Reserve Bank of New Zealand
Te Pūtea Matua

11/2021

Financial Stability Report

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

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

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

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

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Financial Stability Report

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CHAPTER 1
Financial stability risk and policy assessment

Summary

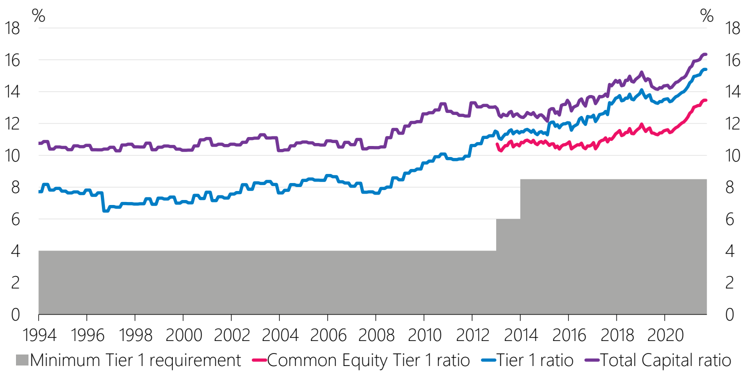
- The global economy continues to face challenges caused by the COVID-19 pandemic. Ongoing supply chain issues are creating additional costs for businesses here and abroad and contributing to higher inflation. Higher global interest rates could prove to be a headwind to asset prices.
- In New Zealand, economic activity was back to strong levels prior to August but restrictions to contain the recent Delta outbreak are presenting economic challenges. A transition towards living with COVID-19 in the community could lead to a change in consumers' preferences and behaviour, affecting the viability of some businesses.
- Strong demand for housing is creating price pressure, resulting in recent buyers borrowing more relative to their income. Loan-to-value ratio (LVR) restrictions are the main tool we have used to date to address risks related to the housing market. We will soon consult on forms of debt servicing restrictions, which could also be used to lean against these risks.
- Climate change presents both long-term risks and opportunities to financial institutions. Understanding and managing climate-related risks is necessary to support ongoing financial stability. Our actions to support this were recently published in a climate change report.
- The unpredictable nature of future economic stresses makes it important that financial institutions are resilient, so that they are in a strong position to keep supporting their customers and the economy. To support this, capital requirements for banks will progressively increase from 1 July 2022.
- We are increasing our focus on financial inclusion. This includes working to make remittances to the Pacific more accessible and cost-effective, supporting the ongoing availability of banking services in regional New Zealand, and identifying barriers facing Māori capital seekers.

The financial system remains sound and financial institutions are robust

The global economy continues to face challenges from the COVID-19 pandemic and, with asset prices appearing stretched, the economic outlook is uncertain. In this environment, New Zealand's financial system has been resilient and continues to support households and businesses as they manage their way through the pandemic. The banking system's earnings have increased over the past year. Coupled with dividend restrictions and lower risk-weighted asset growth, this has contributed to banks' capital ratios increasing to their highest levels since the current risk-based approach to capital regulations was introduced (figure 1.1). Banks are well placed to meet the higher requirements coming as a result of the Capital Review, and to absorb any impacts from Alert Level restrictions that have been in place since August.

Figure 1.1

Capital ratios of locally incorporated banks



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

Banks have also built robust liquidity positions. Stimulatory monetary policy and low credit spreads have contributed to favourable funding conditions in New Zealand and abroad. Banks have begun to return to wholesale funding markets as part of a diversification and normalisation of their funding profiles, taking advantage of currently favourable market conditions. This also reflects that deposit growth has slowed over the past year.

The resilience of the non-bank deposit taker (NBDT), insurance and financial market infrastructure (FMI) sectors has remained relatively stable. The economic recovery since mid-2020 has seen improved earnings and asset quality for the NBDT sector, although some long-term challenges remain. Insurers' profitability has been relatively stable, while their capital buffers have been supported by lower dividend payments.

Several regulatory initiatives are working towards stronger frameworks that will support positive long-term outcomes across the financial sector. The initiatives currently in progress include the Credit Contracts and Consumer Finance Act and Responsible Lending Code, the Deposit Takers Act, climate disclosures, and the new FMI framework. While there are upfront transition costs, these initiatives will enhance financial stability and customer outcomes in New Zealand over the longer term.
We are also progressing initiatives to support financial inclusion, supporting all New Zealanders' ability to participate in the financial system (see Box B).

Economic activity was back to strong levels prior to lockdown…

Households and most businesses have seen a strong recovery in demand since mid-2020. The economy has been supported by fiscal and monetary policy settings and strong balance sheets.[1] For households who were existing mortgage borrowers, recent house price growth has increased their equity. The tight labour market and low mortgage rates are supporting overall debt servicing capacity.

1 See the recent speech by Geoff Bascand on the contribution of strong balance sheets to New Zealand's economic resilience and recovery at https://www.rbnz.govt.nz/research-and-publications/speeches/2021/speech2021-10-14.

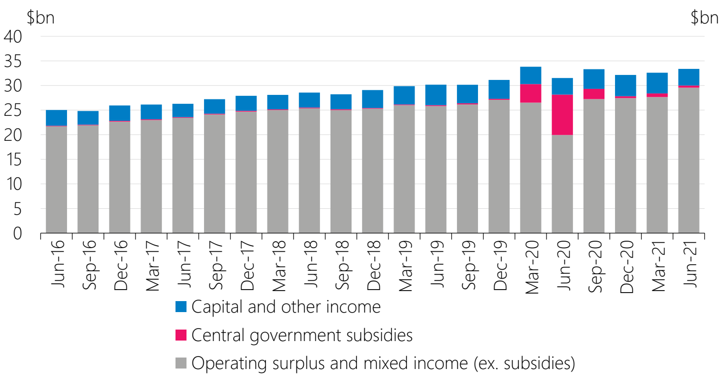
Most businesses outside of industries affected by the decline in international arrivals saw their incomes recover to or exceed pre-pandemic levels prior to August. Business investment had recovered somewhat, while tightness in the labour market was reported as the most limiting factor to business expansion.

...but COVID-19 continues to present economic risks

The financial system has adapted well to the re-emergence of COVID-19 in the community and the return to higher Alert Level restrictions. To date, banks have received only a small rise in applications for assistance from customers. No major issues have been reported in terms of financial market liquidity or banking system functioning.

Fiscal support schemes such as the wage subsidy and resurgence support payments have sustained most businesses through periods of higher Alert Level restrictions (figure 1.2), and this support has continued in the latest outbreak. However, as with last year's lockdowns, the current outbreak is creating stresses for some industries, including hospitality and tourism, particularly in Auckland. As of late October, banks continued to report only modest numbers of business customers requesting financial assistance or finding difficulty in meeting their financial obligations. We remain mindful that the number of firms in stress may rise as cash buffers are depleted over the coming months.

Figure 1.2
Quarterly non-financial business sector income
(indicative, nominal, seasonally adjusted)



Source: Stats NZ, RBNZ estimates.

While the rollout of vaccines worldwide has demonstrated clear improvements in health outcomes, the highly transmissible Delta variant means that population immunity may not be achievable even with high vaccination rates. It is becoming likely that COVID-19 will be a managed, endemic disease over the medium term in most countries.

In New Zealand, tight border controls and an elimination strategy for outbreaks supported favourable health outcomes, and enabled higher average levels of economic activity than in many other countries over the past 18 months. However, the Delta variant has proven harder to suppress, and New Zealand is transitioning to managing the spread of COVID-19 with vaccination becoming the preferred tool to respond to the virus. Activity restrictions are likely to remain in place for some time while the vaccine rollout is ongoing.

The transition from 'pandemic' to 'endemic' creates financial stability risks, although the magnitude of these is still hard to gauge at this stage. While restrictions may ease as vaccination rates increase, living with COVID-19 in the community could lead to changes in consumers' preferences and behaviour. Businesses will need to adapt, and some businesses that have stayed afloat to date may not be viable as support schemes wind down. These changes could drag on economic activity.

Heightened economic uncertainty is likely to remain for some time

As global economic activity has recovered, ongoing supply chain issues, labour shortages, and high energy prices have contributed to higher inflation. The outlook for inflation and activity is uncertain, given the novel nature of this shock, and the risk of further variants developing or a return to tighter restrictions.

Increasing inflationary pressure is causing some central banks to start reducing monetary stimulus, while others are assessing these trends as largely transitory and maintaining current levels of support. In New Zealand, the Monetary Policy Committee reduced the level of monetary stimulus by pausing its Large Scale Asset Purchase programme, and increasing the Official Cash Rate (OCR) to 0.5 percent. The Committee also signalled it expects to further remove monetary policy stimulus over time, with future moves contingent on the medium-term outlook for inflation and employment.

For now, global and domestic monetary and financial conditions remain accommodative, underpinning valuations in equity, bond, housing, and other asset markets. Higher interest rates could prove to be a headwind to asset prices both globally and in New Zealand, and there could be heightened sensitivity from the continued rise in debt burdens around the world.

Looking to the medium term, structural changes to office demand and retailing models prompted by the pandemic may yet bring stresses to parts of the commercial property sector. Vacancy rates have only risen modestly to date, but this may accelerate as current tenancies come up for reassessment, particularly for less attractive sites. Commercial property valuations would also come under pressure in an environment of slower economic growth and higher interest rates.

Strong demand for housing is creating asset price pressure, while supply disruptions are raising building costs

While in aggregate the household sector has endured the pandemic quite well, the level and trajectory of house prices is unsustainable and this is creating risks for recent buyers. The contribution of population growth to demand for housing has declined significantly since the outbreak of COVID-19 last year. Meanwhile, house building has been at record high levels and there is significantly more in the pipeline.

