advanced economy central banks have signalled a willingness to tighten monetary policy rapidly to bring inflation under control, potentially at some cost to output and employment. Financial markets have been volatile, reflecting uncertainty as to how far central banks will need to tighten their policy further.

Figure 2.1

Advanced economy core inflation

(annual CPI inflation, excluding food and energy)



Source: Haver Analytics.

The global growth outlook has weakened, with increasing risks to the downside

The general tightening in monetary policy and elevated level of geopolitical uncertainty have caused the global economic outlook to deteriorate. Forecasts for growth in China have been revised lower as emerging financial difficulties in the residential property development market reduce domestic confidence. In addition, manufacturing is being affected by rolling COVID-19 lockdowns (see Box B). European growth is expected to be dampened by energy market disruptions and monetary policy tightening. The growth outlook for other advanced economies has also weakened materially from six months ago, including that for the United States and Australia.

External demand for New Zealand's exports has remained robust, partly owing to tight market conditions for soft commodities. However, a deterioration in growth and household consumption in our major trading partners could weaken the demand for our exports. This would affect the financial strength and income levels of New Zealand firms and households.

Financial markets have been volatile, reflecting uncertainty as to how far central banks will need to further tighten their policy.

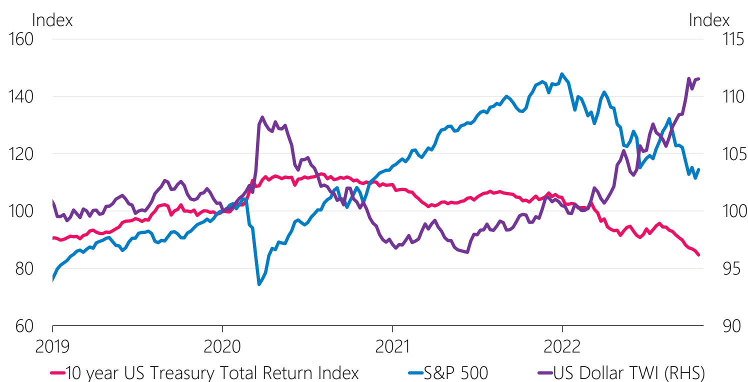
Financial markets have been volatile amid lower investor confidence

International investor confidence has declined and financial volatility has increased. Prices have fallen across a broad range of financial assets, with increased demand for liquid, safe-haven assets (figure 2.2).

Major equity indices have continued to decline from previous record high levels. The cost of new debt issuance has increased for governments and private sectors around the world, raising concerns over the sustainability of debt burdens, especially in emerging economies. Additionally, most governments have borrowed extensively in recent years to cushion the economic and health impacts of the COVID-19 pandemic, leaving less fiscal room to respond to future downturns. The strength of the US dollar, reflecting the Federal Reserve's relatively swift monetary policy tightening, may further compound debt servicing concerns in emerging economies.

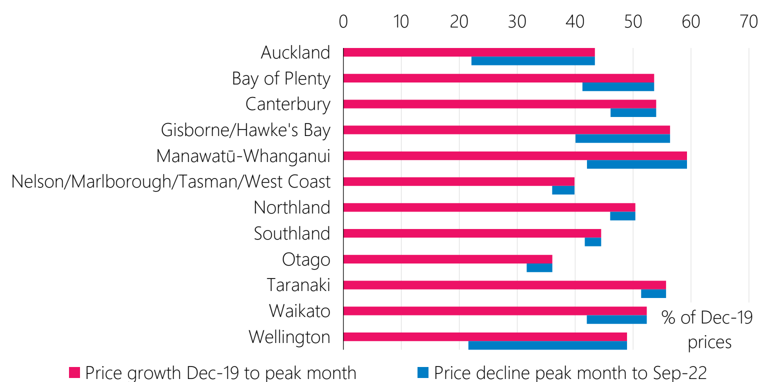
New Zealand banks can typically raise larger amounts of wholesale funding at longer terms in offshore markets than they can in the domestic market. Wholesale funding conditions have become more volatile and generally more expensive compared to six months ago. Banks are expected to weather short-term volatility in funding markets without major concerns, partly as the recent easing in domestic credit demand has reduced the need for banks to access wholesale funding markets. However, sustained volatility and a rise in funding costs would add to debt servicing costs in New Zealand.

Figure 2.2
International financial asset prices



Source: Haver Analytics.

Figure 2.3
Changes in regional house prices
(as percent of December 2019 prices, seasonally adjusted)



Source: REINZ, Reserve Bank estimates.

House prices have fallen towards more sustainable levels, but imbalances persist

Economic and regulatory developments have dampened housing demand in New Zealand. Increases in mortgage rates from late 2021 have substantially raised the debt servicing costs new borrowers face relative to their incomes. In addition, changes to lending standards under the Credit Contracts and Consumer Finance Act (CCCFA) 2003, and tighter LVR requirements, have reduced borrowing capacity for most borrowers.

Since their November 2021 peak, house prices have declined by 11 percent for New Zealand as a whole, and 15 and 18 percent in Auckland and Wellington respectively (figure 1.2). House prices have fallen broadly in other regions too, although not yet to the same extent (figure 2.3). Sales activity in recent months has fallen to levels similar to those seen during the GFC, and inventories are growing as new listings have been relatively stable (figure 2.4).

Given the recent fall in house prices, the gap between the current price level and our estimates of its sustainable level has narrowed. However, our assessment of the sustainable level of house prices has also declined, owing to market expectations for higher long-term interest rates and historically low levels of rental yields, both of which make residential properties relatively less attractive compared to six months ago (figure 2.5). In spite of the fall in prices so far, rising interest rates have meant that the debt servicing burden for new buyers remains at an historically high level (figure 2.6). Furthermore the removal of tax deductibility on interest expenses substantially worsens the cash flows generated by investment properties at high levels of gearing.

In the near term, we expect prices to continue to fall towards more sustainable levels as the effects of higher mortgage rates feed through to declining demand for housing. A sharp decline from the current price level remains plausible, as the low mortgage rates that drove the recent run-up in prices reverse.

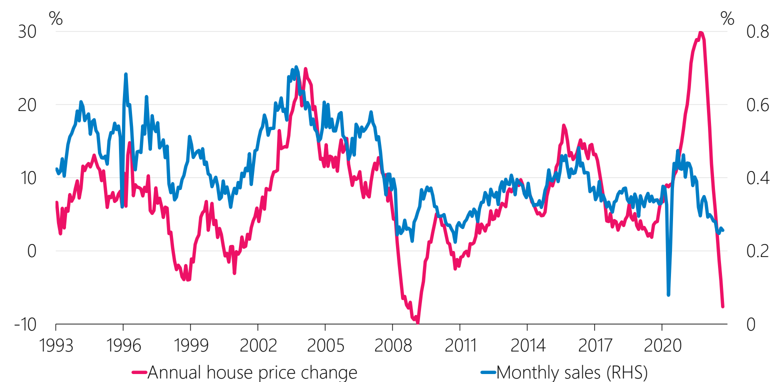
Distressed sales, which have yet to be a large factor in the current downturn, could also reinforce further price declines alongside general negative sentiment.

New builds continue to support dwelling supply, with new dwelling consents being issued at record levels, although the translation of consents into completions has fallen in the past year. Housing supply imbalances will continue to improve in the coming year, as current developments complete, net migration inflows remain low, and changes to zoning regulations free up developable land in major cities. However, with the recent fall in prices of existing houses, developers are experiencing lower demand for new projects and are struggling to obtain enough presale commitments to be able to obtain finance for projects. Some developers that acquired land at high prices face the prospect that previously viable projects are now unlikely to proceed, leading to potential financial losses. Alongside the high cost of building materials, these factors mean that the supply of new builds beyond projects that have already been committed to will slow.

Figure 2.4

House price inflation and house sales

(seasonally adjusted)



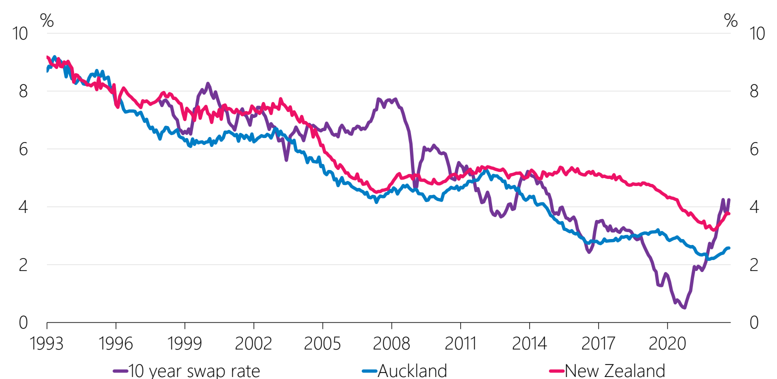
Source: REINZ, Stats NZ, Reserve Bank estimates.

Note: Monthly sales shows the seasonally adjusted number of sales in the month, expressed as a share of the total estimated number of dwellings in New Zealand in that month.

Figure 2.5

Rental yields on residential property

(after expenses, before tax)



Source: QV, MBIE, Haver Analytics, Reserve Bank 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.

Figure 2.6

Indicative debt servicing ratio for new buyers

Source: Stats NZ, interest.co.nz, Reserve Bank 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.

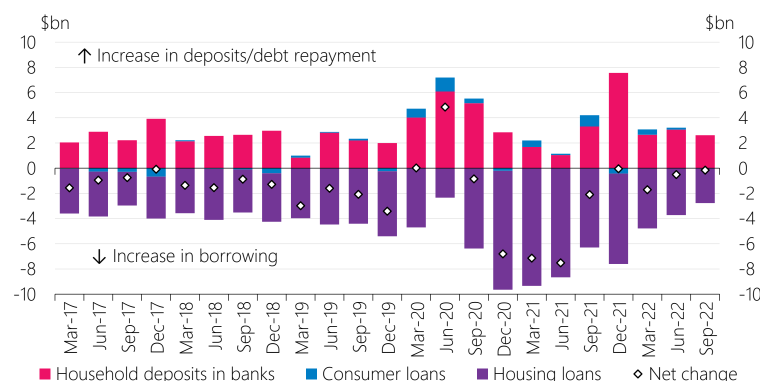
Households

Households have been resilient to the increase in interest rates and fall in house prices seen so far. In general, credit conditions for households have tightened owing to higher interest rates, changes to the CCCFA, and the higher cost of living that banks are reflecting in their serviceability assessments. Vulnerabilities are concentrated in borrowers who took out loans in late 2020 and in 2021, in terms of the risk of negative equity and debt serviceability stress. LVR restrictions have reduced borrowing by households with low deposits. As a result, recent borrowers will be better able to absorb further house price declines without falling into negative equity. In addition, borrowers in recent months are more likely to be able to absorb the impacts of rising interest rates, as the test rates used by banks to assess loan serviceability have increased.

Households' accumulation of savings stopped as spending recovered after COVID-19 restrictions eased

Household deposits grew through the pandemic period, and consumer debts such as credit card balances declined (figure 2.7), supported by the tight labour market, strong wage growth, and subdued consumption from pandemic restrictions. The broad-based accumulation of savings suggests that in aggregate households have a buffer to cushion against shocks. Offsetting this, strong mortgage borrowing in late 2020 and in 2021 as house prices rose has increased indebtedness among a concentrated group of households.

Figure 2.7
Quarterly movements in aggregate household bank deposits and borrowing
(12-month rolling totals)



Source: RBNZ *Bank Balance Sheet survey, Standard Statistical Return.*

Note: Positive movement indicates an increase in deposits over the quarter and/or a reduction in debt, and a negative movement indicates an increase in debt and/or a reduction in deposits. Consumer and housing loans includes banks and non-bank lenders.

There are few indicators of acute household stress so far...

Despite the recent declines in house prices and worsening in the economic outlook, there are still few indications of widespread financial difficulties in the household sector. The share of loans in arrears and impaired lending for owner occupiers has continued to decline in recent months, while the shares for housing investors have been broadly stable at low levels since mid-2021. Among the cohort of mortgage borrowers in 2020 and 2021, data from Centrix, a large credit-reporting agency, indicate a pick-up in arrears on other consumer lending products from mid-2022, but a relatively low level of stress overall compared to history and other borrower groups. The currently tight labour market conditions are supporting households' incomes and debt servicing capacity. However, a sharp increase in the unemployment rate amid a material deterioration in economic conditions could lead to widespread defaults and significant losses for the banking system.

...however, some households are vulnerable to negative equity as house prices fall...

Despite the limited signs of stress so far, some households remain vulnerable to falling house prices. The borrowers most exposed to negative equity are those who took out loans during the second half of 2021, particularly those at high LVRs. Those who took out loans with high LVRs during this period are particularly exposed, as much of the equity in their properties is likely to have been eroded. At present the share of outstanding lending to borrowers in negative equity remains small, at around 2 percent, but it could rise considerably if prices were to fall further (figure 1.3).

Falling house prices may have negative impacts on household consumption, and this would have negative feedback effects on the economy and banks' asset quality in other lending. Our previous research found that falling house prices may have greater impacts on household consumption than increases in house prices.[3]

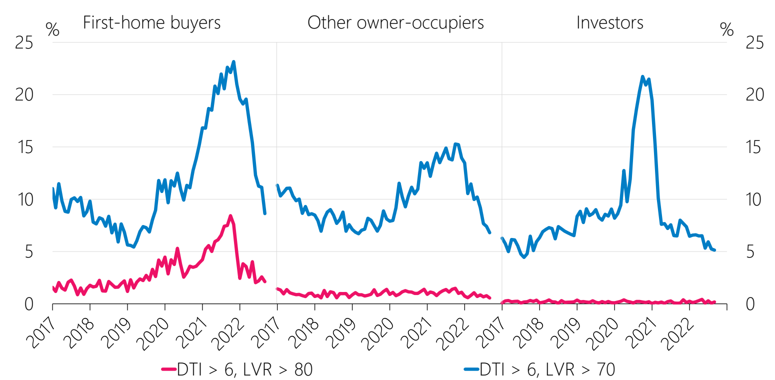
Borrowers who have taken out loans since the beginning of this year are less vulnerable to house price declines than those who took out loans earlier. Following the re-imposition of LVR restrictions in early 2021, and a further tightening in late 2021, there have been sharp falls in highly leveraged lending (figure 2.8). The largest declines in high LVR and high DTI lending have been among investors. Market contacts have noted that some investors may have switched to non-bank lenders as a result of the tight LVR restrictions on bank lending. However, we believe that the scale of this is small (see Box D).

...and some households may face servicing difficulties if mortgage rates rise further

Household debt servicing costs have increased as mortgage rates have risen. Many borrowers from late 2020 to early 2021 fixed their lending at low 1-2 year rates, and are only now gradually repricing onto the much higher interest rates prevailing in the market (figure 2.9). The value of new mortgages from 2020 and 2021 is estimated at about 40 percent of the current mortgage stock, with 10 percentage points of this being first-home buyers. Around half of the stock of mortgages on fixed rates is expected to reprice in 2022, increasing serviceability pressure on these borrowers.

Figure 2.8

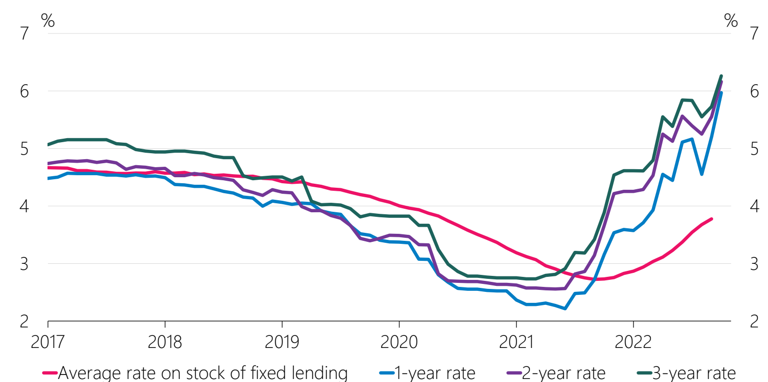
Higher-risk shares of new lending by buyer type



Source: RBNZ *DTI New Commitments survey.*

Figure 2.9

Average mortgage rates



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

At present the share of banks' mortgage lending which is to borrowers in negative equity remains small, at around 2 percent, but it could rise considerably if prices were to fall further.

3 De Roiste, M, Fasianos, A, Kirkby, R and Yao, F. (2019) "Household Leverage and Asymmetric Housing Wealth Effects – Evidence from New Zealand", *RBNZ Discussion Paper 2019/01*

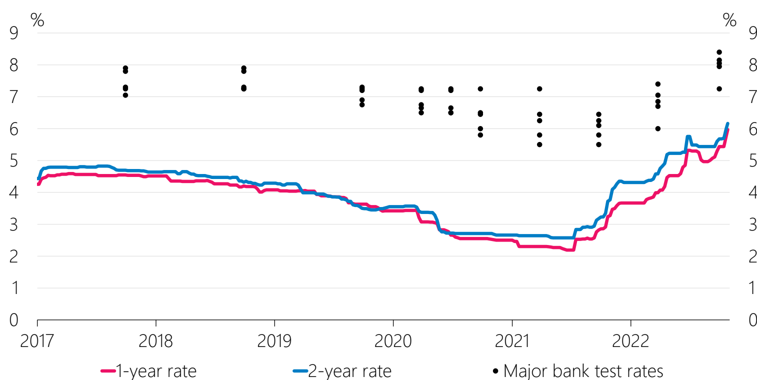
The risk of debt servicing stress from rising interest rates is lower for very recent borrowers. Test rates used by banks to assess loan serviceability have risen to around 8 percent. In contrast, borrowers who took out loans when mortgage rates were near their low points in mid-2021 had their loan serviceability assessed at interest rates similar to current mortgage rates (figure 2.10). As a result, these earlier borrowers are more exposed to further increases in mortgage rates.

We estimate that at average mortgage rates of 5 percent the debt servicing ratios of the majority of the 2021 borrowers would remain below 40 percent of their after-tax incomes (figure 2.11). Currently offered mortgage rates of around 6 percent are significantly higher than a year ago, but are not expected to lead to widespread stresses for these borrowers. However, if mortgage rates rise significantly higher than 6 percent, it is likely that an increasing number of borrowers from 2021 will need to reduce discretionary parts of their consumption in order to continue to service their mortgages. First-home buyers are the most vulnerable as interest rates increase, as they tend to have lower incomes and higher LVRs on average than other owner-occupiers and investors.

Looking ahead, rising debt servicing burdens and a slowing economy will create challenges for households. In situations where households are struggling to make their repayments but are still earning their usual incomes, lenders are likely to be able to provide relief in the form of term extensions or temporary interest-only periods. However, there will be some borrowers who find their mortgage debts to be unsustainable, and will be forced to sell their properties. A significant deterioration in labour market conditions remains a possibility, and would lead to further household debt servicing arrears and increase borrower defaults. This could contribute to fire-sale dynamics and accelerate a decline in house prices. A general reduction in consumption by households in financial difficulty would have negative flow-on effects for businesses' revenue.

Figure 2.10

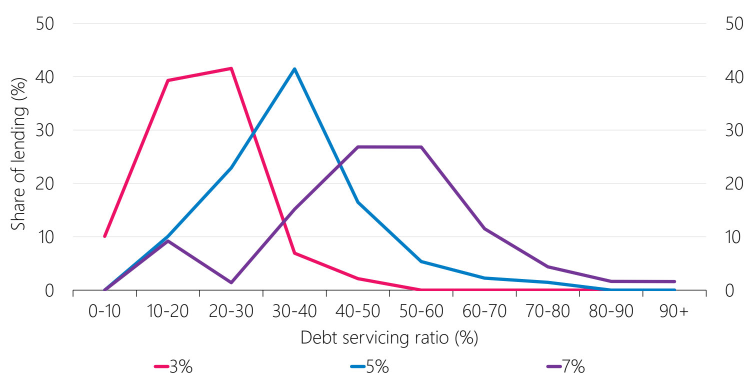
Actual mortgage rates compared to the five largest banks' servicing test rates



Source: interest.co.nz, Reserve Bank.

Figure 2.11

Debt servicing ratios of 2021 borrowers, under different interest rates



Source: RBNZ *DTI New Commitments survey*, Reserve Bank estimates.

Note: Debt servicing ratio is defined as the ratio of the interest component of a borrower's mortgage repayments to the borrower's after-tax income.

46%

At an interest rate of 7 percent, we estimate that around 46 percent of 2021's mortgage borrowers would need to spend at least half of their after-tax income on interest payments.

Business

Businesses benefited from strong demand and profitability in the first half of 2022…

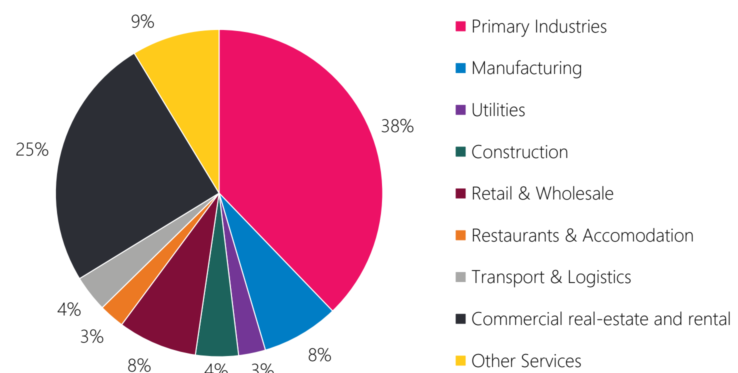
The banking system holds approximately $180 billion of loans to businesses, compared to around $340 billion in mortgage lending. Around 40 percent of this lending is to primary industries and a quarter to the commercial real-estate sector (figure 2.12). Other sectors on an individual basis make up a relatively small part of bank assets.

In general, businesses' balance sheets and their profitability have remained healthy in the past six months, underpinned by solid customer demand in the first half of 2022. This was despite growing challenges, including elevated inflation in labour and material costs, and rising interest rates. Asset quality in banks' business lending portfolios has been high, with low non-performing loan ratios in all sectors. Annual business lending growth excluding agriculture has been stable so far in 2022, at around 8.4 percent.

…but rising input costs and debt servicing burdens present challenges ahead

The range of factors driving up firms' operating expenses have remained broadly unchanged during the past six months. The most significant challenge has been a shortage of labour in all sectors, a major hurdle to businesses benefiting from the currently strong demand. Staff turnover and absences have been elevated, primarily as employees have caught COVID-19 or other illnesses. Wage inflation has continued to be high across all industries as firms compete for workers. Inflation in other input costs, particularly transportation, and supply chain disruptions have remained persistent problems, although firms have been better able to adapt to these than they have been with respect to labour supply. Firms have generally increased prices to maintain their margins, but the extent to which they have been able to do so has varied across industries. Cost inflation may persist for some time, presenting a downside risk to profitability.

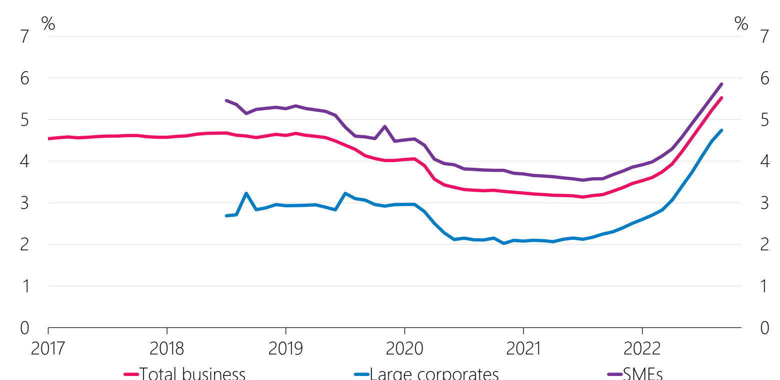
Figure 2.12
Bank lending to businesses, by sector



Source: RBNZ *Bank Balance Sheet survey.*

The economic outlook points to a weakening in spending growth as monetary policy is tightened. The main risk to the business sector is a sharp downturn in the economy, alongside a large increase in the unemployment rate, which would curtail household demand. Should this occur, the high demand growth that businesses have benefited from in recent quarters would reverse quickly. A weaker economic outlook together with higher debt servicing burdens would put pressure on businesses. Weighted average interest rates on banks' business loans increased to 5.5 percent in September 2022 from their mid-2021 lows (figure 2.13), and they tend to adjust to interest rate increases relatively quickly compared to other types of lending. While asset quality is currently strong, a greater utilisation of credit limits and the demand for working capital in recent months are potentially early signs of cash flow pressure in the business sector.

Figure 2.13
Average interest rates on bank business lending



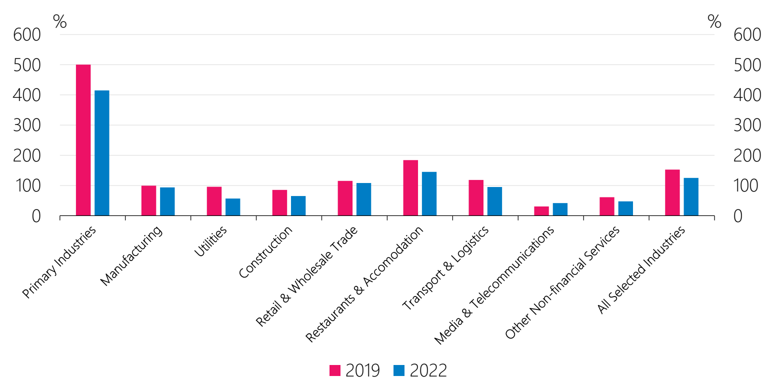
Source: RBNZ *Income Statement survey.*

Businesses balance sheets have deleveraged over recent years, improving resilience

Businesses have reduced leverage on their balance sheets compared to pre-pandemic levels, and this is reflected in a decline in the estimated DTI ratio for most industries (figure 2.14). They have also built up a significant savings buffer, partly as a result of previous government support schemes. While the slowing economy presents challenges, we expect businesses to be able to absorb higher interest rates without severe cash flow stress. The greatest risk lies in a sharper deterioration in the economy and demand, potentially occuring alongside ongoing input cost pressures. Moreover, certain sectors that have been affected more negatively by the pandemic, such as tourism, retail and accommodation, appear more vulnerable.

Figure 2.14

Estimated business bank debt-to-income ratio



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

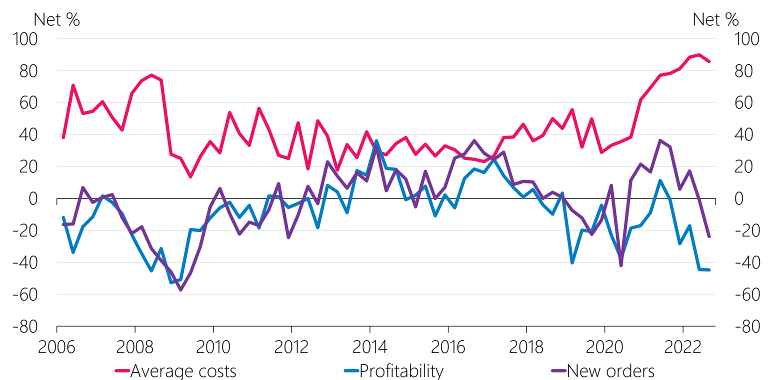
Housing market downturn creates acute downside risks for the residential construction sector

Downside risk appears to be more salient for the residential construction sector. Buyer enquiries for residential pre-sales have declined heavily as the perceived risks in purchasing off-the-plans properties grows, given declining prices for existing properties and ongoing construction cost inflation. Developers have found it very difficult to meet banks' pre-sale conditions for finance, leading to a sharp decline in the volume of viable new projects.

Like other businesses, residential developers continue to face a shortage of suitably skilled labour and high inflation in the cost of materials, and with less confidence that any cost escalation can be offset by the final price as would be the case in a rising market (figure 2.15). Recently, inflation in the cost of materials has started to ease from high levels, as supply chain bottlenecks have diminished. The number of construction and property development company failures has picked up but remains low relative to the approximately 70,000 registered companies in the sector (figure 2.16). Despite the acute challenges facing the sector, we have not seen a material deterioration in banks' asset quality so far, and developers have generally been able to obtain necessary finance to complete existing projects.

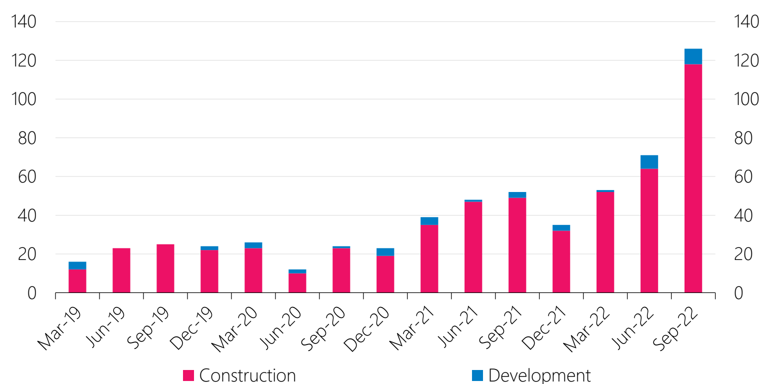
A deterioration in loan performance could materialise as loans reprice and firms exhaust the list of viable projects. Residential development loans are inherently high risk, although banks' exposure to the sector is small. A widespread failure and exit of firms in the construction sector would restrain future growth in housing supply, hindering the rebalancing of house prices with their sustainable levels. In turn, this could lead to a future build-up of overvaluation and financial stability risks in the housing market.

Figure 2.15
Builders' expectations for costs and profitability, and reported new orders



Source: NZIER Quarterly Survey of Business Opinion.

Figure 2.16
Number of construction and development company insolvencies, voluntary administrations, and receiverships



Source: Companies Office.