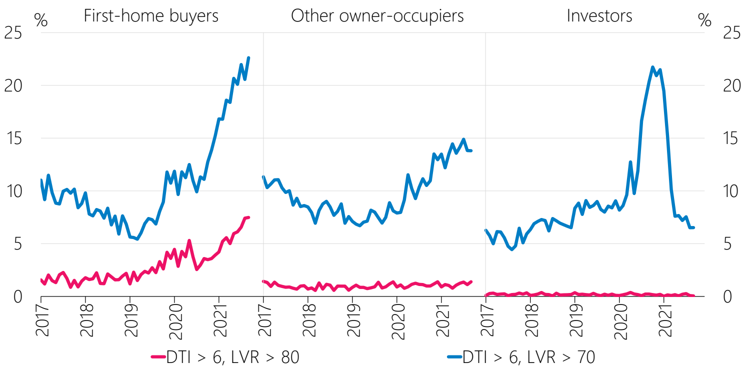
Housing demand has been underpinned by low mortgage interest rates over the past 18 months and re-leveraging of earlier equity gains as existing owners trade up. Investor activity has been relatively subdued following previous tightening of LVR requirements and tax changes, which will also affect house prices.

Recent buyers have needed to borrow more and are increasingly vulnerable to future shocks (figure 1.3). Recent high-LVR borrowers are vulnerable to a decline in prices from their current levels. Also, while current debt servicing costs are quite low, higher mortgage rates could see debt servicing costs rise substantially for some borrowers as a share of their income, creating financial stress and reducing aggregate demand.

Figure 1.3

High-risk lending to recent buyers

(share of new lending to each buyer type)



Source: RBNZ DTI *New Commitments survey.*

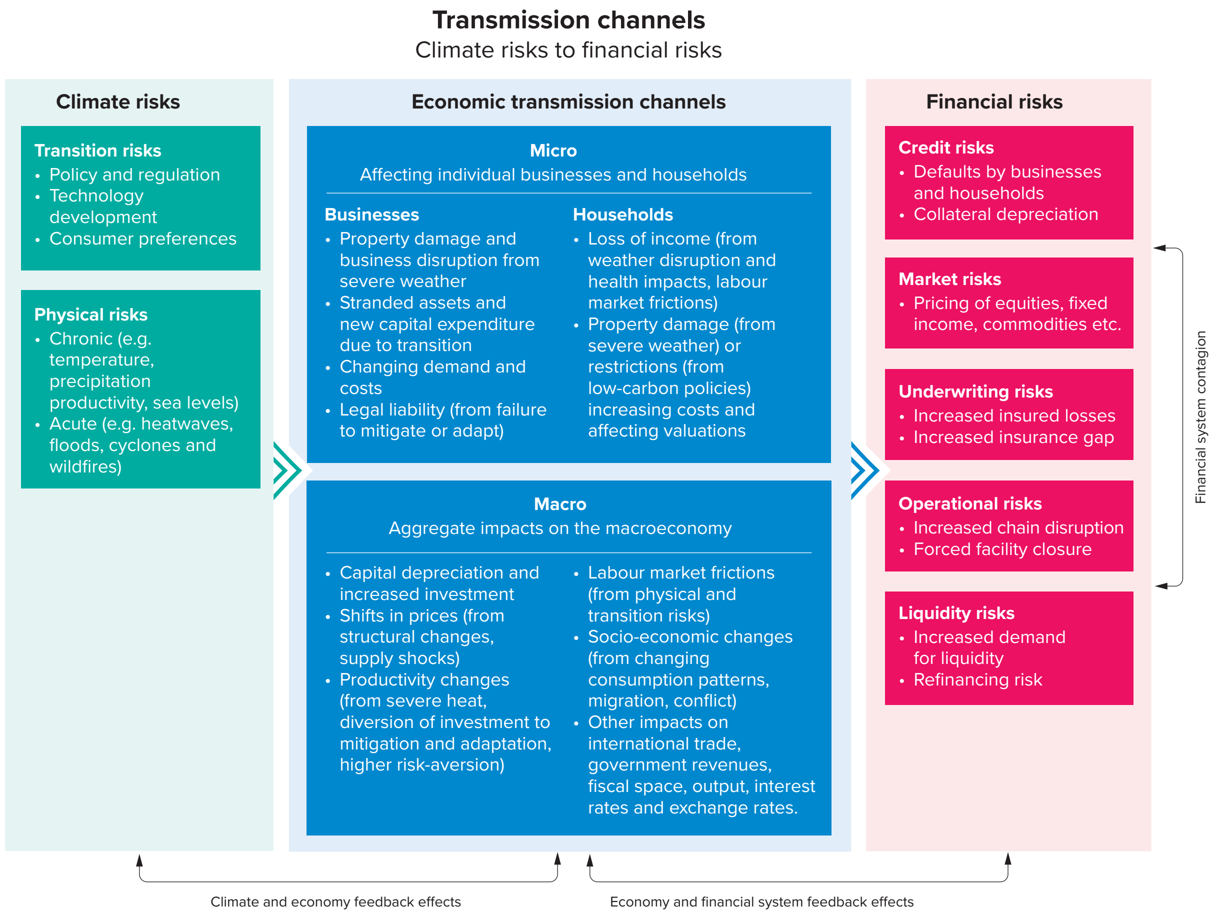
Heightened risks are emerging in property development, particularly for small and medium-scale residential projects. Labour, material supply, and logistical constraints are raising costs and pushing out completion timelines. Attractive sites for development continue to increase in price. Combined, these factors are eroding and adding risk to developer margins. Stresses amongst developers may emerge if these costs continue to increase or house prices decline. The financial system retains a relatively low exposure to development risks, but the effect of stresses in the sector may spillover to broader market sentiment, reinforcing any potential softening.

Understanding and managing climate-related risks is needed to support ongoing financial stability

Climate change presents both long-term risks and opportunities to financial institutions, with the physical impacts of climate change becoming more common. For general insurers this will mean increasing claims and more large spikes in claims. Over time, the trend could mean some assets become uninsurable. For banks this will mean increased risks to the property they rely on as collateral. In addition, the scale and pace of change to transition to a low-carbon economy create risks. There will be higher costs of doing business, and we could see significant shifts in asset values. There are also risks around changing consumer preferences, changing investor preferences (away from high emission industries), and possible carbon tax border adjustments (figure 1.4).

Figure 1.4

Financial stability risks from climate change



Source: Network for Greening the Financial System.

We recently published a climate change report outlining the actions we are taking to help ensure climate-related risks are appropriately understood and managed. Our 2021 stress test programme is considering the impacts of the increased frequency of droughts and other weather events on banks and insurers, including impacts on profitability and capital. We are undertaking further analysis of the impacts of climate change to understand the extent of these risks.

Macroprudential policies reduce the build-up of risks on borrowers' and banks' balance sheets, thereby helping to mitigate the scale of economic downturns. By limiting a build-up of homeowners at risk of a fall in house prices, our LVR adjustments will further support financial stability.

Policy assessment

The unpredictable nature of future economic stresses makes it important that financial institutions are resilient, so that they are in a strong position to keep supporting their customers and the economy.

As set out in our Capital Review decisions, capital requirements for banks will progressively increase from 1 July 2022. This will ensure that the banking system is resilient to all but the most severe economic risks. The banking system has already made significant progress on this, with profitability having recovered over the past year while dividend restrictions have remained in place. Banks are well placed to manage the Capital Review transition.

In addition, we intend to increase the minimum core funding ratio (CFR) requirement to its previous level of 75 percent on 1 January 2022, subject to no significant worsening in economic conditions.

Specific concerns around high-risk lending to recent buyers in the housing market and the sustainability of house prices, noting the Government's direction earlier this year, have led to a tightening in macroprudential policy. Macroprudential policies reduce the build-up of risks on borrowers and banks' balance sheets, thereby helping to mitigate the scale of economic downturns. When assessing whether to deploy restrictions, financial stability benefits need to be weighed against efficiency costs, as these tools curtail the ability of affected borrowers to participate in the housing market.

LVR restrictions are the main tool we have used to date to address financial system risks related to the housing market. In May this year, we tightened LVR restrictions on new lending to investors above 60 percent. In addition, the maximum share of new lending to owner-occupiers with LVRs over 80 percent was reduced from 20 percent to 10 percent from 1 November. By limiting a build-up of homeowners at risk of a fall in house prices, these adjustments will further support financial stability.

Low interest rates during the COVID-19 pandemic have seen debt servicing costs decline, increasing borrowing capacity and the share of new lending at high debt-to-income (DTI) ratios. This is potentially leading to an accumulation of longer-term servicing vulnerabilities. We will soon consult on forms of debt servicing restrictions which could be used to lean against this type of risk.

Malicious attempts to exploit IT system vulnerabilities have become more frequent and sophisticated in recent years. Our role in addressing cyber risks has included publishing cyber guidance and a cyber-incident data collection plan. We also played a key role in coordinating and managing the financial sector response to the September 2021 cyber attacks, working closely with other agencies. It is essential that financial sector entities continue to be proactive in further bolstering their cyber resilience strategies. We will also continue to take a proactive and collaborative regulatory stance, looking for opportunities to optimise policy and incorporate cyber considerations whenever relevant (see Box C).

Box A

Changes to the Reserve Bank's financial stability legislation

In November 2017 the Government announced a review of the Reserve Bank of New Zealand Act 1989. The review has provided an opportunity to modernise the Reserve Bank's legislation. Phase 1 of the Review introduced the Monetary Policy Committee (MPC) and added maximum sustainable employment as a monetary policy objective. Phase 2 was split into two tranches.

The first tranche considered the Bank's governance and accountability arrangements, and resulted in the reforms enacted by the Reserve Bank of New Zealand Act 2021. This Box summarises elements of the Act that are most relevant to prudential regulation.[2]

The second tranche considered significant changes to the frameworks for prudential regulation and supervision of deposit takers and the introduction of deposit insurance. The second tranche of Phase 2 will result in a Deposit Takers Act.