Table 2.1
Sectoral summary

Small and medium-sized enterprises (SMEs)
SME credit demand has been weaker than that of large firms. Bank lending to small firms (turnover below $1 million) contracted 1.1 percent in the year to September, while lending to medium-sized firms (turnover $1-50 million) grew 7.7 percent. SME credit growth has been driven by demand for working capital, particularly among smaller firms. This may point to emerging cashflow stress as SMEs struggle to deal with current challenges. Industries dominated by SMEs appear to be more affected by staffing shortages and COVID-related disruptions, for example hospitality, tourism, and retail. While asset quality for banks' SME lending remains healthy, this lending is more vulnerable to a severe economic downturn than it is in large firms.
Large corporates
Larger firms' credit demand has been stronger. Annual bank lending growth to large firms (turnover above $50 million) was 12.4 percent in September after rebounding from negative values in the middle of 2021. Lending growth has been driven by investments in plant and machinery and premises, acquisitions, and demand for working capital. Some businesses have increased automation to address labour shortages. Our industry contacts report that larger firms are better able to deal with ongoing challenges around a tight labour market, input cost inflation, and disruptions. Larger firms have more flexibility to cover for staff who are sick and stockpile inventories in anticipation of supply disruptions.
Commercial property
Banks' lending to the commercial property sector is relatively small, at around 9 percent of total lending. However, commercial property exposures have often been a source of losses in financial crises, including following the GFC (figure 2.17). Industrial properties have been performing well, driven by strong demand from tenants and constrained supply. Vacancy rates have been low for industrial properties (figure 2.18). There remains a risk of property values falling as interest rates rise, especially as yield compression in recent years has driven capital gains. In contrast, office properties' performance remains mixed in different quality grades. High-quality offices face solid demand, with prospective tenants prioritising collaborative and attractive workspaces. Lower-quality offices face muted tenant demand, and greater challenges around safety and environmental standards. Vacancy rates for lower-quality offices could increase from a low level as tenancies come up for renewal. Demand for CBD retail properties is subdued and vacancy rates are increasing. Standalone shops and small shopping strips continue to be affected by the trend towards remote working and low international tourism. Large shopping centres and supermarkets are generally performing better. Banks are cautious around lending to new commercial property developments or investments owing to the risks to the economic outlook. However, existing clients are generally being supported and banks have relaxed their interest coverage ratio requirements. Indicators of non-performing loans and serviceability stress remain low. Banks have built up their resilience to risks in the commercial property sector by applying conservative lending standards for a number of years. However, low borrower stress may also reflect the fact that interest rates, valuations, and rental contracts have yet to fully reflect recent developments.

Agriculture

The milk price is currently sufficiently high for farmers to maintain profitability, with Fonterra having a midpoint projection above $9 per kilogram of milk solids this season. There are downside risks to dairy prices, notably slowing global demand.

The agriculture sector has been facing cost inflation at a similar rate to that of other businesses. Higher costs are being driven by imported fuel and fertilisers, due partly to the war in Ukraine. Ongoing labour market tightness is also constraining the agricultural sector's output. The struggle to find workers has contributed to delays at meat processing sites and is curtailing horticulture output.

The agricultural sector is also facing higher debt servicing costs (figure 2.19), as interest rates have risen in response to tighter monetary policy settings, although stresses remain low for now (figure 2.20).

Regulatory change is an ongoing feature, with an increasing focus on climate and environmental regulation. The Government is consulting on new proposals for an emissions pricing framework for agriculture, and new environmental standards for plantation forestry.

The risk of foot and mouth disease (FMD) has come into focus following an outbreak in Indonesia. In New Zealand, the probability of an outbreak remains low owing to effective border controls and the lack of direct flights from Indonesia currently. However, an outbreak would have a large adverse impact on the sector if it occurred, as it would be likely to trigger a swift suspension of all FMD-susceptible animal-based exports. We are working with other parts of government to monitor the current Indonesian outbreak and risks to New Zealand.

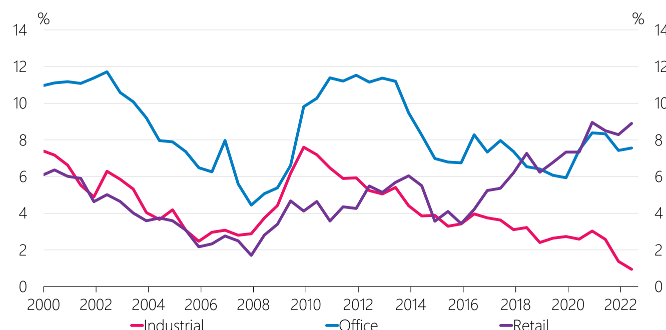
Figure 2.17

Non-performing loan ratios for banks' commercial property lending

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

Figure 2.18

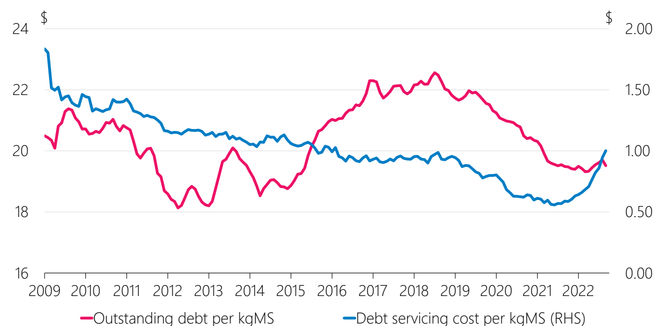
Vacancy rates by commercial property sector



Source: JLL.

Figure 2.19

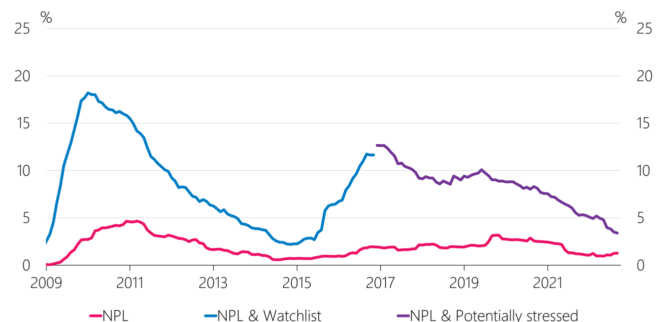
Dairy debt and debt servicing costs per kgMS produced



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

Figure 2.20

Dairy lending stress indicators



Source: RBNZ *Bank Balance Sheet survey*.

Box B

Implications of a slowdown in Chinese growth

China is a key driver of global economic growth and New Zealand's second largest trading partner. Consequently, New Zealand is particularly exposed to spill-overs from economic and financial risks in China. In recent months, China's economy has faced multiple headwinds stemming from a weakening property market and successive COVID-19 lockdowns. This box discusses the implications of a slowdown in the Chinese economy for New Zealand.[4]

China's COVID-19 management strategy continues to involve strict lockdowns and mobility restrictions in areas of outbreaks. Authorities remain committed to this strategy to reduce strain on the health system, partly given low vaccination rates among older populations. Such measures impose significant constraints on local economic activity, although over time authorities have adjusted the restrictions to mitigate disruptions to transport, supply chains, and businesses.

Alongside headwinds from containing COVID-19, parts of China's property development sector have come under severe financial strain. Rapid urbanisation and real estate development have been an important source of wider economic growth. Moreover, local governments in China have long depended on ongoing property development-related revenue to fund their own investment activities and provision of services.

After the emergence of financial difficulties among some large property developers with highly leveraged business models, authorities introduced new regulations to restrict financial risks among property development companies. In addition, falling consumer confidence has seen new home sales decline 34 percent in the past year and future development pipelines appear set to fall considerably (figure B.1). With the drop-off in new home sales, which would previously have been a source of fresh liquidity, financial conditions for developers have tightened significantly in the past year. Analysis by the IMF suggests that around 45 percent of developers may not be able to pay their debt obligations with current earnings, while around 20 percent could become insolvent.

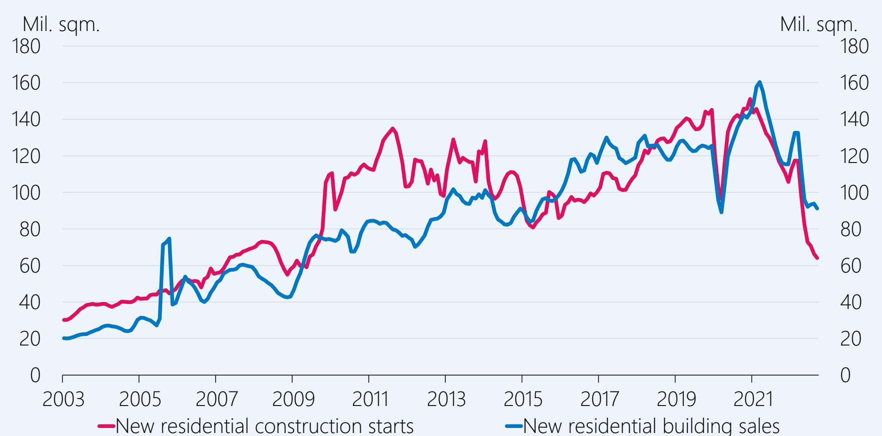
More recently, many home buyers are reported to have stopped making mortgage payments on incomplete housing projects, highlighting the concerns which have spread from financial markets to households. Stalling development projects that end up in default may have very low recovery rates, which could lead to contagion to the rest of the economy through a hit to banks' capital. In aggregate, around 8 percent of total lending is to property developers, with another 20 percent to mortgage borrowers. While stress testing by the People's Bank of China suggests larger banks would be resilient to a property-driven downturn, the greater risk lies with the smaller, less well capitalised banks that have a higher exposure to the property development sector.

Given these challenges, forecasts for economic growth have been repeatedly revised down this year, and a further deterioration remains a possibility. Weaker activity is evident across a number of indicators.

Figure B.1

New residential real estate sales and construction starts

(seasonally adjusted, three month moving average)



Source: China National Bureau of Statistics, Haver Analytics.

4 See https://www.rbnz.govt.nz/hub/publications/bulletin/2019/rbb2019-82-04 for how the Reserve Bank analyses international developments and their impact on New Zealand.

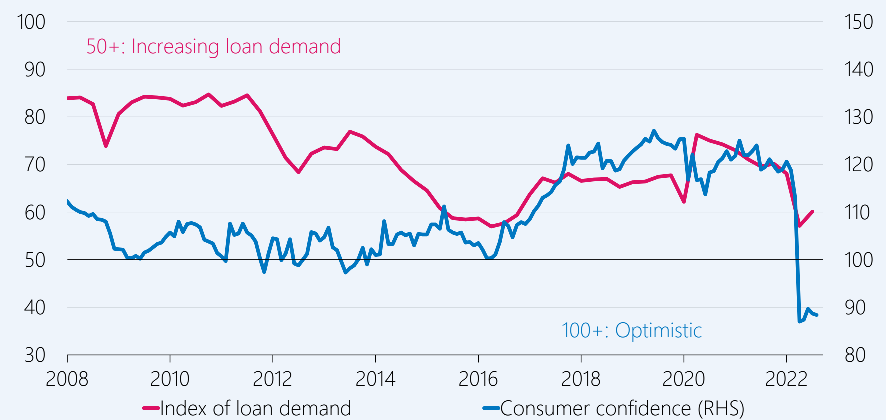
Manufacturers' expansion intentions remain weak due to ongoing lockdowns, recent heatwaves and electricity shortages. Retail sales have continued to be suppressed by low consumer sentiment (figure B.2).

Implications for New Zealand

A slowdown in China's growth would affect New Zealand through its impacts on trade, financial markets, and uncertainty.

- China has been a major driver of global economic growth and trade in the past decade. Australia is an important supplier of many of China's key raw material imports for constuction, and is therefore directly exposed to a contraction in property development. A slowdown in Australia's economic activity would have significant flow-on effects to New Zealand's economy, for example through a reduction in demand for our tourism and food exports. Additionally, emerging Asian economies with economic growth closely tied to China's, are also important export markets for New Zealand. New Zealand's exporters have a relatively limited direct exposure to China's property development sector, with our main exports being dairy and meat products. However, a general slowdown in Chinese household consumption would likely affect our meat and dairy exports. A more direct link to property development is New Zealand's forestry exports, with around three quarters of our logs exported to China. In the event of a greater slowdown in Chinese growth, export prices could decline, putting pressure on the New Zealand dollar exchange rate to depreciate, contributing to domestic inflationary pressure.

Figure B.2
Loan demand and consumer confidence



Source: People's Bank of China, China National Bureau of Statistics, Haver Analytics.

Note: Index of loan demand measures the net percentage of bankers' assessments of loan demand, with a result above 50 indicating demand being above normal. Consumer confidence measures confidence on a scale from 0 to 200, with a result above 100 indicating general consumer optimism.

- Foreign investors hold around 4 percent of China's total outstanding bonds, limiting their direct exposure to financial losses. Credit growth is likely to wane as confidence in future housing construction by home buyers declines. Stress in the property development sector has contributed to an easing in monetary policy settings in China in an effort to stimulate economic activity, particularly as the Federal Reserve has tightened its policy rate. This has contributed to a historically large depreciation in the Chinese yuan relative to the USD in the past six months.
- Due to the scale of the downturn in China's real estate sector and the role China plays globally, uncertainty around Chinese growth prospects affects global risk sentiment. This shapes sentiment in New Zealand and thus is likely to affect investment and spending, along with other risks to global growth.

We continue to monitor financial stability risks in China and their potential impact for New Zealand. Chinese authorities will likely act in the event of a financial stability crisis and hold extensive assets and foreign reserves to do so. External debts are minimal and central government debt is low. Furthermore, large parts of China's banking system are state owned. This suggests that the central government has the capacity to intervene to stabilise financial markets, and provide direct support to the banking system and local governments if necessary. However, addressing vulnerabilities in the financial system and achieving a smooth transition away from investment-led growth remains a challenge, and may entail a long period of slower growth than China has seen in recent decades.

New Zealand's financial institutions

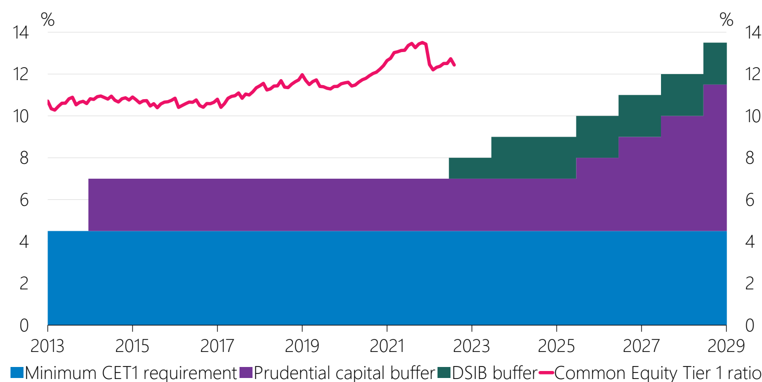
CHAPTER
03

Aotea, Great Barrier Island. Photo: Findlay Boyes

CHAPTER 3
New Zealand's financial institutions

A sound and efficient financial system is fundamental to the overall health of New Zealand's economy. Financial institutions have continued to build their resilience in the past six months. Banks' capital positions have improved in preparation for higher regulatory requirements. Profitability has recovered to pre-pandemic levels, and asset quality remains high. Insurers have retained capital during the period of economic uncertainty. Developments in Financial Market Infrastructures will enable New Zealanders to send and receive funds in a more timely and convenient manner.