Reserve Bank of New Zealand Act 2021

The Reserve Bank of New Zealand Act 2021 received Royal Assent in August and is expected to come into force in the middle of 2022. The purposes of the Act are to provide for the continuation of the Reserve Bank and to *"promote the prosperity and well-being of New Zealanders and contribute to a sustainable and productive economy."*

The Act will replace the existing soundness and efficiency objectives with a single financial stability objective, with efficiency-related considerations included in the decision-making principles in sectoral prudential legislation (figure A.1).[3]

The financial stability objective encompasses soundness and also covers the need to adjust policy settings to manage the financial cycle, and considers how regulatory settings can affect the wider economy. This objective, in conjunction with the purposes and principles of sectoral prudential legislation, will provide greater clarity about our financial policy goals.

The Act will establish a new governance board for the Reserve Bank with statutory authority over all Bank decisions other than those reserved for the MPC.

The Act also requires the Minister of Finance, after consulting the Bank, to issue a Financial Policy Remit. The Financial Policy Remit provides a mechanism for the Government to communicate its policies and priorities to the Reserve Bank Board. This will allow the Government to specify areas of Government policy that the Board should have regard to when setting the Reserve Bank's strategic direction for financial stability. The matters addressed in the Remit will be in addition to any decision-making principles provided for in the sectoral prudential legislation.

Deposit Takers Act

The future Deposit Takers Act will significantly reform the prudential framework for deposit-taking institutions in New Zealand. In April Cabinet agreed on key aspects of the new Act, and an exposure draft is currently being prepared. The description below reflects the decisions taken by Cabinet.

Cabinet agreed that the purpose statement of the Deposit Takers Act will be consistent with the overarching purpose in the Reserve Bank Act of promoting the prosperity and well-being of New Zealanders, and with the financial stability objective. As such, the purpose of the Deposit Takers Act will be to:

- promote the safety and soundness of deposit takers;
- promote public confidence in the financial system; and
- mitigate the adverse effects of risks to the financial system and risks from the financial system that may damage the broader economy.

2 For a discussion of the broader reforms in the new Act see the Reserve Bank Act Review web page (link).

3 The sectoral prudential regulation legislation includes the Insurance (Prudential Supervision) Act, the Financial Market Infrastructures Act, the Non-Bank Deposit Takers Act, and Parts 4 and 5 of the Reserve Bank of New Zealand Act 1989.

The Act will also have decision-making principles that will apply to our prudential regulatory functions. The principles will ensure that financial stability decision-making includes efficiency-related considerations, such as the need to consider net benefits in undertaking regulatory actions. For example, the principles will require us to take into account the need to maintain competition in the deposit-taking sector.

Cabinet also agreed that the Deposit Takers Act will merge the prudential regimes for banks and non-bank deposit takers (such as building societies, credit unions, and deposit-taking finance companies) into a single regulatory regime. Under the new regime all deposit takers must be licensed by the Reserve Bank, subject to criteria specified in the Act, and in consultation with the Financial Markets Authority (FMA), which will license the institutions from a market conduct perspective.

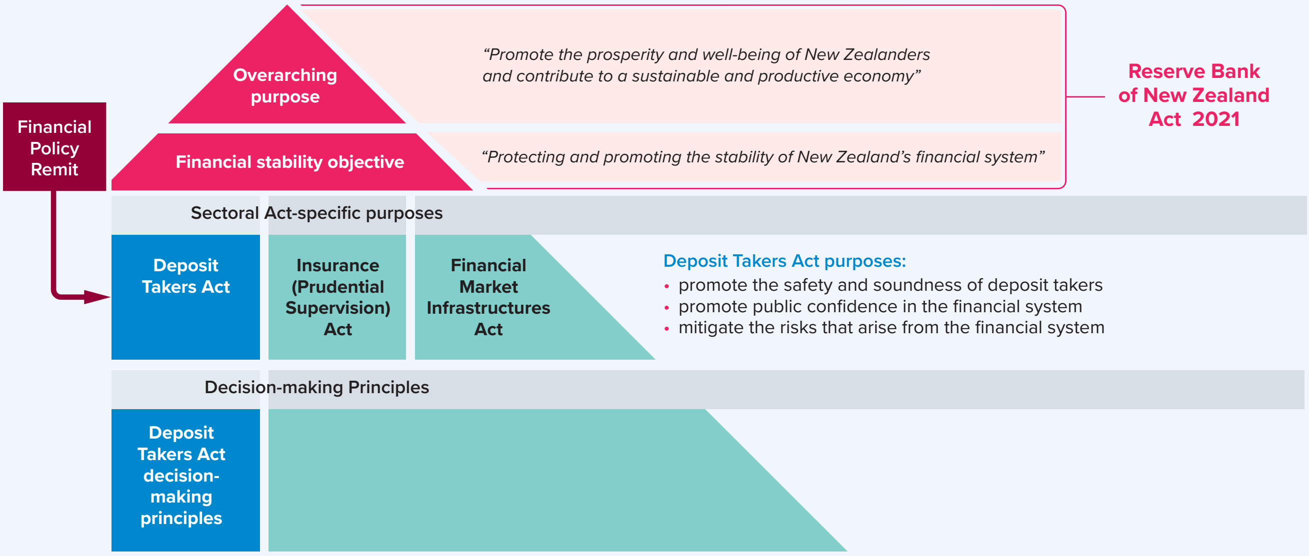
The primary regulatory instrument in the new regime will be 'standards'. Standards are legislative instruments and will replace prudential requirements currently set by conditions of registration for banks and by regulations for non-bank deposit takers. We will also have a broader range of supervision and enforcement tools, including a new power to conduct on-site inspections.

In addition, the Act will strengthen the framework for financial crisis management and resolution of deposit takers in the event of a failure. As part of this framework, Cabinet agreed to introduce a new deposit insurance scheme that will protect up to $100,000 per depositor per institution.

We aim to publish the exposure draft for public submissions later in 2021, with the Bill introduced into Parliament sometime during the second quarter of 2022 and passed in early 2023. Full implementation of the new prudential framework for deposit takers will take several years. The new deposit insurance scheme will be implemented first and should be operational by late 2023. There will be a transitional period during which other parts of the new prudential regime will be introduced, with deposit takers expected to be operating fully under the new regime by the start of 2027.

Figure A.1

Stylised illustration of the Reserve Bank's hierarchy of objectives and purposes



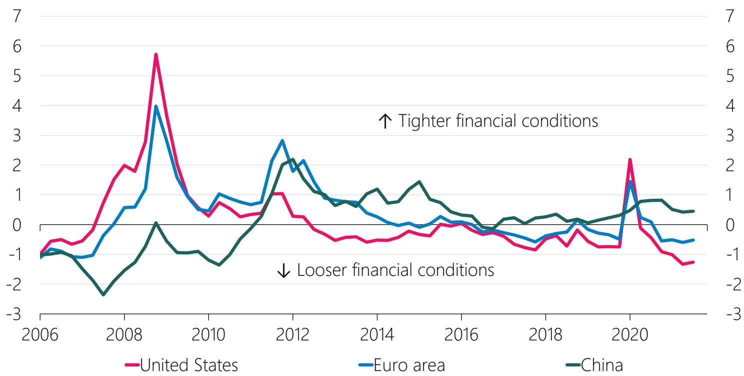
Asset prices, households, and businesses

CHAPTER 02

CHAPTER 2
Asset prices, households, and businesses

Global financial conditions in major economies remain accommodative but uncertainty remains high over the resolution of the pandemic, the economic outlook, and normalisation of policy settings. Risks relating to the housing market are high, but macroprudential policies are limiting an accumulation of vulnerabilities. Domestically, the current COVID-19 outbreak poses a challenge for businesses, and stresses may yet emerge in commercial property.

Figure 2.1
Financial conditions in major economies
(index, standard deviations from mean)



Source: International Monetary Fund.

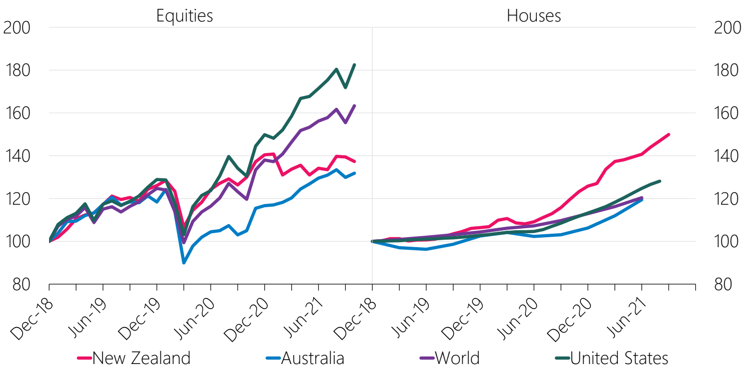
Asset prices

The global financial system has been resilient throughout the COVID-19 pandemic, assisted by substantial fiscal and monetary support across countries. While the spread of the Delta variant has tempered market participants' expectations for the strength of the global economic recovery, historically low interest rates have continued to support asset prices across markets. Financial market conditions remain accommodative, characterised by low sovereign yields, tight credit spreads, and high equity prices (figure 2.1). With this in mind, there is a question of whether risks are being appropriately priced, given the large uncertainties in the global economic and policy environment.

Asset prices have continued to increase, supported by strong fiscal and monetary support

Equities and other income-producing assets have experienced continued growth in valuations as interest rates have declined (figure 2.2). However, there are concerns about potential mismatches between asset prices and their corresponding long-term earnings potential. Vulnerability to a sharp correction remains high should growth prospects disappoint.

Figure 2.2
International asset prices



Source: S&P, Australian Bureau of Statistics, REINZ, OECD, Haver Analytics.

Note: Share price indices exclude dividend payments. House prices for OECD members serve as a proxy for world prices.

Faster than expected policy normalisation may create asset valuation vulnerabilities

Given the enormous level of economic stimulus in advanced economies since the onset of COVID-19, there is uncertainty around how governments and monetary authorities will approach policy normalisation. The near-term outlook for global economic growth has weakened somewhat, due to the spread of the Delta variant, increasing energy prices, ongoing supply chain issues, and signs of a slowdown in the Chinese real estate market.

Increasing inflationary pressure is causing some central banks to start gradually reducing monetary stimulus, while others are seeing current inflation as largely transitory and that current settings are needed to support growth. Should inflationary pressure prove more persistent, and inflation expectations increase, this could prompt a faster increase in interest rates. Coupled with weaker growth, such a scenario could lead to declines in asset valuations and lead to a sudden tightening in financial conditions.

In addition, the quality and quantum of fiscal spending and supply-side responses poses a question for the sustainability of governments' long-term fiscal position. Advanced and emerging economies alike have taken on high levels of public debt to mitigate the immediate effects of pandemic-related restrictions on household and business incomes. High public and corporate debt burdens will increase economies' sensitivity to interest rates. In the recovery phase, as fiscal policy turns to supporting a resumption of economic activity, governments will need to ensure that fiscal strategies are sustainable and growth-enhancing.

Resolution of the pandemic remains uncertain, creating risks to the global economic recovery

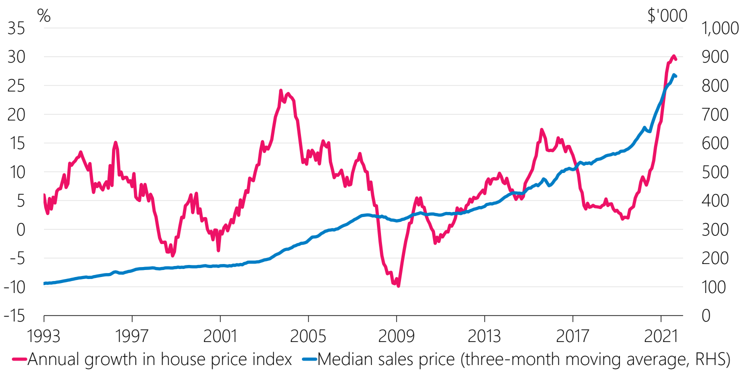
Compared to most advanced economies, many developing economies are lagging in their recovery path due to weaker economic fundamentals and more limited access to COVID-19 vaccines. A double hit to these countries from worsening pandemic dynamics and tighter external financial conditions could result in large capital outflows, given their high financing needs. Such a scenario could constitute a drag to global recovery and add to geopolitical risks.

Moreover, the ability of the virus to spread across borders means the global fight against COVID-19 could be jeopardised by unequal vaccination rates. The Delta variant is an important reminder of the need for widespread global access to vaccines to slow the pandemic and support the economic recovery.

Figure 2.3

New Zealand house prices

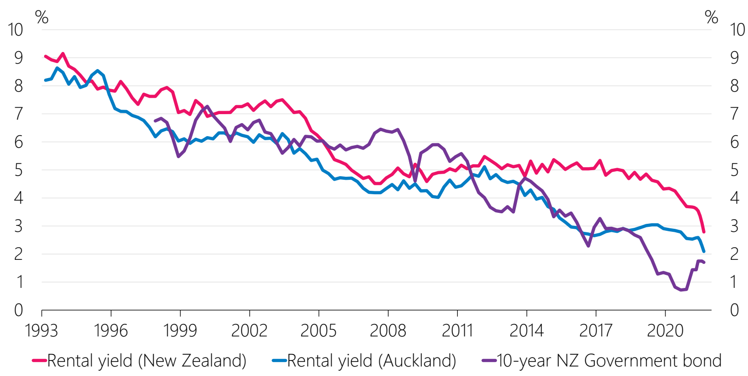
(seasonally adjusted)



Source: REINZ, RBNZ estimates.

Figure 2.4

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



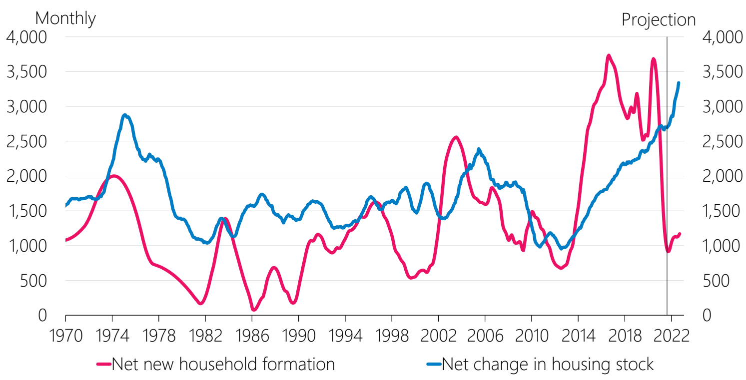
Source: QV, MBIE, Haver Analytics, RBNZ estimates.

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

Figure 2.5

Net growth in housing stock and household formation rate

(12-month moving average)



Source: Stats NZ, Electricity Authority, RBNZ estimates.

Note: Chart is indicative only. The supply projection is based on an estimated relationship between building consents and subsequent electricity connections. The population growth projection is a Reserve Bank estimate. Population growth is scaled by a people per dwelling ratio, which is the March 2021 ratio adjusted for changes in the age structure of the population over time.

New Zealand house prices are above what is sustainable...

House prices in New Zealand have grown rapidly since the onset of COVID-19, reflecting the global low interest rate environment, favourable domestic economic conditions, and existing supply constraints. The low mortgage interest rates seen over the past 18 months reflect both a long-term, global trend, and a cyclical response to a lower inflation and employment outlook. The effect of declining interest rates in raising house prices is particularly strong where housing supply is less responsive to demand, for example where land-use restrictions are binding.

Market momentum has been maintained at a strong level, although at a slightly slower pace in recent months (figure 2.3). Valuation metrics such as price-to-rent ratios highlight that prices are vulnerable to a decline as interest rates increase from their recent lows (figure 2.4). In the August *Monetary Policy Statement* we projected a moderation in house prices over the coming year, but the precise timing of this is uncertain.

...with the risk of a decline over the medium term further increased

Trends in population growth and new housing supply suggest housing market pressures that have been elevated over the past decade could ease. New building activity is hovering at record high levels, despite the temporary slowdown due to the recent COVID-19 outbreak, while population growth has slowed significantly since border restrictions were put in place (figure 2.5). Building consents data suggest a significant pipeline of new houses will become available by the middle of next year, which should suppress rent and house price inflation. The previous peak in new housing supply was during the 1970s, which coincided with a reduction in real house prices.

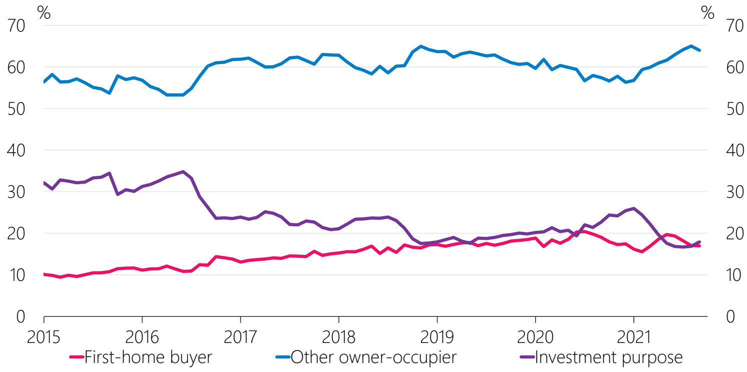
Another important factor for housing market dynamics is the price and availability of developable land. The value of the land now accounts for around 60 percent of New Zealand's median house price, compared to around 40 percent five years ago, reflecting constraints in the supply of developable land on urban fringes, and limitations on intensification in some areas. New building intensification rules will allow for more dwellings to be built within existing urban areas.[4] By easing one of the constraints on new housing supply, these policy changes should support supply responsiveness and a greater moderation of rent and house prices than would otherwise have been the case.

Further, policy actions earlier this year are moderating housing demand from investors. Effective housing investment returns have declined for existing houses following the removal of the tax deductibility of interest expenses from rental income. The extension of the bright-line test for tax on capital gains will also affect some investors' expected returns. Along with tighter LVR requirements, these policy changes have constrained investors' buying activity in recent months (figures 2.6 and 2.7).

Momentum in house price growth can persist even if prices are above a medium-term sustainable level. This reflects that sentiment, expectations, and prevailing narratives surrounding the housing market can have a significant bearing on housing demand and house prices. The further house prices rise above their sustainable level, the larger the realignment could be.

Figure 2.6

Share of the value of new lending commitments by loan purpose

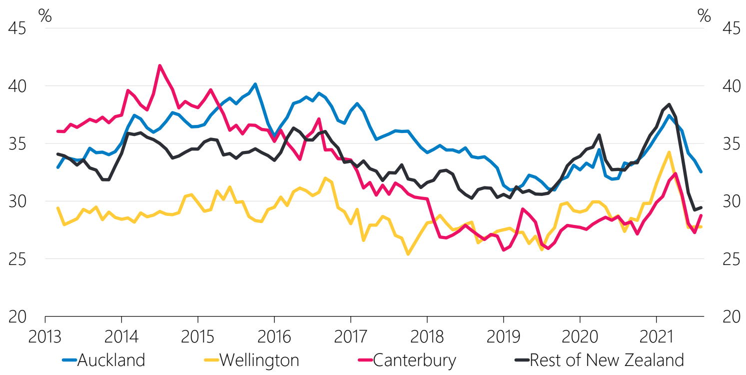


Source: RBNZ *LVR New Commitments survey.*

Figure 2.7

Share of housing purchases by multiple property owners, by region

(three-month moving average)



Source: CoreLogic, RBNZ estimates.

Note: Multiple property owners refers to individuals identified as owning more than one property.

We estimate that the value of the land now accounts for around 60 percent of New Zealand's median house price, compared to around 40 percent five years ago.