Figure 3.1
Common Equity Tier 1 capital ratio of locally incorporated banks



Source: RBNZ *Capital Adequacy survey.*

Note: In January this year as part of the implementation of the Capital Review, a credit risk floor came into force for banks using the internal ratings-based 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, lowering reported capital ratios. However, the banking system's level of CET1 capital has been steadily increasing through this time.

Registered banks

Banks are building their capital levels as regulatory requirements increase

Banks' capital ratios have continued to improve in the past six months on the back of solid profitability, with banks retaining earnings in anticipation of upcoming increases in capital requirements (figure 3.1). By providing a cushion to absorb financial losses during economic downturns, higher capital buffers enable banks to continue making credit available to the economy, instead of rationing credit and amplifying a downturn.

Capital buffer requirements will be rising gradually in the next six years.[5] From 1 July 2022 the four largest locally incorporated banks have been subject to a domestic-systemically important bank (D-SIB) buffer requirement of 1 percent of risk-weighted assets (RWA).[6] The D-SIB buffer is an additional component of the Prudential Capital Buffer (PCB) that applies to all locally incorporated banks, currently set at 2.5 percent. A bank that falls into its PCB is not in breach of its conditions of registration, but becomes subject to increasing restrictions on dividends and supervisory responses aimed at restoring its capital levels.

Strong bank profitability has been underpinned by resilient net interest margins, low credit losses, and cost-efficiency measures

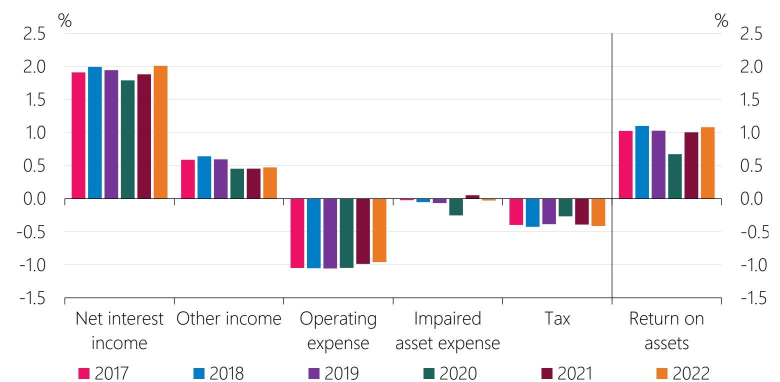
A profitable banking system fosters financial stability, as banks' earnings underpin their capital bases and therefore their ability to keep supporting credit provision in more challenging economic environments. New Zealand banks' earnings have recovered during the past year, following a slight decline in the pandemic period (figure 3.2).

Net interest margin (NIM) measures the difference between the interest income a bank makes on its lending and the cost of the funds used to finance that lending. NIM is therefore a key measure of how profitable a bank is at its core business of borrowing and lending. Banks' NIMs are currently around historical averages, with a slight pick-up in the past year (figure 3.3). Deposit rates have increased in the past year by less than wholesale interest rates, supported by the high proportion of deposits in low or zero interest rate on-call accounts, compared to term accounts. Partly reflecting this, margins on mortgage lending relative to wholesale rates have been compressed in the past year compared to historical levels.

Figure 3.2

Components of banks' after-tax return on assets

(percent of average assets, September years)

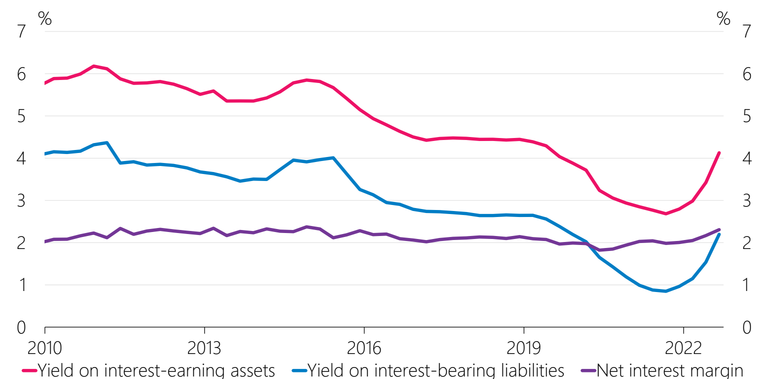


Source: RBNZ *Income Statement survey.*

Figure 3.3

Net interest margin, asset yields and cost of funds

(quarterly, all registered banks)



Source: RBNZ *Income Statement survey.*

From 1 July 2022 the four systemically important banks have been subject to an additional 1 percent capital buffer requirement.

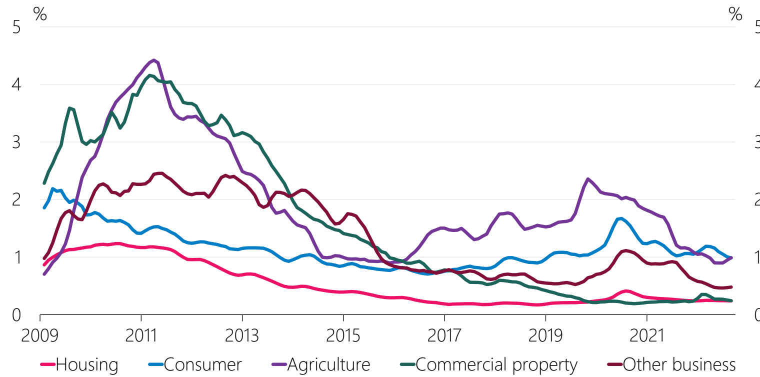
5 For further details about the implementation of these new requirements, please refer to the Capital Review Implementation Timeline.

6 A prudential capital buffer is an amount of capital above the minimum capital requirement. A bank that operates with a capital ratio within the prudential capital buffer applying to it would not be in breach of its conditions of registration, but it may have restrictions placed on it and be required to rebuild its capital levels over time.

Figure 3.4

Bank non-performing loan ratios by lending portfolio

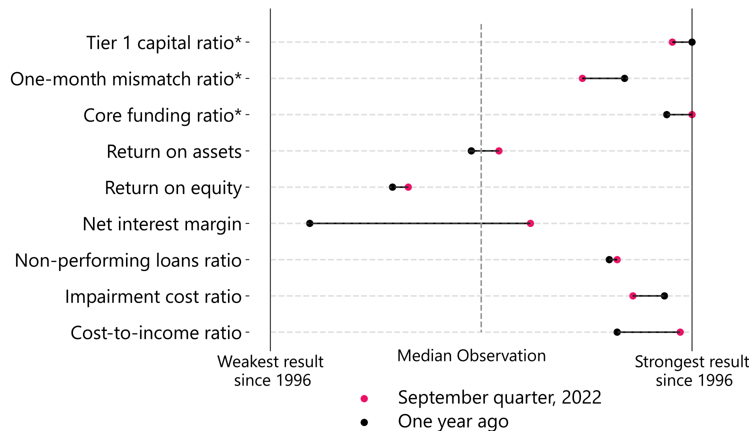
(3 month moving average)



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

Figure 3.5

Banking system resilience indicator suite



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

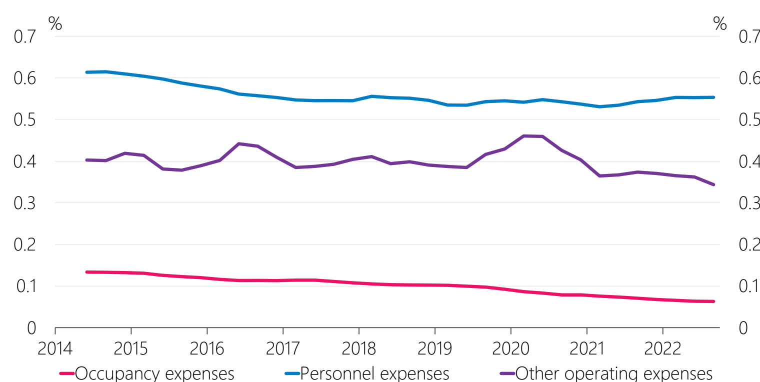
Note: Non-performing loans, impairment cost and cost-to-income ratios are presented in inverted scales for readability purposes, so that lower outcomes for these variables are shown on the right hand side (stronger resilience metrics).

*Data for Tier 1 capital ratio is as at August 2022. Liquidity metrics begin in June 2010.

Figure 3.6

Components of banks' operating expenses

(12 month rolling totals, percent of average assets)



Source: RBNZ *Income Statement survey.*

Also supporting profitability, banks' asset quality has remained high as stresses among households and businesses have remained low so far, with non-performing loan ratios at low levels across all major lending portfolios (figure 3.4). Banks have largely unwound the loan loss provisions they made early in the pandemic, as credit quality has not deteriorated to the extent anticipated in early 2020. With that said, the uncertainty mounting about near-term economic conditions may prompt a pick-up in provision levels.

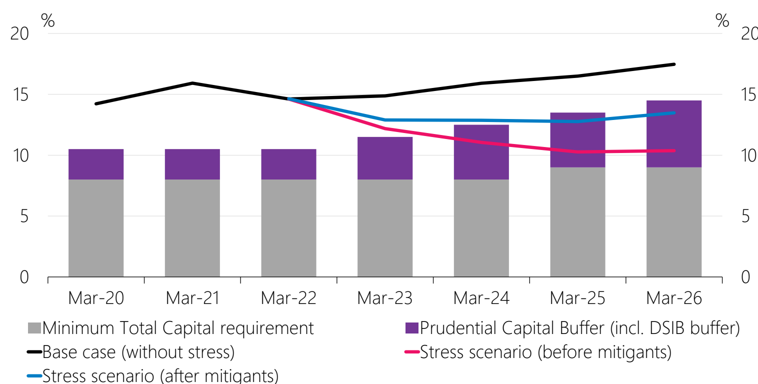
Overall, banking system resilience has strengthened in the past year, with most metrics currently showing healthier results than long-term averages (figure 3.5). With ongoing investments in digitalisation, product offering range simplification and declining occupancy costs as banks reduce their office footprints and branch networks, operating expenses have been contained and the banking system's cost-to-income ratio sits at 40 percent, near long-term lows (figure 3.6).

Stress testing shows that the banking system is in a strong position to weather a severe downturn in economic conditions

Our 2022 solvency stress test assessed the resilience of the five largest locally incorporated banks and four smaller banks against a scenario involving a severe slowdown in global economic activity, high inflation and rising interest rates, and lingering impacts from the pandemic. In this hypothetical scenario the New Zealand economy experiences protracted high unemployment and large declines in GDP as well as a 1-in-25 year cyber risk event. Full details of the 2022 stress test were recently published in a *Bulletin* article[7].

Figure 3.7

Total capital ratio in 2022 Stress Test



Source: Reserve Bank.

Note: Buffer and minimum requirements increase in line with implementation of the Capital Review.

Under this prolonged stress scenario, the aggregate capital ratios decline materially but do not fall below regulatory minimum levels, even taking into account scheduled increases in the minimum requirements (figure 3.7). Results also indicate sufficient capital in the system to maintain lending in the economy before mitigating actions are implemented, such as raising additional capital or reducing customers' credit limits. Encouragingly, once mitigating actions are accounted for, banks only marginally enter into their Prudential Capital Buffers.

Given the prevalence of cyber-attacks internationally and the increasing importance of digital technologies for banking operations, this year we asked banks to consider an adverse cyber event. A variety of scenarios were considered including DDoS attacks, kill chain malware, ransomware and attacks on external parties which impacted the general banking sector. Most attacks were modelled to extend over a few months, with losses provisioned for factors such as reimbursements to customers, consultancy and legal fees, loss of business, brand/reputational damage, technology upgrades and communication and media costs.

Under the prolonged stress scenario aggregate capital ratios decline materially, but do not fall below regulatory minimum levels, even taking into account scheduled increases to these regulatory minima.

7 See: https://www.rbnz.govt.nz/hub/publications/bulletin/2022/rbb2022-85-02

The banking system is well funded as credit growth softens…

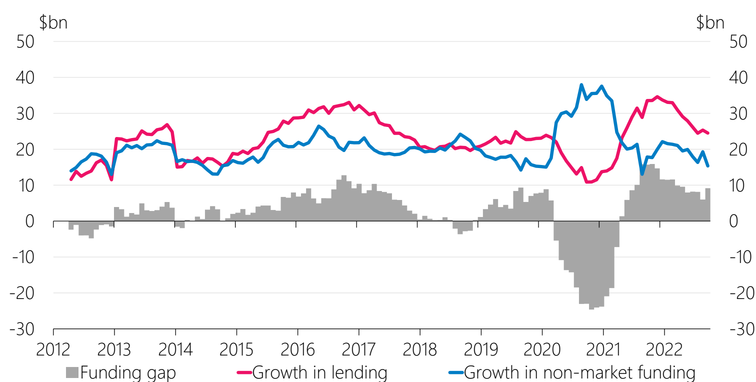
Overall, the New Zealand banking system's funding profile remains resilient, with the average core funding ratio sitting near 90 percent, well above the minimum 75 percent requirement (table 3.1). For banks to undertake their core business of credit intermediation, they need to match their assets (largely loans to households and firms) with various types of funding, including retail deposits, funding from wholesale lending markets, and equity from their shareholders. The core funding ratio requirement tasks banks with choosing a mixture of funding that is sufficiently stable over time, so that disruptions to funding markets do not impair their ability to provide credit to the economy.

The funding gap, calculated as the difference between the growth in banks' new lending and their deposit funding, measures the extent to which the banking system needs to seek funding from non-deposit sources, such as wholesale markets. The banking system's funding gap has narrowed over the last six months (figure 3.8), and is expected to continue to decline due to slowing mortgage demand as the housing market declines. Results from our recent credit conditions survey showed that demand for new credit continued to remain low amongst households and corporates.[8]

Figure 3.8

New Zealand banking system's funding gap

(12 month rolling total)

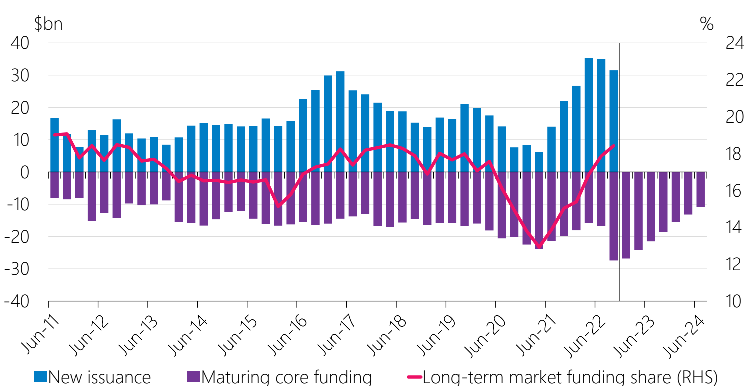


Source: RBNZ *Liquidity survey.*

Figure 3.9

Issuance and maturity of bank core funding

(12 month rolling total)



Source: RBNZ *Liquidity survey,* Reserve Bank estimates.

…limiting the need for wholesale market funding in times of accentuated volatility

Wholesale market funding conditions have been volatile in the past six months, due to geopolitical tensions and continually rising global interest rates. In general, offshore funding markets have become more expensive. However, with low new funding needs New Zealand banks have been able to access wholesale funding at opportune times and with reasonable pricing. The replacement of maturing wholesale core funding is not expected to pose challenges for banks (figure 3.9).

In addition, the Funding for Lending Programme (FLP) has acted as a backstop for banks' medium-term funding needs. The end of access to the FLP from December 2022 is not expected to cause any difficulties for banks' funding. Proceeds from the FLP will remain on banks' balance sheets for a period of three years from the drawdown date, meaning most will have progressively rolled off by early 2025.

8 Please refer to *Credit Condition Survey* September 2022 See https://www.rbnz.govt.nz/statistics/series/lending-and-monetary/credit-conditions.

Rising interest rates have prompted a shift back into term deposits

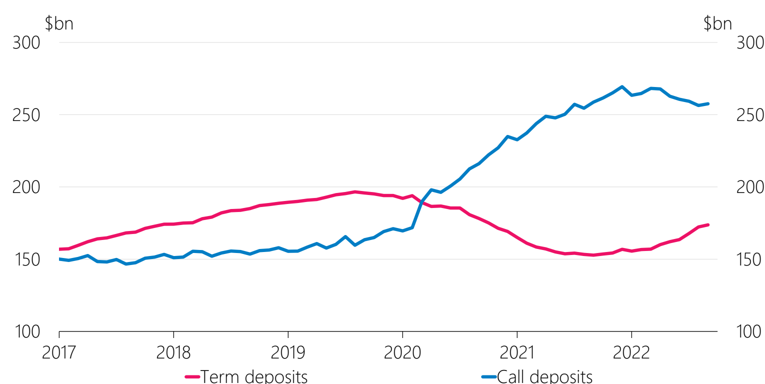
A large proportion of maturing term deposits migrated into on-call accounts, as monetary policy easing in 2020 reduced the relative return on term deposits. On-call deposits also grew as a result of the large fiscal stimulus instituted at the start of the pandemic. Rising wholesale interest rates and the ending of the FLP are seeing banks increase term deposit rates, and as a result depositors are now shifting their funds back into term accounts (figure 3.10). By lengthening the maturity profile of their funding, this switch back into term deposits will support banks' liquidity mismatch positions, offsetting the decline in the banking system's liquid assets expected to occur as alternative monetary policy measures wind down.

Liquidity stress test indicates improving resilience

The 2022 Bank Liquidity Stress Test examined the resilience of 10 locally incorporated banks to idiosyncratic liquidity shocks over a six month scenario. This longer term scenario provides a complementary assessment of liquidity risks to the prudential mismatch ratios. The 2022 test was a repeated exercise from last year's liquidity stress test, using the same scenario assumptions.[9]

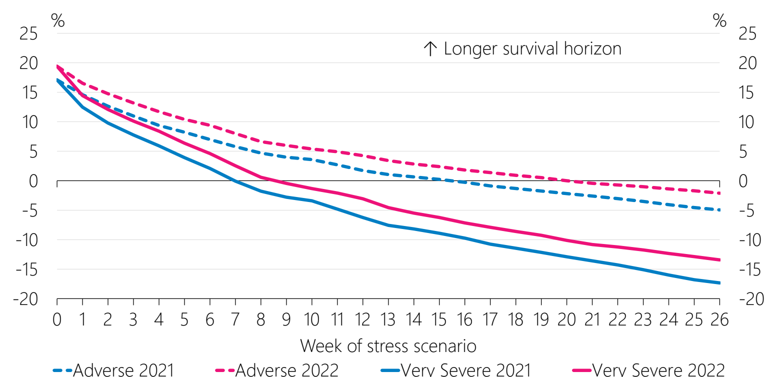
The average length of time before the five largest banks run out of cash (survival horizon) improved from 7 to 9 weeks, in the very severe scenario, indicating an improvement in the resilience of the system to a liquidity shock, compared to 2021 (figure 3.11). Smaller banks on average had a longer survival horizon in this year's test, although their results were not as strong as in the 2021 exercise. Banks are beginning to use this stress test to inform their liquidity risk management, benchmark internal stress testing and confirm their contingent funding plans.

Figure 3.10
Composition of banking system deposit funding



Source: RBNZ *Bank Balance Sheet survey.*

Figure 3.11
Net cash position in 2021 and 2022 liquidity stress tests, before mitigants
(percent of opening funding, simple average of the 5 largest banks)



Source: Reserve Bank.

Note: Figure plots the total value of liquid assets less the cumulative net cash outflows projected in the liquidity stress test scenarios, by week of the stress scenario, as a percentage of total funding.

9 See our Bulletin article, https://www.rbnz.govt.nz/hub/publications/bulletin/2021/rbb2021-84-03

Table 3.1

Key metrics for registered banks

Metric	Value (%, end of September)					Regulatory minimum (%)	Comment
	2018	2019	2020	2021	2022		
Tier 1 capital ratio	13.5	13.3	13.8	15.4	14.1*	8.5**	Tier 1 capital ratios have declined slightly over the past 12 months due to recent methodological changes.
Mismatch ratio (one month)[1]	4.8	5.2	6.5	6.2	7.1	0	Mismatch ratios remain elevated, reflecting the high level of settlement balances in the system.
Core funding ratio	88.0	87.4	88.6	87.3	90.6	75	Core funding ratios have risen, reflecting a slowing in credit growth over the past year.
Annual return on assets (after tax)	1.10	1.03	0.67	1.00	1.09		Profitability has returned to pre-pandemic levels.
Annual return on equity (after tax)	14.4	13.4	9.0	12.9	13.6		Banks' return on equity has risen, following a decline at the start of the pandemic.
Net interest margin (12 month running total)	2.11	2.06	1.92	2.00	2.14		Net interest margins have risen over the past year.
Non-performing loans ratio	0.48	0.60	0.71	0.45	0.38		Non-performing loans are at very low levels, compared to historical norms.
Annual credit impairment expense (% of average loans)	0.06	0.08	0.32	-0.06	0.03		Impairment expenses remain at negligible levels.
Cost-to-income ratio	40.0	41.6	46.7	42.3	38.7		Operating expenses have been consistently decreasing to pre-pandemic levels.

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.

* Tier 1 capital ratio for 2022 is as at August.

** Includes the Prudential Capital Buffer of 2.5 percent of risk-weighted assets, which banks must maintain to avoid dividend restrictions. For domestic-systemically important banks, the PCB also includes an additional D-SIB buffer of 1 percent of risk-weighted assets as of July 2022.

Non-bank deposit takers (NBDTs)

There are currently 15 NBDTs actively operating in New Zealand, which include building societies, credit unions, and deposit-taking finance companies. They have a diverse range of business models, with credit unions having a high share of their lending in a mix of residential and consumer loans to their members, while building societies and finance companies tend to focus on a range of types of property lending (figure 3.12).

Total net lending by NBDTs is around $2.3bn, compared to $540bn in lending by banks. While small relative to the rest of the financial system, the NBDT sector covers a diverse range of organisations that support financial inclusion by serving communities that may traditionally be under-serviced by the banking system.

Longer-term structural challenges have led to credit union consolidation

There has been consolidation in the NBDT sector in recent years, particularly among credit unions.[10] Overall, since 2018, the number of credit unions operating in New Zealand has fallen from 13 to 5 (table 3.2).

Many of the profitability challenges faced by the credit union sector are due to lack of scale, with high operating costs relative to income (figure 3.13). Combined with a limited ability to raise external equity given their mutual structure, some institutions have had a limited capacity to build up the capital buffers that are needed to absorb unexpected shocks while maintaining credit growth.

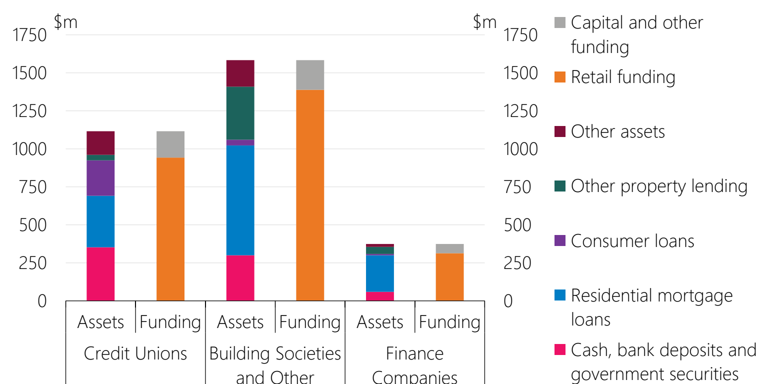
While attaining economies of scale has been challenging for some credit unions, net interest margins have moderately increased in recent years as interest rates have declined, supporting their financial sustainability (figure 3.14).

10 Since the last *Report*, the New Zealand Firefighters Credit Union merged with NZCU Auckland in June, Westforce Credit Union merged with First Credit Union in August, and Steelsands Credit Union has announced it will merge with First Credit Union in December.

Figure 3.12

Balance sheets of NBDTs

(August 2022)



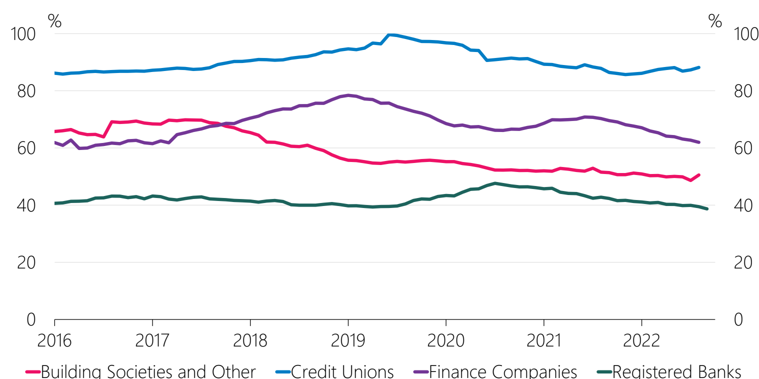
Source: RBNZ *Non-Bank Deposit Takers survey*.

Note: Building societies and other includes Christian Savings Limited.

Figure 3.13

Cost-to-income ratios for NBDTs and banks

(12 month rolling)



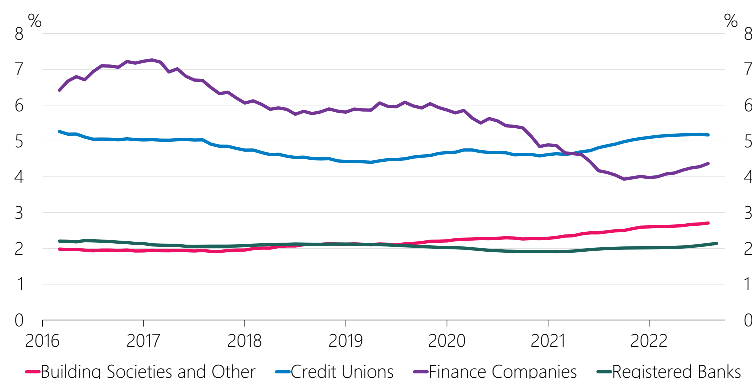
Source: RBNZ *Non-Bank Deposit Takers survey, Income Statement survey.*

Note: Building societies and other includes Christian Savings Limited.

Figure 3.14

Net interest margins for NBDTs and banks

(12 month rolling)



Source: RBNZ *Non-Bank Deposit Takers survey*, *Income Statement Survey.*

Note: Building societies and other includes Christian Savings Limited.

Table 3.2

Key metrics for NBDTs (year ended June)

Metric	Segment	2018	2019	2020	2021	2022
Total assets ($m)	Finance Companies[1]	220	270	218	296	357
	Credit Unions	1,149	1,131	1,152	1,126	1,106
	Building Societies and Other[2]	1,084	1,217	1,303	1,400	1,553
Capital ratio (%)	Finance Companies	15.6	14.8	17.8	15.7	17.2
	Credit Unions	14.9	14.7	14.1	12.9	12.7
	Building Societies and Other	11.0	11.6	12.4	13.7	13.7
Non-performing loan ratio (%)	Finance Companies	5.6	7.3	10.3	1.9	1.9
	Credit Unions	2.6	2.5	3.3	2.9	3.1
	Building Societies and Other	0.3	0.1	0.2	0.1	0.3
Return on assets, before tax (%)	Finance Companies	2.5	1.7	1.9	1.8	2.4
	Credit Unions	0.1	-0.6	0.0	0.4	0.1
	Building Societies and Other	0.8	0.9	0.9	1.2	1.5
Number of operating entities	Finance Companies	7	7	6	6	6
	Credit Unions	13	9	9	8	7
	Building Societies and Other	4	4	4	4	4

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

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

2 Other NBDT refers to Christian Savings Limited.

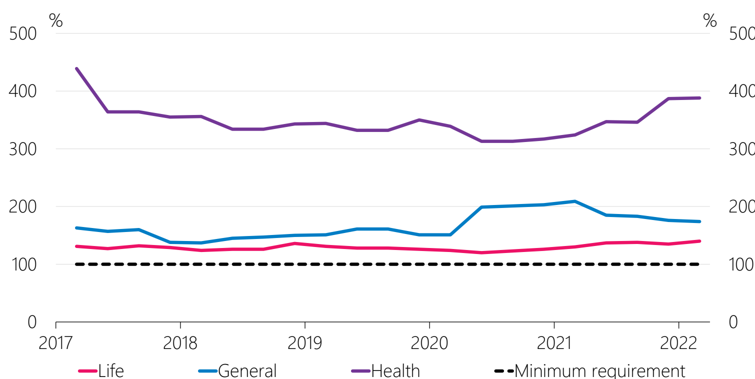
Insurers

Insurers in New Zealand provide a valuable risk management function for both individuals and businesses by pooling risks. The risk of large, potentially ruinous financial losses is substantially reduced by purchasing insurance. General insurers account for the largest part of New Zealand's insurance sector, with around 61 percent of total gross premium revenues, while life insurers account for around 25 percent, and health insurers around 14 percent.

Insurers have retained capital during the period of economic uncertainty

The solvency capital ratio of the general insurance sector has continued to decline in recent quarters from its peak in March 2021 (figure 3.15), but remains above the level seen before the COVID-19 pandemic. In 2020 the Reserve Bank provided guidance to insurers on retaining capital and not paying dividends. Once the Reserve Bank withdrew that guidance in 2021, insurers have taken a relatively cautious approach to capital management and the resumption of dividend payments. The solvency ratio for the life insurance sector has increased modestly over the last year, but remains near its long-run average level. Meanwhile the solvency ratio for the health insurance sector continues to fluctuate around previous levels at three-to-four times the minimum requirement.