4 For example, the National Policy Statement on Urban Development directs local authorities to allow for greater intensification of land near urban centres and public transport services. The Medium Density Residential Standards will enable land owners to build up to three homes up to three storeys high on most sites in major urban areas without requiring a resource consent.

Households

In aggregate, household balance sheets and debt serviceability have strengthened over the past six months. Household vulnerabilities to a decline in house prices or higher interest rates do not currently pose a major threat to financial stability. This is partly due to a gradual build-up of resilience over several years from LVR restrictions. However, recent home buyers with high debt levels are more vulnerable. We have recently tightened LVR settings accordingly and are consulting on serviceability rules to limit an accumulation of risk.

Aggregate household incomes and balance sheets have strengthened

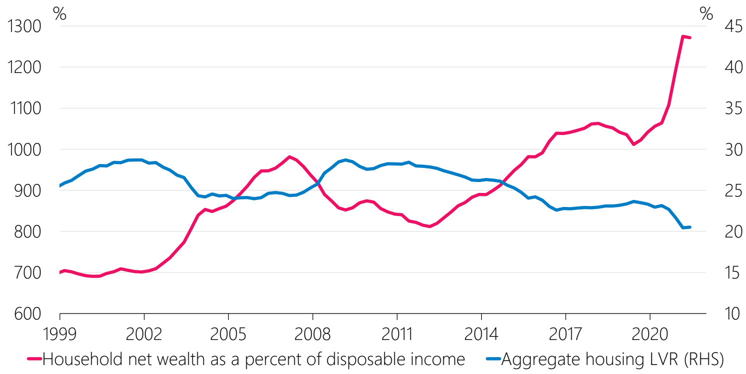
Most property-owning households have substantial equity buffers, due to a combination of the cumulative effects of past LVR restrictions that limited household leverage, and a large rise in property and financial asset valuations since April 2020 (figure 2.8). In the 18 months to June 2021, total household net wealth rose by more than 27 percent. Reflecting the makeup of New Zealand households' wealth, property – mainly the land component – accounted for around half of this gain.

Importantly, most homeowners have enough net wealth to absorb a sizeable fall in asset prices. Taking into account recent price growth, we estimate that the proportion of mortgage borrowers who would be in negative equity in the event of a 30 percent decline is less than 10 percent at present. Moreover, the healthy labour market has meant households have generally had stable incomes through the pandemic, helped by fiscal and monetary support and favourable public health and macroeconomic outcomes.

Overall household credit growth remains at a high level, reflecting the strong growth in house prices, although the rate of change has slowed in recent months (figure 2.9). Consumer credit products, such as credit cards and personal lending, continue to decline.

Figure 2.8

Aggregate household sector net wealth and housing leverage

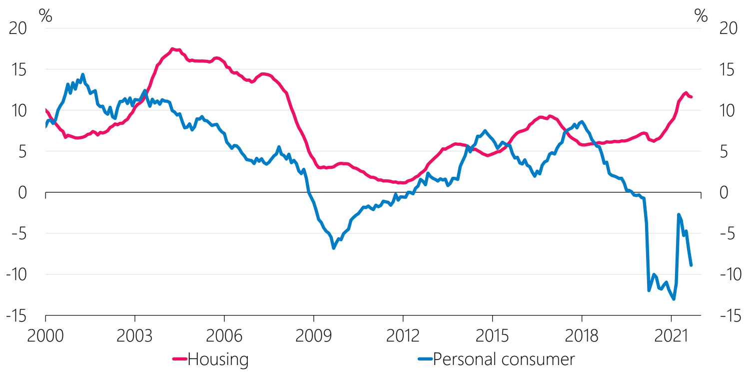


Source: RBNZ *Household Balance Sheet*, Stats NZ.

Note: Aggregate housing LVR compares the total outstanding value of residential mortgage lending (including for investment properties) to the estimated total value of all residential properties.

Figure 2.9

Annual growth of residential mortgage and other consumer credit



Source: RBNZ *Bank Balance Sheet survey, Standard statistical return*.

Note: Data on personal consumer credit does not include outstanding balances on Buy Now Pay Later (BNPL) products, but currently we do not consider the value of BNPL balances to be material relative to major forms of consumer credit.

However, recent borrowers are exposed to a decline in house prices or rising mortgage rates

The gain in net wealth has been distributed highly unevenly, with households that already owned homes before the recent price growth seeing the largest gains in the value of their equity. On the other hand, recent buyers who took out relatively large mortgages have significantly less equity in their homes on average, and mortgagor vulnerability is concentrated in this group. This is generally the case after strong house price growth, but at present the difference between recent and earlier buyers' balance sheets is starker than usual due to the magnitude of the price gains earlier buyers have benefited from, and the level of prices new buyers are paying.

Among recent buyers, first-home buyers are more vulnerable than other owner-occupiers or investors because they generally entered the housing market with less purchasing power, less wealth to absorb a house price decline, and less disposable income for managing a rise in debt servicing costs. With deposit affordability stretched for first-home buyers, lenders allocate almost all of their allowed high-LVR lending to this group. Risky lending that is both high-LVR and at a high DTI ratio rose sharply along with house prices from mid-2020 through mid-2021 for all three groups, but with first-home buyers standing out as particularly at risk (figure 1.3).

We have tightened macroprudential policy to lean against housing market risks

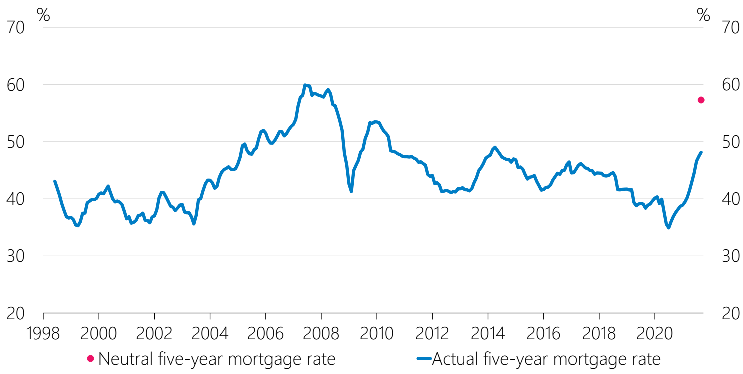
To lean against an accumulation of risky lending, we reinstated LVR restrictions in early 2021 for all buyers, with tighter limits now in place for both owner-occupiers and investors than before COVID-19. Restricting new buyers' leverage will help to maintain a low proportion of lending at risk of house price falls, protecting households and the financial system from potential losses.

Higher house prices have also pushed up debt servicing costs for new buyers (figure 2.10), but from a starting point in 2020 that was the lowest since the early 2000s due to historically low interest rates. Debt servicing costs relative to incomes are still manageable at current interest rates. However, with elevated debt levels relative to income, recent buyers are exposed to an increase in debt servicing costs if mortgage interest rates were to return to levels seen prior to the last few years.

Figure 2.10

Indicative debt servicing ratio for new buyers

(percentage of disposable income)



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

Note: Debt servicing costs include both interest and principal repayments, based on a 30-year mortgage term. Estimates are for buyers purchasing at the median selling price with a 20 percent deposit. The neutral five-year mortgage rate shows our estimate of the five-year mortgage rate in a situation where the Official Cash Rate is at a level that is neither stimulatory nor contractionary.

A material increase in debt servicing costs would have negative feedback effects on the aggregate economy, as some households could have to cut back on consumption to cover the additional expense.

We will soon consult on introducing debt serviceability restrictions (see Chapter 4). While LVR restrictions are mainly effective in reducing the losses faced by banks and borrowers in case of a default, serviceability restrictions are designed to improve borrowers' ability to repay a loan, reducing the likelihood they will default in the first place. Debt servicing restrictions would complement LVR restrictions and help to achieve our statutory objective of promoting the maintenance of a sound and efficient financial system.

Businesses

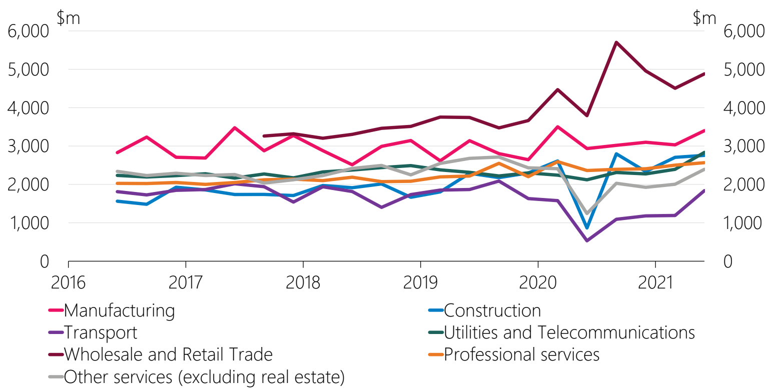
Businesses were broadly in a strong financial position with robust cashflows leading into the current COVID-19 outbreak, supported by strong economic activity and accommodative monetary and fiscal policy settings. Client-facing industries such as tourism and hospitality remain impacted by the recent outbreak, particularly in Auckland. High export prices have seen dairy sector deleveraging continue, and banks are continuing to diversify their agricultural lending towards horticulture. Some risks are emerging in the residential property development sector, with a concentration of highly leveraged small-scale developers vulnerable to rising debt servicing costs and declining profit margins.

The business sector's financial position had strengthened going into the current lockdown

Business balance sheets have been resilient, with debt mostly stable since 2010 as a share of GDP and debt servicing costs at low levels as interest rates have fallen. The financial strength of the business sector also reflects the strong economic recovery from previous lockdowns. Real GDP in the June quarter was above the level prior to the pandemic.

The recovery has been supported by strong fiscal stimulus and policy measures to support businesses' cashflow, including the wage subsidy scheme, business finance guarantee scheme, and the small business cashflow loan scheme. In many cases, the strength of economic activity saw business incomes generally recover to pre-pandemic levels (figure 2.11).

Figure 2.11
Quarterly operating profits by industry grouping
(indicative, nominal, seasonally adjusted)



Source: Stats NZ.