Figure 3.15
Insurer solvency ratios



Source: RBNZ *Insurer Solvency Return*.

Even though the worst-case economic scenarios envisaged earlier in the pandemic have not materialised in New Zealand, the health and financial impacts of long COVID-19 are still unclear and may only be identified over a prolonged period of time by life insurers and health insurers. Furthermore, supply chain constraints and higher levels of inflation mean that general insurers may see elevated claims costs for a prolonged period. Therefore, we continue to expect that all insurers will 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 ongoing uncertainties.

Higher inflation could lead to more under-insurance

Increasing inflation and continuing supply chain issues are flowing through to higher general insurance claim costs. Reinsurance renewals are also becoming more expensive, contributing to premium increases. If the cost of living outpaces incomes for a prolonged period of time, New Zealanders may reduce their insurance cover, which would leave them exposed to more costly losses. Moreover, property sums insured may not be increasing enough to reflect sharply increasing rebuild costs. This would increase any shortfall in the event of a total loss. Both customers and insurers need to regularly review sums insured so that they remain realistic and provide the desired level of protection. Unexpectedly high inflation may also be problematic for insurers with small profit margins, given premiums are set in advance and claims may be larger than anticipated.

EQC cover for buildings increased from $150,000 to $300,000 on new and renewing polices from 1 October 2022 and will take 12 months to fully implement. Private property insurers use risk-based pricing models to differentiate their customers based on the riskiness of the location of the property and therefore charge different premiums, whereas the EQC levy is flat-rated across all of New Zealand. This means that properties in more earthquake-prone regions of the country (e.g. Wellington) are likely to see a material reduction in the total payments of insurer premium plus EQC levy, while properties in areas of low earthquake risk (e.g. Auckland) will have an increase in the total payments of insurer premium plus EQC levy. This change will place greater reliance on the public sector to fund the cost of recovery after a catastrophe, and private sector insurers will need less reinsurance to fund their portion of the recovery.

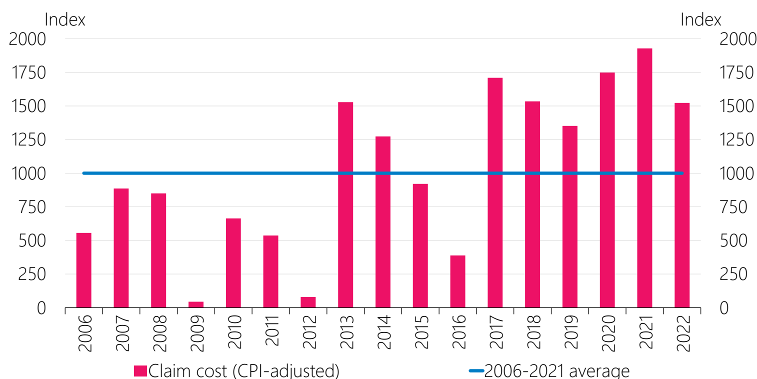
COVID-related uncertainties are likely to remain in the short term...

Overall New Zealand insurance sector remains resilient and has coped well with COVID-related issues. The Omicron variant wave infected a substantial proportion of New Zealanders and led to a rise in deaths. Because New Zealanders are less likely to have life insurance compared to peer countries, the direct financial impact on life insurers has been minimal. Health and life insurers are continuing to monitor claims trends to identify any longer term impacts that may be related to long COVID health conditions. Additionally, 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 3.16

Insurance claims from weather events

(indexed)



Source: Insurance Council of NZ, Stats NZ, Reserve Bank estimates.

Note: 2022 data includes cumulative claims to August 2022. Claim costs are deflated by the purchase of new housing component of the Consumers Price Index, as an approximation of the changing value of property insured.

...and in the long term extreme weather events are likely to be more common

The frequency of extreme weather events has increased over recent years and the costs to the insurance industry have been relatively high. In the last 5 years, the claims cost of natural disasters (excluding man-made and earthquakes, and adjusted for the value of built-up property) have consistently been above long term averages (figure 3.16). In the past, general insurers have been able to rely on years with benign weather conditions to offset elevated claims costs from years with more extreme events, without needing to make significant adjustments to premiums for insured businesses and individuals. Insurers are continuing to develop their granular, risk-based, pricing models and there is greater variation in the level of premiums charged to customers in higher-risk locations, such as those prone to flooding.

The impact of new standards for insurers is likely to be modest

In 2023 insurers will be required to comply with updated solvency standards that reflect changes in insurance accounting standards in IFRS17. For most insurers, the new requirements will lead to their published solvency ratios declining, but this is the result of both the numerator of the ratio (actual capital held by the insurer) and the denominator (the minimum amount of capital that must be held) both increasing. As such it reflects a change in calculation rather than an increase in risk. The dollar value difference between those two values is the Solvency Margin and it is expected to remain steady.

Table 3.3

Key metrics for New Zealand's insurance sector

Metric	Value (%, year to March)				Regulatory minimum	Comment
	2019	2020	2021	2022		
General insurers						
Solvency ratio	151	151	209	174	100	Solvency ratios increased significantly in 2021 when general insurers ceased paying dividends and retained capital.
Profit margin	17.2	6.9	14.9	12.5		Profit margin volatility in recent years is driven by competitive pricing pressures and the frequency of natural disasters.
Expense ratio	12.7	13.1	12.9	12.9		Expenses have been relatively stable over recent years.
Life insurers						
Solvency ratio	131	124	130	140	100	Some life insurers are operating with small margins over their minimum solvency requirements, and the Reserve Bank is monitoring those insurers closely.
Profit margin	19.1	12.6	6.3	7.3		Profit margins have materially decreased, in part due to rising interest rates.
Expense ratio	21.2	23.3	22.0	20.2		Non-commission expenses have dipped slightly from previous highs.
Health insurers						
Solvency ratio	344	339	324	388	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	1.8	3.6	5.7	6.3		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	11.3	12.3	12.0	11.2		Expenses have been relatively stable over recent years.

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

Notes:

1) Profit and expense figures are from the *Quarterly Insurer survey* for the year to March 2022. These cover just over 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).

2) Solvency figures are from the *Insurer Solvency Return* to March 2022 for all insurers subject to the Reserve Bank solvency requirements. Most foreign insurers are exempted.

Financial Market Infrastructures (FMIs)

Financial Market Infrastructures (FMIs) are the systems through which payments, securities, derivatives and other financial transactions are cleared, settled, and/or recorded. FMIs' importance to the stable operation of the financial system makes it crucial that they operate with minimum risk, are reliable, and are proactively regulated. Over recent years New Zealand's major FMIs continued to exhibit high availability and resilience despite the significant impacts of the pandemic.

New Zealand's FMI landscape is constantly evolving, with ongoing changes in regulations and functionality

We have been working with the Financial Markets Authority (who also regulate FMIs) to implement the new FMI Act 2021. This involves assessing the systemic importance of designated FMIs and developing the standards designated FMIs will need to comply with in the new regime. While FMIs have been operating in an effective and stable manner, the implementation of the FMI Act provides the regulator with additional tools to help ensure that New Zealand FMIs continue to have sound risk management frameworks and appropriate governance arrangements.

Financial Market Infrastructures in New Zealand are constantly evolving

There are significant technological and process advancements that are changing the way that FMIs interact with New Zealanders and the wider financial system. In particular, payment system participants are currently working to implement two significant technological changes that will affect the processing of payments.

The first of these projects is the adoption of the ISO 20022 standards for interbank payment messaging. Worldwide, all users of the secure financial messaging network operated by SWIFT, including New Zealand banks, need to modify their systems to be able to send and receive payment messages in the new format. The new ISO 20022 messages will enable efficiencies, increased stability, and an enhanced customer experience for the New Zealand financial system and globally. In addition, ISO 20022 will enable advances in open banking through new capabilities for application programming interfaces (APIs).

The successful adoption ISO 20022 is of high importance for the stability of the New Zealand financial system. Processing using ISO 20022 messaging in the Exchange Settlement Account System is set to commence from this month, and will coexist alongside the existing messaging format. We continue to closely monitor banks' implementation of the system changes needed to allow them to process messages in the new format.[11]

Advances in FMIs will enable New Zealanders to send and receive funds in a more timely and convenient manner

The second major project under way is to establish the ability to settle some payments 365 days per year. This initiative is being led by Payments NZ and will mean that New Zealanders will be able to make and receive payments with same day settlement not only on normal business days but also on weekends and public holidays. Individuals and businesses will be able to complete bank transfers in a more timely manner, and receive payments for goods and services without having to wait over the weekend for funds to be received. Faster settlement of payments will help to improve stability in the financial system by reducing risk, as there will be fewer financial transactions in the system that are awaiting receipt/payment at any given time. The change should also provide a foundation for further improvements in the payment system. Payments NZ expects that the project will go live in April 2023.

11 See also https://www.rbnz.govt.nz/payments-and-settlement-systems/exchange-settlements-account-system/moving-to-iso-20022.

With continued change in the payments industry, the government has taken an active regulatory approach

As the payments landscape continues to evolve and advance in New Zealand, so do the regulations that support them.

The Retail Payment System Act 2022 establishes a new regulatory regime to govern New Zealand's retail payments system and the entities involved in retail payments. The purpose of the act is to promote competition and efficiency in the retail payment system for the long term benefit of merchants and consumers in New Zealand.

Another development in the FMI landscape is the initiative to establish a framework for consumer data rights (CDR) in New Zealand. CDRs enable data holders to share customer data with a third party if the request originates from the consumer to whom that data relates. In the financial sector, it is expected that the establishment of a CDR will encourage innovation in open banking, APIs, and the development of new payment instruments.

Box C

Residential mortgage exposure to flooding risks

The financial system is exposed to a range of risks from climate change. Financial institutions have been making progress towards identifying and understanding these risks over the last few years, partially in preparation for disclosure under the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021.

To build on industry efforts, this year we are undertaking risk assessments of New Zealand's largest banks as part of our stress testing programme, covering banks' residential mortgage and agricultural exposures. Our long-term aim is to support banks to build their capability to identify climate risks and find solutions to the significant data and modelling challenges involved. In turn, this will lead to more proactive management of climate risk. In the near term, the exercise will provide estimates of exposures to selected climate hazards, which we will use to assess system-wide risk and to design further climate-related stress testing activities.

This Box presents headline results from our assessment of flooding risks to banks' residential mortgages – both coastal flooding risks, and river and surface flooding risks. Further detailed analysis of the flooding results will be published in a forthcoming Reserve Bank Bulletin article, and results from the second component focussing on banks' agricultural exposures will be published in the first half of 2023.

Coastal flooding: regionally concentrated exposures

For coastal flooding, we asked banks to measure the exposure in their mortgage portfolios, as they currently stand, to flood zones under varying levels of sea level rise. The flood zone is defined as the flooded area in a 1-in-100 year storm tide event.[12]

We asked banks to identify the value of their mortgage exposures that would be affected by permanent sea level rises of 20 centimetres, 50 centimetres and one metre in the most severe case.

This range of sea level rise is consistent with climate change modelling out from 2040 to 2100.[13]

Across the participating banks, 2.5 percent of mortgaged properties are exposed to the flood zone with 50 centimetres of sea level rise.[14] This increases to 3.8 percent in a more severe climate outcome with one metre of sea level rise (figure C.1).

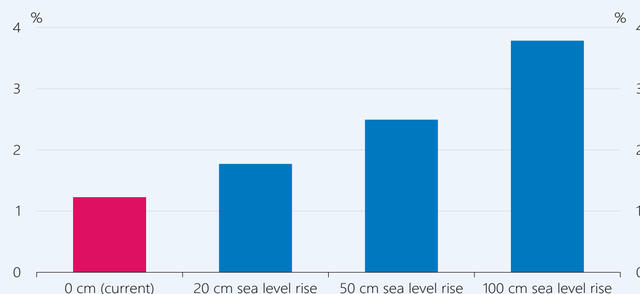
Coastal flood exposure is concentrated in certain regions. According to bank submissions, for 50 centimetres of sea level rise, the largest share of national lending at risk is in Christchurch (22 percent of the national total) followed by Wellington (14 percent of the national total).

Across regions, there are significant differences in the share of mortgage lending on properties that lie within a coastal flood zone. Hawke's Bay is particularly at risk, with 15 percent of mortgage lending in the region's flood zone for 50 centimetres of sea level rise, and almost 20 percent for one metre of sea level rise (figure C.2). At the other extreme, in Auckland just under 1 percent of mortgage lending is within a flood zone for one metre of sea level rise.

Figure C.1

Residential mortgage lending in a 1-in-100 year storm tide flood zone

(under different sea level rise scenarios)



Source: Reserve Bank.

12 The storm tide event is the water level with a 1 percent probability of occurrence in a given year, resulting from the combined effect of a storm surge and the tide level.

13 These sea level rises are chosen to represent a range of climate futures. The 20 centimetre and 50 centimetre sea levels are in the range for Representative Concentration Pathways (RCP 2.6, 4.5, 6.0, and 8.5) between 2040 and 2060; while 100 centimetres is a 'worst case' which is included to account for factors including uncertainty bands and localised differences in sea level (e.g. from vertical land movement). See *IPCC (2013), Annex II: Climate System Scenario Tables. In: Climate Change 2013 The Physical Science Basis* for more information on RCPs. Due to data constraints, the actual levels modelled by banks differ slightly from the prescribed levels.

14 This is similar to NIWA estimates that 2.9 percent of New Zealand's population and 3.5 percent of buildings (including non-residential) are in the flood zone at 50cm of sea level rise.

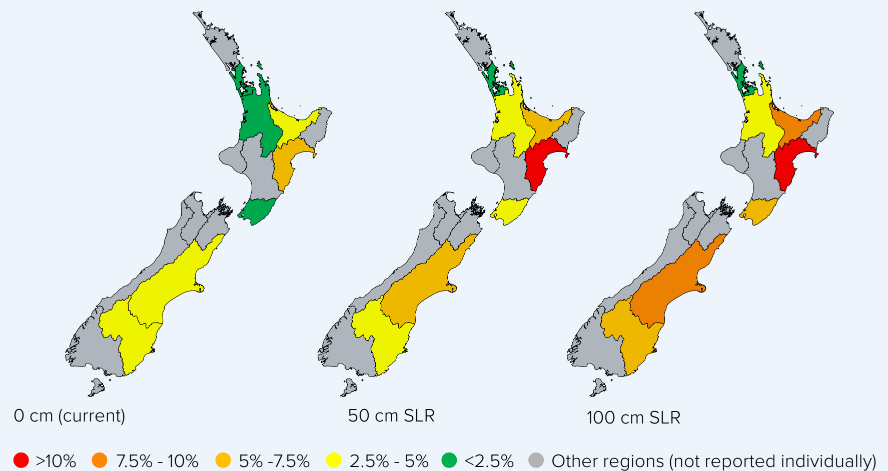
River and surface water flooding risk in Auckland

Data and capability for assessing river and surface water flood risk at the national level are not as advanced as that for coastal flooding. Working within these constraints, we asked banks to assess their exposure to river and surface water flood risk in the Auckland region. Banks use data from the Auckland Council that maps a 1-in-100 year flood zone aligned with a scenario where current climate policies remain unchanged to 2050.[15] Although there was some variability in banks' approaches, most results include a conservative assumption that a property is at risk if any part of the land area touches the flood zone.

The results of this exercise illustrate the magnitude of river and surface water flood risk in a severe climate change outcome. In Auckland, we found that more than a quarter of the banks' mortgage lending was in the flood zone. This is equivalent to around 12 percent of their total mortgage lending at a national level, under a severe climate change outcome. This exercise has now shown that river and surface water flooding looks to be a greater climate-related hazard for residential mortgages than coastal flooding, in terms of total lending.

Figure C.2

Share of mortgage lending in 1-in-100 year storm tide flood zone by region



Source: Reserve Bank.

Note: Geographic coverage varies somewhat between bank submissions, so aggregate results are approximate; for example results for Christchurch may or may not cover other parts of Canterbury. Results for the residual 'other regions' group were not collected individually as they have relatively low individual mortgage totals, so they are excluded from the regional breakdown in the map.

Implications for banks

Climate change-induced increases in flooding risk, and related potential changes in insurance behaviour, are unlikely to be fully captured in current house prices. Therefore, owners may see a fall in property values in flood zones as we gain an improved understanding of the risks and this is priced into the housing market.

This risk assessment looked into how banks' current mortgage portfolios would be affected by flooding risks out to 2100, assuming no change in the types of properties banks will lend against compared to their current practices. New mortgages typically have a maximum 30 year term, and on average a mortgage's principal will be paid down over a shorter time horizon. This means that, through gaining a deeper understanding of likelihood and extent of future flooding risks, banks can position themselves to avoid being exposed to these risks over time, for example by tightening lending requirements in high risk flood zones. It also gives banks an opportunity to work with existing customers to manage and mitigate risk.

Importantly for banks, 80 percent of current mortgages in the identified flood zones have LVRs below 60 percent. A low LVR means the mortgage borrower has a significant amount of equity to absorb a decline in property value, if this were to occur faster than the remaining term of the loan. Falls in the value of properties securing mortgages do not on their own lead to losses for banks. However, with less security supporting a loan, a bank would be more exposed to loss in the event a borrower defaults. The impact on bank losses, exploring a range of property value sensitivities, will be analysed in the forthcoming Reserve Bank *Bulletin* article.

15 Auckland Council maps a 17 percent increase in rainfall depth which corresponds to a 2.1 degree Celsius increase in temperature. This is the temperature outcome in the Network for Greening the Financial System "current policies" scenario, see here. For further information, see flood prone areas and flood plains maps.

Box D

Lending by non-deposit taking institutions

In recent years lending by non-bank institutions that are not funded with deposits has grown much more rapidly than lending by registered banks and NBDTs. Unlike registered banks and NBDTs, non-bank, non-deposit taking lenders (NBNDTs) are not regulated by the Reserve Bank, but we collect data on the sector.

The non-deposit taking sector is highly diverse, with a range of operating structures and business strategies. Non-deposit taking lenders provide a range of services, including personal loans, residential mortgages and property development finance. The sector complements the lending activities of the banking sector by providing loans to borrowers with an adverse credit history or to those who cannot meet the income documentation requirements to obtain a loan from a bank. Some of these borrowers have higher credit risk than those accepted by banks. This risk is reflected in the lending rates of these institutions, which tend to be higher than bank lending rates. Some borrowers switch from non-bank lenders to banks when they have established a better credit history.

Funding sources for non-deposit takers vary across entities. This includes securitising loans, either through bank credit facilities ('warehousing') or by selling bonds backed by loans to institutional investors. Other institutions are funded by equity investments from high net worth individuals and bond investments by wholesale investors. Finally, some other lenders are structured as managed funds.

Table D.1

Residential mortgage lending by banks, NBDTs, and non-deposit taking lenders

	Total mortgage lending ($b)			Growth over previous 12 months (%)		
	Banks	NBDTs	NBNDTs	Banks	NBDTs	NBNDTs
Aug-19	267.2	0.98	1.91	6.3	0.5	31.3
Aug-20	284.4	1.03	2.35	6.4	4.3	22.9
Aug-21	317.0	1.15	3.32	11.5	12.4	41.3
Aug-22	335.2	1.28	4.82	5.7	10.7	45.0

Source: RBNZ *Balance Sheet survey, NBDT Statistical Return, Standard Statistical Return.*

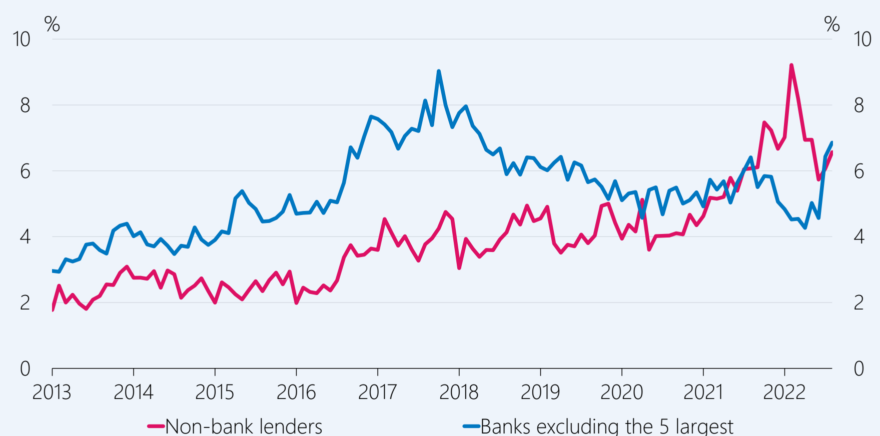
Note: Lending by non-deposit taking lenders excludes lending by managed funds.

Residential mortgage lending by non-deposit taking entities has grown rapidly recently (table D.1). Since 2019, the value of housing lending by non-deposit takers has more than doubled. Lending by banks and NBDTs increased by around 25 percent over this period. Non-bank lenders (deposit takers and non-deposit takers) have recently accounted for around 7 percent of new mortgages, similar to the share of smaller banks (i.e. excluding the 5 largest banks) (figure D.1).

Market contacts have suggested the strong lending growth reflects a number of factors, including more flexible access to funding compared to deposit-funded entities, supportive monetary conditions, and lower costs of regulatory compliance. Non-deposit takers also have more flexible lending policies than banks, making them better able to adapt their terms for atypical borrowers.

Figure D.1

New mortgages registered by lenders other than the five largest banks



Source: CoreLogic, Reserve Bank estimates.

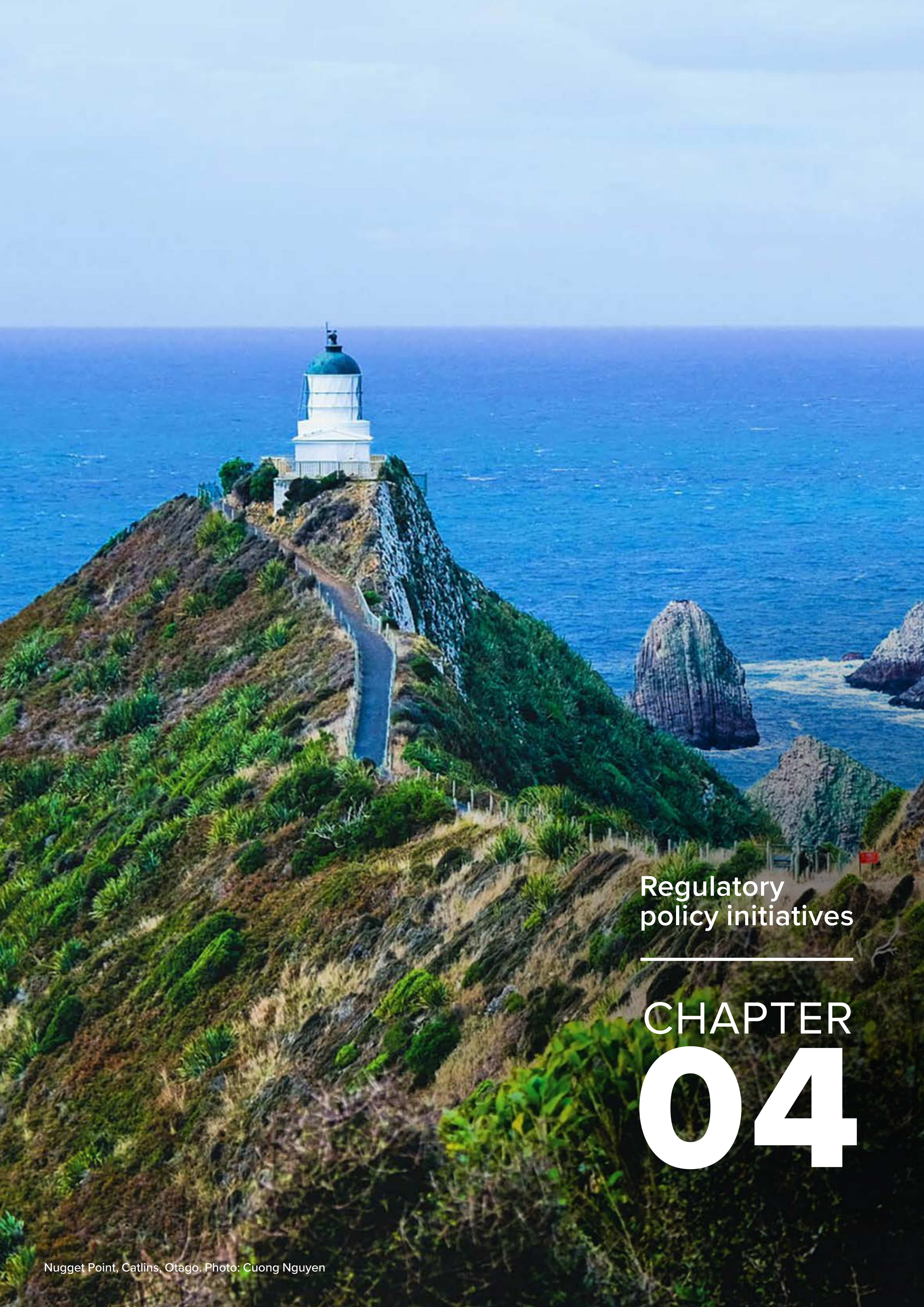
Note: This figure plots the share (by count) of property transfers in each month where a mortgage is registered, by the type of institution taking a mortgage over the property.

Non-bank lenders are not directly subject to the LVR speed limits imposed by the Reserve Bank. However, non-banks still have to maintain prudent lending policies in order to obtain funding from investors. For example, banks may impose covenants on the credit facilities they provide to non-banks requiring them to limit high-LVR lending.

In addition to residential mortgage lending, some non-deposit takers focus on financing residential development projects. Bank lending for residential developments has typically focussed on projects with high shares of properties that are sold off plans before being completed, to limit risk. Non-deposit takers are more willing to fund development projects with lower pre-sales or that have properties that get sold after being completed ('spec' or 'turn-key' housing). Developers may also use a combination of bank and non-bank finance structured in a way to meet the risk appetite of both types of lenders, for example through subordination. Market contacts have reported that as the housing market has slowed and pre-sales have fallen, overseas investment funds are also playing an increasing role in financing residential development projects.

We assess that there are limited risks to financial stability from the non-deposit taking sector. Despite this recent strong growth, non-deposit takers' share of lending is still small, at around 1.4 percent of the total value of residential mortgage loans outstanding. It is possible that a further slowdown in housing market activity could put some development projects funded by non-deposit takers at risk of being unable to be repaid in full.

The exposure of banks to non-deposit takers is relatively low. In addition, retail investors have little direct exposure to non-deposit taking institutions, and the impact of any non-bank lender failure is likely to be mainly on the equity holders and other wholesale investors in these institutions.

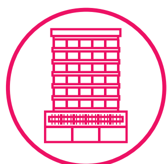


Regulatory policy initiatives

CHAPTER 04

Nugget Point, Catlins, Otago. Photo: Cuong Nguyen

CHAPTER 4
Regulatory policy initiatives



As part of our work to protect and promote financial stability, we continue to improve the regulatory structures of the New Zealand financial system, by prioritising work on major legislative reforms and other key initiatives linked to our assessment of vulnerabilities. This chapter provides updates on this work, with particular focus on seven key initiatives.

Regulatory prioritisation

We have a large programme of work underway to review and modernise the prudential legislation and regulatory underpinnings of the sectors that we supervise. This is part of our transition towards a regulatory approach that is more closely aligned with international practice, a feature of which will be enhanced monitoring and more regular reviews and updates of regulatory policy settings. This work is important to enable and maintain a healthy, resilient and vibrant financial system, which supports a sustainable and productive economy.

The breadth of the work underway, in addition to feedback from industry, has meant that in the past six months we have undertaken an enhanced prioritisation of our regulatory initiatives. This has related to both work currently underway and to new initiatives under consideration.

When considering prioritisation we have taken a number of factors into account, including:

- The extent initiatives will promote financial stability based on our assessment of risks and vulnerabilities;
- Our role as *kaitiaki* (guardian) of the financial system, to ensure our policies remain fit for purpose and reflect changes in international best practice where appropriate;
- Our legal obligations and objectives;
- Availability of resources, including the impact on industry; and
- The Council of Financial Regulators' (CoFR) work programme.

The outcome of this process identified our major legislative reform programmes as priorities, along with completion of some high priority policy work. These include:

- Supporting the progression of the Deposit Takers Bill, including the Depositor Compensation Scheme (DCS);
- Completing the branch review to provide clarity for industry, including on the scope of branches' permitted activity prior to implementation of DCS;
- Implementation of the Financial Markets Infrastructure Act 2021;
- Review of the Insurance (Prudential Supervision) Act 2010 and solvency standard;
- Development of the debt-to-income macro-prudential tool;
- Liquidity policy review; and
- Completing the implementation of the Capital Review.

We recognise that these represent large scale changes for both us and our regulated industry. The result has been that in the past six months we have not launched any new major regulatory initiatives.

We have also delayed and extended timeframes on several items on the existing regulatory work programme. These include:

- Extending the timeline for Liquidity Policy review;
- Extending the implementation timeframe of the DTI macroprudential framework once finalised to 12 months;
- Delaying consultation on cyber data collection;
- Delaying detailed consultation signalled as part of the 2019 Capital Review decisions on:
  - Standardised Measurement Approach to Operational Risk; and
  - Operational framework for the counter-cyclical capital buffer;
- Delaying implementation of dual reporting for internal ratings-based (IRB) banks;
- Pausing planned updates and enhancements to the Banking Insights Dashboard; and
- Pausing a planned refresh of the market risk framework.