The strength of the recovery since the middle of last year has seen some rebound in business investment, although it remains below its level as a share of GDP prior to the pandemic. Business investment remains constrained by several factors, not least the ongoing economic uncertainty about the COVID-19 recovery path. Businesses are facing increased costs and squeezed profit margins, due to both tight labour market conditions partly due to border restrictions, and international disruptions to supply chains and trade logistics.

As with last year's lockdowns, the current outbreak is creating stresses for many customer-facing industries, including hospitality and tourism. However, the country's move away from an elimination strategy, and the behavioural responses of customers to an ongoing level of community transmission of the virus, make a quick rebound in trading conditions less likely for these industries. As a result, the long-term viability of some firms will now be in question, and business closures are likely to increase as government support schemes are wound down. Conversely, a freeing-up of border movements could see labour constraints ease across other sectors.

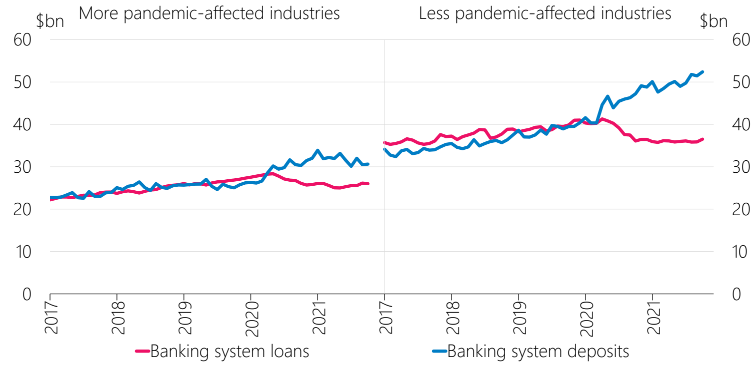
Demand for business borrowing is subdued, and the quality of borrowing remains high

Business sector borrowing had increased somewhat before the latest lockdown but remains below pre-COVID levels for both large corporates and small and medium-sized businesses (SMEs) (figures 2.12 and 2.13). Results from our *Credit Conditions survey* indicate that banks expect business credit availability (reflected in lending policies and pricing) to increase for most business lending categories over the next six months (figure 2.14). Overall, the level of business borrowing is still mainly constrained by limited demand for credit rather than banks' willingness to lend.

Figure 2.12

Banking system loans to and deposits from non-financial industries

(excludes commercial real estate and agriculture)



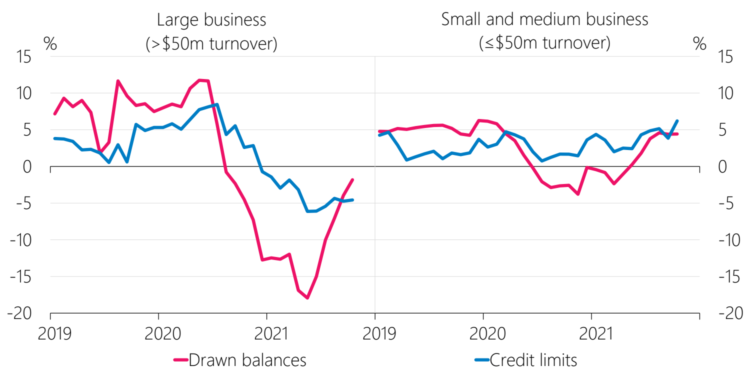
Source: RBNZ *Bank Balance Sheet survey*.

Note: 'More pandemic-affected industries' includes retail trade, accommodation & food services, transport & storage, education & training, health & community services, arts, culture & recreation, and personal services. 'Less pandemic-affected industries' includes manufacturing, utilities, construction, wholesale trade, information technology, professional services, and administration & support services.

Figure 2.13

Business credit limits and drawn balances

(annual percentage change)

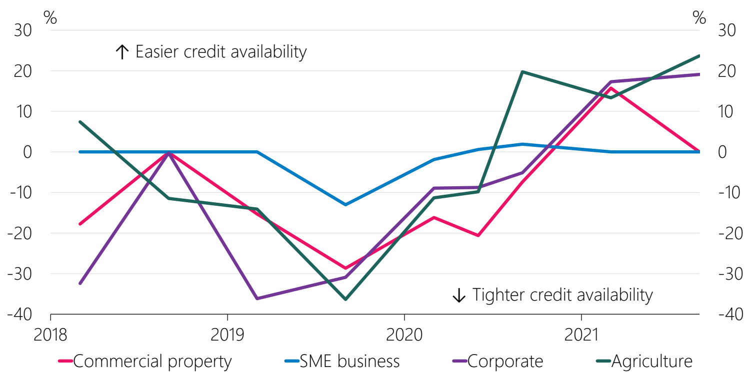


Source: RBNZ *Bank Balance Sheet survey.*

Figure 2.14

Expected change in credit availability over next six months

(net percentage of banks)



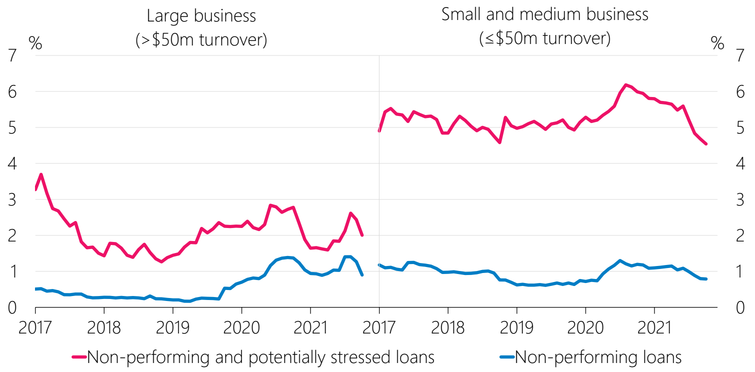
Source: RBNZ *Credit Conditions survey.*

While investment in plant and machinery remains subdued, banks have reported increased demand for credit from the business sector to finance property investment. Generally, businesses have seen property as a more attractive form of investment than other forms of capital in the current environment. In this respect, banks have reported that new lending to SMEs has been primarily to enable businesses to purchase premises they were previously leasing, or to buy neighbouring properties for future expansion.

The quality of business borrowing remains high, with most businesses having sufficient cashflow to service debt (figure 2.15). The strong recovery in domestic economic activity has contributed to some improvement in the quality of loans to SMEs, although the effects of the current outbreak on loan performance will take some time to be seen. Meanwhile, loans to larger firms have deteriorated slightly, possibly due to greater exposure to the impact of disrupted international supply chains on profitability and cashflow to service borrowing.

Figure 2.15

Non-performing and potentially stressed business lending



Source: RBNZ *Bank Balance Sheet survey.*

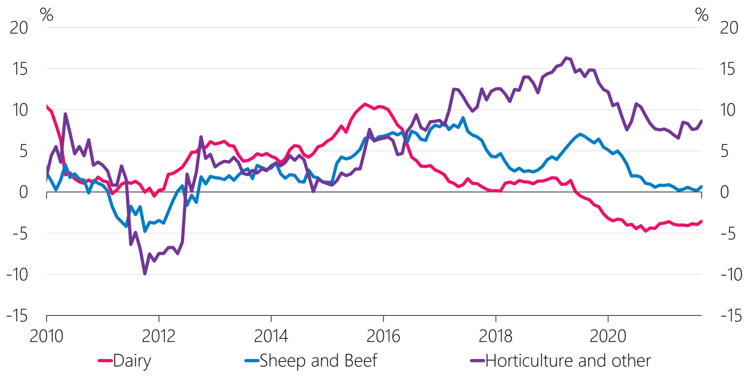
Note: Non-performing loans includes loans classified as 90+ days past due or impaired. Potentially stressed loans includes loans that banks have assigned internal credit rating grades equivalent to B (S&P/Fitch) or B2 (Moody's) or lower, but which are not non-performing.

Banks continue to diversify their agricultural lending as the dairy sector continues to deleverage

The rebound in international economic activity since the middle of 2020 supported world commodity prices. Prices of New Zealand export commodities remain close to recent high levels, although they have eased slightly from recent peaks in some industries. Fonterra recently increased its forecast payout for the 2021/22 season to a midpoint of $8.40 per kilogram of milksolids (kgMS), which follows a final price for the 2020/21 season of $7.54/kgMS.

Figure 2.16

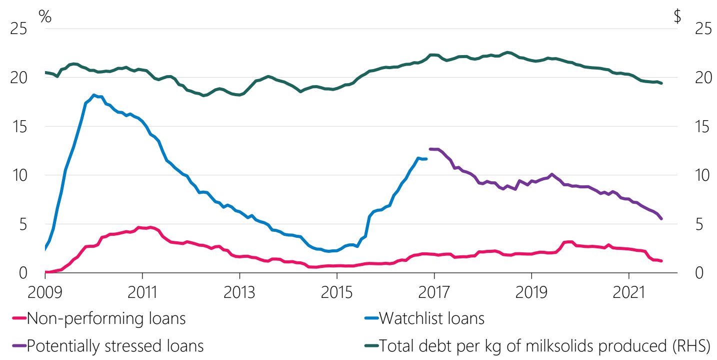
Annual growth in agricultural sector lending



Source: RBNZ *Bank Balance Sheet survey.*

Figure 2.17

Dairy lending stress indicators



Source: RBNZ *Bank Balance Sheet survey*, private bank reporting, Dairy Companies Association of New Zealand.

Note: Non-performing loans are loans that are at least 90 days past due or are otherwise impaired. Potentially stressed loans are those that banks have assigned an internal credit risk grade equivalent to or worse than an S&P B rating, but which are not non-performing. Watchlist loans were reported by banks in our previous data collections, and are conceptually similar to potentially stressed loans.

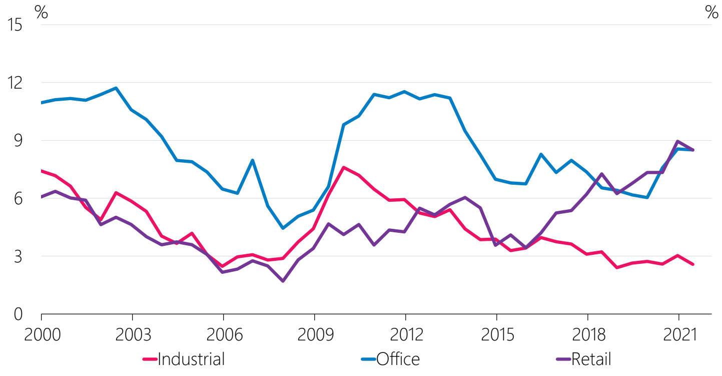
Banks have continued to actively diversify their agricultural lending portfolio away from the dairy sector and towards other sectors, especially horticulture (figure 2.16). Elevated export prices have allowed the dairy sector to continue to deleverage, and banks have continued to encourage dairy farmers to improve their long-term viability (figure 2.17). This will mean the sector is better placed to deal with any potential future downturn in dairy prices.

High export prices and low financing costs have resulted in the market for rural land becoming more liquid, with prices rising. In addition, the price of carbon in the Emissions Trading Scheme is at a historical peak, creating favourable conditions for conversion of marginal sheep and beef farming land into production and permanent forestry. By raising the value of alternative land uses, a sustained high carbon price will underpin rural land prices more generally, which will support farm owners to transition away from activities with high emission intensity. So far, however, this conversion has been only on a limited scale.

Banks have reported broad internal work programmes under way on climate-related risk, including a focus on understanding the emissions profiles of business customers, especially in the agricultural sector. A general concern noted by banks is variable data quality, making it difficult to combine scientific and financial data to understand climate change impacts at a farm level, both physical and transitional, and the resulting financial risks.

Figure 2.18

Commercial property vacancy rates by sector

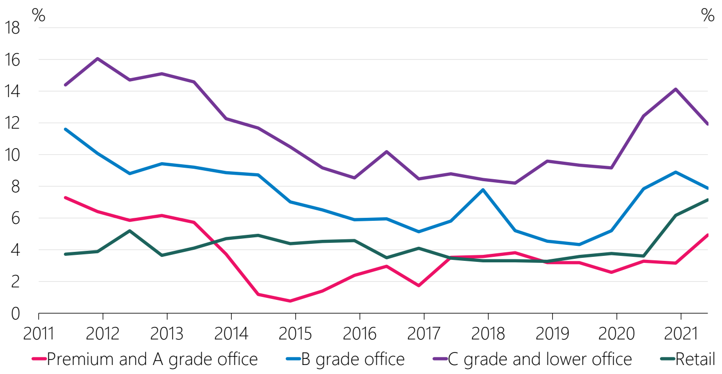


Source: JLL.

Figure 2.19

Vacancy rates for Auckland and Wellington CBD commercial property

(by quality grade)



Source: JLL.

As consumers and businesses adjust to COVID-19 being embedded in the community, there is a risk that tenant demand for less desirable office and retail sites could further soften.

Commercial property vulnerabilities vary across the sector...

The strength of demand pressures has continued to vary across different parts of the commercial property vacancy rates sector, reflected in vacancy rates (figure 2.18). For instance, demand for industrial properties remains strong. This has been supported by growth in demand for data centres and distribution centres due to increased online shopping during lockdowns. Demand for high-quality office space also remains robust, especially for buildings close to the centres of Auckland and Wellington. In contrast, demand for lower-quality office space has been soft, reflected in declining rents (figure 2.19).

There is also a divergence in the retail property sector, with demand holding up mostly for properties in suburban areas, including malls. While property prices are elevated in the sector, yields remain at reasonable levels given strong growth in rents in the sections of the market in which demand is strong. As consumers and businesses adjust to COVID-19 being embedded in the community, there is a risk that tenant demand for less desirable office and retail sites could further soften. Generally, investors are increasingly basing investment decisions on assessments of individual commercial properties rather than on broad sectoral trends.

Banks are increasing their lending for commercial property development, but overall their exposure remains low at around 0.4 percent of the aggregate stock of bank lending. In recent years banks have tended to have conservative lending policies for commercial property development, requiring high levels of pre-sales of properties, long-term leases, and LVRs on completion below 65 percent. Outside of bank funding, commercial property development has been mainly financed through equity, high net worth individuals, and retail investors investing through property trusts. This limits the extent to which difficulties in commercial property development could undermine broader financial stability.

...and some risks are emerging in residential property development

Residential property development has increasingly shifted away from apartment buildings towards construction of townhouses, coinciding with a price premium for sections that allow higher-intensity development. Townhouse developments generally carry lower risks than apartments due to their smaller scale, a shorter construction timeframe, and favourable per unit costs. The recently announced planned change to building intensification rules in major cities will support this trend towards townhouse development.

Residential developments are currently facing material supply and logistical constraints, as well as labour shortages, which are raising development costs and eroding profit margins. Industry contacts reported that residential developments are increasingly being carried out by developers who may previously have only been involved in investing in finished properties. Newer developers reportedly tend to be more leveraged, and may be less familiar with the risks of property development projects than more established developers. As a result, inexperienced developers may be stretched financially if profit margins erode and debt servicing costs increase. Banks generally set conservative covenants for residential development projects. Recently, much of the funding for riskier and larger-scale residential development projects has come from individual wholesale investors, and overseas investment funds.

46,453

Consents in year to August 2021

This is 83 percent higher than the average over the 10 years to August 2020.

Financial sector dynamics and institutional resilience

CHAPTER 03

CHAPTER 3
Financial sector dynamics and institutional resilience

The resilience of financial institutions has generally strengthened over the past six months. This chapter outlines the developments affecting institutions we regulate and supervise, including the growing risks and changes to the regulatory environment. There are four sections covering registered banks, non-bank deposit takers (NBDTs), insurers, and financial market infrastructures (FMIs).

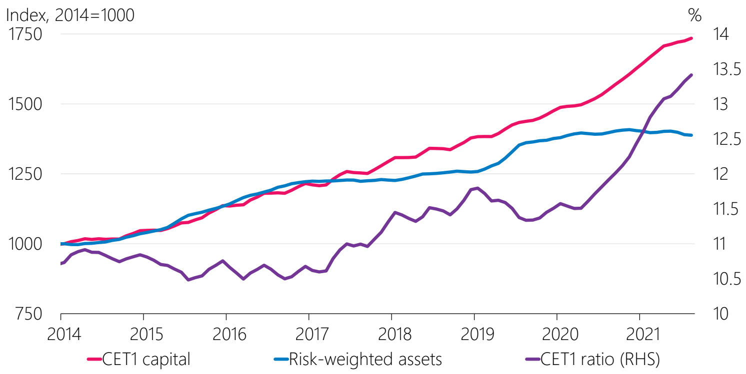
Registered banks

Banks are well placed to support lending and meet higher capital requirements

Banks have continued to increase their capital buffers over the past six months, aided by stable underlying profits and dividend restrictions that limited payouts to shareholders (figure 3.1). The increase has also been underpinned by low risk-weighted asset (RWA) growth due to a decline in business lending. Higher capital ratios put banks in a stronger position to support the economy through a downturn.

Our 2021 solvency stress test assessed the resilience of the five largest locally incorporated banks to a scenario involving a resurgence of COVID-19 globally, with governments having to respond with repeated lockdowns similar to those seen in early 2020, and unemployment reaching 11.8 percent. In addition, the exercise assumed a prolonged drought strikes the North Island for two years, curtailing agricultural production. The improved starting position of banks saw them able to maintain capital ratios well above their minimum requirements, and continue lending to the economy. Full results from the 2021 bank stress test will be published in a forthcoming *Bulletin* article.

Figure 3.1
Common Equity Tier 1 capital of locally incorporated banks

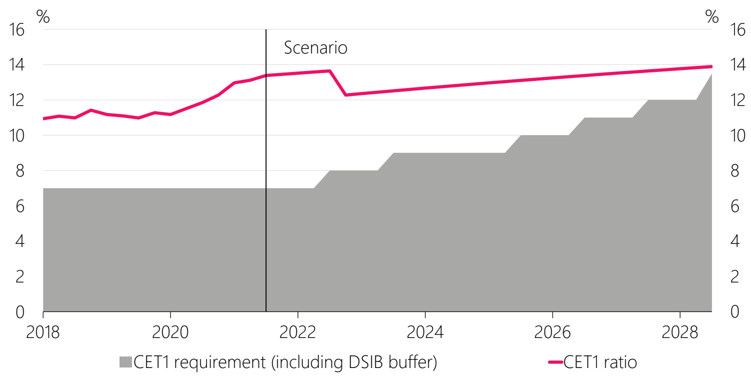


Source: Registered banks' *Disclosure Statements*, RBNZ *Capital adequacy survey*.
Note: Minimum Tier 1 requirement includes a 2.5 percent conservation buffer from 2014.

Figure 3.2

Projection of locally incorporated banks' aggregate Common Equity Tier 1 capital ratio

(scenario with 50 percent dividend payout ratio)

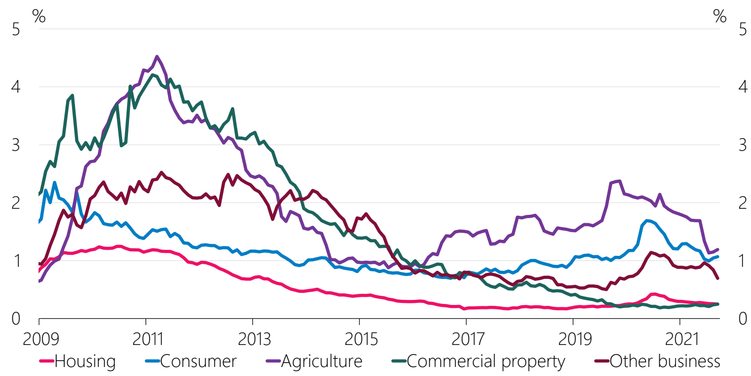


Source: RBNZ *Capital Adequacy survey*, RBNZ estimates.