We recognise the importance of co-ordination and collaboration with the wider regulatory community. CoFR is committed to working constructively across our functions, and continuing to enhance the way we work together. This includes recently agreeing to enhance the Regulatory Initiatives Calendar.[16]

A further important development in our policy work over the last six months has been the introduction of the Financial Policy Remit (see Box A).

Update on previously reported regulatory initiatives

Deposit Takers Bill

The Deposit Takers Bill is the final phase of the review of the Reserve Bank of New Zealand Act 1989. The Bill aims to ensure that New Zealand's financial system is stable by promoting the safety and soundness of individual deposit takers; fostering public confidence; and mitigating risk both to the financial system, and also from the financial system to the broader economy. In developing the Bill we must also take into account a number of principles such as the desirability of taking a proportionate approach to the regulation, the need to maintain a competitive deposit-taking sector, and avoiding unnecessary compliance costs, as well as the factors outlined in the Financial Policy Remit.

The Bill establishes a framework for the regulation and supervision of financial firms that take deposits and lend to households and businesses. The Bill also introduces a Depositor Compensation Scheme to protect depositors up to $100,000 per depositor, per institution.

The exposure draft of the Bill was published in December 2021 with submissions closing in February 2022. We received 21 submissions in total. As part of the consultation, we ran workshops with banks and NBDTs. Based on the feedback received and further policy work, Cabinet made further decisions in June 2022, resulting in a range of changes to the Bill. These changes are outlined in the Regulatory Impact Statement, published along with a summary of submissions on the Reserve Bank website,[17] alongside a suite of other documents to support the introduction of the Bill.

The Bill was introduced to Parliament in September and is being progressed to the Select Committee.

16 See https://www.cofr.govt.nz/files/regulatory-initiatives-calendar/regulatory-initiatives-calendar-q3-2022.pdf.

17 See https://www.rbnz.govt.nz/about-us/responsibility-and-accountability/our-legislation/proposed-deposit-takers-act.

Debt servicing tools

The Memorandum of Understanding on macroprudential policy between the Reserve Bank and the Minister of Finance was updated in 2021 to include debt serviceability restrictions. Following consultation on debt servicing restrictions, in April we published our response to the feedback received and announced we will proceed with designing a framework for operationalising DTI restrictions.[18]

Since that time we have met with banks to discuss detailed design issues. We intend to consult on the draft regulatory framework in November 2022 with a view to making final decisions on the framework in early 2023. Approximately a year will be allowed for implementation once the framework is finalised.

Given the current conditions in the mortgage market and recent increases banks have made to their servicing assessment rates, we do not consider that this timeframe presents financial stability risks. However, we continue to monitor the market and could impose a serviceability assessment interest rate floor as an interim tool relatively quickly if financial stability risks warranted it. DTI limits will be an important tool for managing any future build-up of financial stability risks.

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. Of the 27 registered banks operating in New Zealand, 12 are branches, accounting for proximately 8 percent of banking system assets. Of the 12 registered branches, seven are dual-registered, which means that the New Zealand banking group comprises both a branch of the overseas bank and a locally incorporated subsidiary of the overseas bank, and that both are registered as banks in New Zealand.

The objective of the review is to create a simple, coherent, and transparent policy framework for branches that promotes financial stability.

We published the second consultation paper in August.[19] Key proposals include:

- that all branches in New Zealand be restricted to engaging in wholesale business (that is with corporates, institutions and other wholesale investors), meaning they could not take retail deposits or offer products or services to retail customers;
- to limit the maximum size of a branch to NZ$15 billion in total assets; and
- that we continue to allow the dual registration of branches, provided:
  - the relevant subsidiary and branch are sufficiently separate, and any identified risks are mitigated by specific conditions of registration; and
  - dual-registered branches only conduct business with large wholesale customers (those with consolidated turnover greater than NZ$50 million).

The proposals in the consultation paper aim to allow branches to provide benefits to the financial system through innovation, competition and cheaper funding for businesses, while also mitigating risks that branches present to financial stability. We welcome feedback on the proposals before the end of the consultation period on 16 November. We expect to communicate final policy decisions in 2023 and are proposing a three-year transition period for branches to be fully compliant with the new policy settings.

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18 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/debt-serviceability-restrictions.

19 See https://www.rbnz.govt.nz/have-your-say/review-of-policy-for-branches-of-overseas-banks.

Capital Review

We have been continuing to implement the changes in the Capital Review decisions announced in December 2019.

The first increase in the Prudential Capital Buffer (PCB) took place in July and affected the four banks that we have identified as domestic-systemically important banks (D-SIBs). The PCB applying to these banks increased by 1 percent of risk-weighted assets (RWA) and is now 3.5 percent. D-SIBs must have this buffer in addition to the minimum total capital requirement of 8 percent. If they do not have enough capital to meet the PCB then they are subject to restrictions on dividend payments. This means that the banks classified as D-SIBs must now have capital of 11.5 percent of risk-weighted assets, including all minimum requirements plus buffers. All other banks must have a PCB of 2.5 percent, which means that their total capital ratio must be 10.5 percent.

The next increase in the PCB will occur on 1 July 2023, when the PCB applying to D-SIBs will increase by another 1 percent of RWA. Further increases applying to all the banks will take place each year until 2028, at which point the minimum requirement including all buffers will be 18 percent for D-SIBs and 16 percent for all other banks.

The other recently implemented change is an increase in the IRB scalar to 1.2 from 1.06 that IRB banks use when calculating their RWAs. This will require IRB banks to have more capital.

There are three active consultations currently underway for other topics identified during the Capital Review:

- IRB banks will be required to report both their modelled and standardised equivalent RWAs for credit risk (dual reporting). A consultation on this change closed in May.[20] Decisions about the final shape of dual reporting will be made in the coming months and implementation is likely to begin in June 2023.
- Consultation for the design of a capital instrument that would qualify as Common Equity Tier 1 for mutual entities closed in June.[21] We expect to announce decisions in the next few months.
- In September, we published a paper proposing a small number of amendments and clarifications to the RWA framework.[22] The proposals would not alter the Capital Review decisions from 2019, and are designed to respond to questions raised as part of the Review. Decisions on these proposals are likely to be announced during 2023.

Insurance (Prudential Supervision) Act Review

We are reviewing the Insurance (Prudential Supervision) Act 2010 (IPSA), which is the legislation that underpins our regulation and supervision of New Zealand's insurance sector. We are approaching the end of the first stage of the review, which has involved four public consultations on different aspects of the current legislation.[23]

The final in this series of consultations, on governance, supervisory processes and disclosure, will likely be released later in November. The consultation discusses greater use of Standards to set out our expectations of insurers' governance and risk management. It looks at increasing the accountability of directors and other key officers. It discusses changing the procedures for supervisory review of significant transactions (changes of control, changes of corporate form, transfers and amalgamations) to be more proportionate to risk. Finally, we suggest using a data and disclosure standard to enable the publication of some additional insurer data, to enhance market discipline.

Once that consultation is complete, we will draw together analysis and feedback and prepare an omnibus consultation setting out a full set of proposals for amending IPSA.

20 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/debt-serviceability-restrictions.

21 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/capital-instruments-for-mutual-banks.

22 See https://www.rbnz.govt.nz/have-your-say/risk-weights.

23 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/review-of-the-insurance-prudential-supervision-act-2010.

We expect to publish this omnibus consultation in the middle of 2023. We will then proceed to the legislative process, with amendments likely to come into force around 2026 or 2027.

Insurance Solvency Review

Solvency standards are designed to ensure that insurers maintain minimum levels of capital. This requirement means that insurers should be able to meet their obligations to policyholders in a wide range of adverse circumstances.

We initiated a review of the solvency standards in late 2020, in response to both the impending introduction of a new insurance accounting standard (NZ IFRS 17), and also to the findings of several reviews of our regulation and supervision.[24]

Following consultation, the Interim Solvency Standard 2023 was issued by the Reserve Bank Board in September. It will come into force on 1 January 2023 and be applied to individual insurers when they commence accounting under NZ IFRS 17, the incoming financial reporting standard for insurance contracts. Explanatory material relating to the Interim Solvency Standard will be published in late November 2022.

The main changes in the standard are

- the alignment of requirements for life, health and non-life insurers under a single standard;
- a move to an economic valuation basis for capital; and
- the phased introduction of an operational risk charge.

Initially, we are expecting decreases in the dollar value of solvency margins for most life insurers as their insurance liabilities now need to incorporate risk adjustments. We are not expecting across-the-board decreases in solvency margins for non-life and health insurers.

Solvency ratios will decrease for most life and health insurers and for some non-life insurers. However, this does not mean their financial position is deteriorating. Rather, the quantum of both their solvency capital and their capital requirement is increasing.

We are currently planning stage two of the review of the solvency standards, which will result in a final solvency standard that addresses the remaining objectives of the review. The timeline for stage two will be aligned with the IPSA review, meaning that the final solvency standard will be available in 2026 or 2027.

Liquidity Policy Review

We are undertaking a comprehensive review of our liquidity policy (BS13). The purpose is to ensure the policy remains fit for purpose to promote financial stability by lowering the risk of liquidity problems affecting deposit takers.

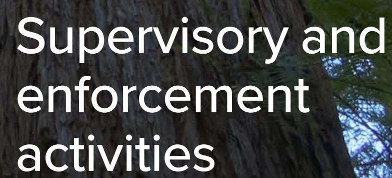
We released the first consultation paper for this review in February, which contained the proposed issues and scope for the review, as well as the principles we proposed be used to guide the review and our decision-making. The comment period for this first consultation closed in April and we have since finalised the principles for the review.[25]

We expect to release the second consultation paper for this review in the near future. This paper will consult on a number of fundamental issues, including whether we should adopt, at least in some form, the quantitative liquidity standards used internationally (the Liquidity Coverage Ratio and the Net Stable Funding Ratio), how liquidity requirements should be applied across deposit takers in a proportionate manner, as well as the eligibility criteria for liquid assets.

Subsequent to this second consultation paper, we intend to issue at least two more consultation papers as part of the review, with the entire review spanning approximately three to four years, before arriving at a final liquidity policy.

24 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/review-of-the-insurance-solvency-standards.

25 See https://www.rbnz.govt.nz/have-your-say/closed-consultations/review-of-liquidity-policy.



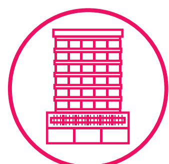
Supervisory and enforcement activities

CHAPTER

05

Whakarewarewa, Rotorua. Photo: Charles Lilly

CHAPTER 5
Supervisory and enforcement activities



We are expanding our capacity and activities as we become a more intensive prudential supervisor. We are empowered to take action when non-compliance with the relevant legislation and regulatory frameworks is identified. This chapter provides information on recent supervisory activities, identified instances of non-compliance, and enforcement action, to achieve our statutory objectives.

Supervisory activities

We are responsible for the prudential supervision of 27 banks, 17 NBDTs, and 90 insurers. We also supervise 5 designated FMIs, as well as 79 banks, life insurers and NBDTs under the Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) Act 2009. The number of firms we supervise varies over time, which reflects the dynamic nature of the New Zealand financial system as new firms seek licences and registrations to enter the market, existing firms merge, and others exit.

We have continued our work on becoming a more proactive and intensive supervisor, while maintaining strong and productive relationships with those we supervise. We have focused the expansion of our resource in Tāmaki Makaurau (Auckland), where many financial institutions are headquartered.

In September we published the *Statement of Prudential Policy*, which describes how our supervisory approach works to promote and protect financial stability. We engage proactively with firms and stakeholders to understand the emerging risks in their business and to ensure that firms fully understand the regulatory expectations we have of them. The findings from our Relationship Charter survey indicate that banks and large insurers have a positive view of their engagement and relationship with the Reserve Bank, while there are opportunities to improve our relationship with small insurers.

In conjunction with the FMA, we are undertaking a cross-sector thematic review on the governance of 32 regulated firms. The review focuses on boards and their ability to effectively govern and provide oversight to their firms. We are seeking to identify best-practice and areas for improvement. Specific feedback will be provided to the firms in the sample, and we expect to publish a joint report with the FMA on overall themes and findings in the second quarter of 2023.

Areas of regulatory non-compliance

The number of instances of identified non-compliance by regulated entities with their prudential requirements has been broadly stable over the past six months. Of the issues identified in the banking and insurance sectors, over half relate to reporting and disclosure.

The majority of identified non-compliance with the AML/CFT requirements relate to the prescribed transaction reporting requirements or wire transfer identity requirements under the AML/CFT Act.

Responding to non-compliance

Our *Statement of Prudential Policy* also outlines how we will act when investigating compliance with our prudential framework and taking enforcement action.[26] Where non-compliance is identified, we take a risk-based approach to ensure our enforcement resources have the most impact. We prioritise the issues that are likely to have a greater impact on our objectives or support our credibility as a regulator and ability to achieve appropriate outcomes.

Current investigations relate to failures under the AML/CFT Act to ensure originator information accompanies wire transfers, and to correctly report prescribed transactions.

Bank of New Zealand

On 8 July, we issued a formal warning to the Bank of New Zealand (BNZ) under section 80 of the AML/CFT Act.[27]

BNZ failed to report the correct location for around 50,000 domestic physical cash transactions in prescribed transaction reports between November 2018 and April 2020.

BNZ identified the cause of the failure to be a technical coding error, which led to it providing incorrect location information for these transactions to the Police Financial Intelligence Unit. After becoming aware of the error in its reporting, BNZ promptly remediated the matter.

Enforcement framework

We are building a modern, responsive model and are increasing the intensity of our supervisory activities and strengthening our approach to enforcement.

Our enforcement framework sets out what we consider when we select matters for investigation, conduct investigations, and ultimately take decisions relating to enforcement matters. The foundation of our enhanced enforcement framework is the enforcement principles and criteria guidelines (P&C) that we published in May. The enforcement framework will also consist of additional public guidance that is currently under development.[28] The enforcement principles guide the direction of our investigation and enforcement strategy and inform our approach to applying our enforcement discretion. Our three enforcement principles are: risk-based, proportionate, and transparent.

The enforcement criteria are specific considerations for deciding on the appropriate enforcement response to non-compliance. Our four enforcement criteria are: seriousness of conduct, responsiveness, public trust and confidence, and efficacy.

The P&C will be supplemented by enforcement guidelines and investigation guidelines which we expect to publish in the next six months. The enforcement guidelines will describe our escalating regulatory response model and provide further detail on how we apply the P&C when determining the appropriate enforcement response. The investigation guidelines will describe our approach to formal investigations and how we apply the P&C throughout an investigation.

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26 See https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/prudential-policy.

27 See https://www.rbnz.govt.nz/hub/news/2022/07/bnz-issued-formal-warning-under-aml-cft-act.

28 See https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/enforcement/enforcement-principles-and-criteria-full-guidelines.pdf.

Future developments

As described in Chapter 4, the Deposit Takers Bill was introduced to Parliament in September. The Bill provides for an expanded suite of supervisory and enforcement tools, including on-site inspection powers, criminal offences, civil pecuniary penalties, infringement offences and enforceable undertakings.