Note: Scenario assumes same growth in RWA and profitability as averaged between 2015 and 2020. The decline in the CET1 ratio in 2022 is due to an increase in the scaling factor applied to internally modelled credit RWA.

Figure 3.3

Bank non-performing loan ratios by sector

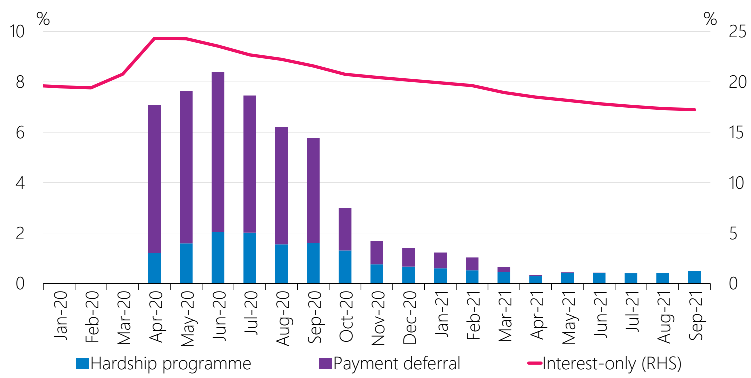


Source: RBNZ *Bank Balance Sheet survey*, private reporting.

Figure 3.4

Residential mortgage lending on payment deferral or hardship programmes, and interest-only

(share of total mortgage lending)



Source: RBNZ *Bank Balance Sheet survey*.

Banks are also well positioned to meet the new capital requirements resulting from the Capital Review, which are unlikely to be a major constraint on lending growth. Based on their pre-COVID levels of profitability and lending growth, if banks pay out only 50 percent of earnings as dividends during the transition period, this would allow them to meet the incremental increases in capital requirements (figure 3.2), although greater profit retention may be needed to remain significantly above capital minimums in the final year. If dividends are lower, at 30 percent of profits, banks would be able to meet capital requirements comfortably.

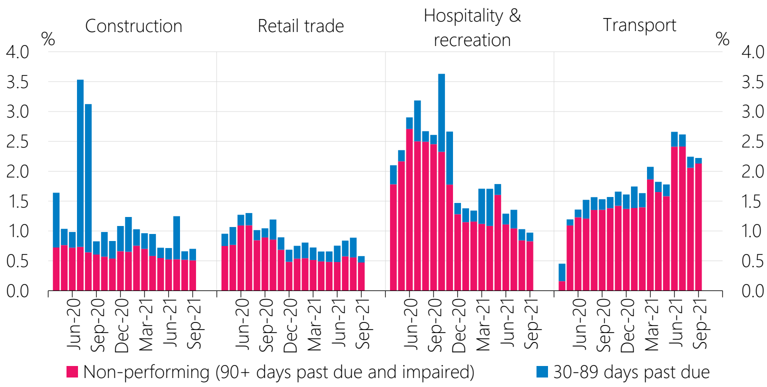
Improved asset quality has lifted bank profitability

Banks' asset quality remains high, with non-performing loans returning to the low levels seen before the initial COVID-19 outbreak in 2020 (figure 3.3). Almost all mortgage borrowers who temporarily deferred their payments, or switched to interest-only, have returned to making principal repayments. Further, borrowers on banks' hardship programmes remain low, despite the recent outbreak (figure 3.4).

Provisions made early in the pandemic have been increasingly released across the banking sector, with the strength of the economic recovery meaning credit losses have been lower than initially anticipated. The more recent COVID-19 outbreak and containment measures may lead banks to refrain from further releasing provisions.

Figure 3.5

Non-performing loan ratios for selected industries



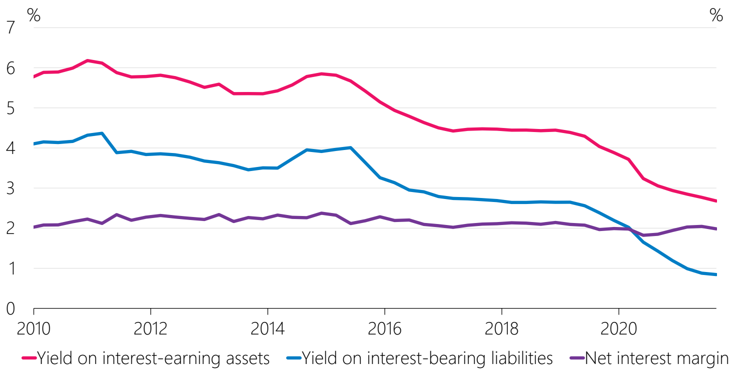
Source: RBNZ *Bank Balance Sheet survey*.

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

Figure 3.6

Net interest margin, asset yields and cost of funds

(quarterly, all registered banks)

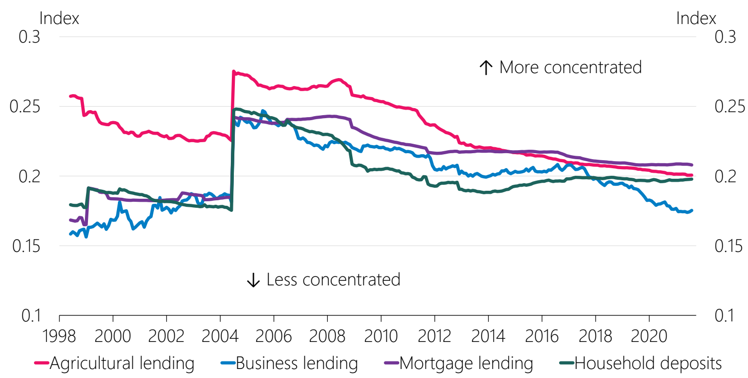


Source: RBNZ *Income Statement survey*.

Figure 3.7

Measures of concentration among New Zealand banks

(Herfindahl – Hirschman Index of lending and deposits by value)



Source: RBNZ *Standard statistical return*, *Bank Balance Sheet survey*, RBNZ estimates.

Note: The Herfindahl-Hirschman Index (HHI) is a measure of the degree of concentration among firms in a market, and can serve as an indicator of competition amongst them. The HHI is calculated as the sum of the square of the market shares of each firm in a market. An increasing HHI corresponds to an increasing concentration of market share among a smaller number of firms. In 2004 ANZ Banking Group (New Zealand) completed its acquisition of The National Bank of New Zealand, reducing the number of major banks from five to four.

Industries more affected by COVID-19 restrictions, such as hospitality, tourism, and transport, experienced elevated non-performing loans, and may still see stresses emerge from the current outbreak (figure 3.5). However, the worst-affected industries tend to represent small shares of banks' overall lending.

Fiscal and monetary policy support has played a significant role over the past year in dampening the short-term impact of COVID-19 on banks' asset quality. Nevertheless, as the current outbreak highlights, the uncertain economic environment means banks need to maintain prudent levels of provisions to absorb any future potential credit losses.

Banking system profitability has remained solid, supported by housing lending growth, the unwinding of provisions, and an increase in non-interest income. Additionally, net interest margins (NIMs) have recovered from a decline during the first half of 2020, further boosting profitability (figure 3.6). The recovery in these margins has been driven by a decline in bank funding costs that reflects the large-scale fiscal and monetary stimulus since the COVID-19 outbreak in early 2020.

Banking market concentration has gradually decreased

While New Zealand's overall banking industry continues to be dominated by the four large Australian-owned institutions, measures of concentration across key bank lending and deposit markets point to gradually decreasing levels of market concentration since the last major change to the industry structure when ANZ acquired the National Bank (figure 3.7). Domestic-owned banks have grown their market shares in the residential mortgage lending and household deposit markets over the past two decades. In agricultural and business lending, strong competition from other foreign-owned banks has seen the market share of the Australian-owned banks decline, particularly over the past five years. In addition, differences in their long-term growth strategies for agricultural and business lending have seen the Australian-owned banks converge to now having more even market shares amongst themselves than was the case in the early 2000s.

Stimulatory monetary policy contributes to ample deposit funding and liquidity for the banking system

Funding risk occurs when banks experience difficulty in securing funding at a reasonable price. To guard against funding risks, New Zealand banks are subject to a minimum core funding ratio requirement. Currently around 87 percent of the funding of banks' lending is from stable, long-term funding sources, and is well above regulatory requirements.

Banks also hold ample liquid assets to meet their expected cash outflows given a period of liquidity stress. As previewed in the May *Financial Stability Report*, in 2021 we conducted a liquidity stress test of the 10 largest banks. Results from the exercise show that banks would be able to manage liquidity stress through mitigating actions and drawing down cash reserves, although those that rely more on call deposits tend to face higher levels of stress.

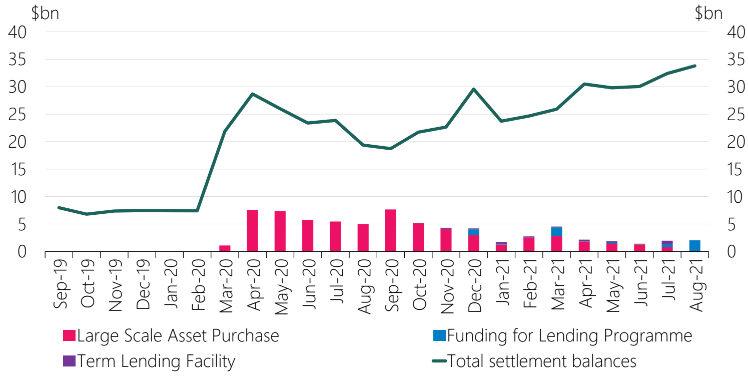
Monetary policy stimulus has supported the funding and liquidity of banks (see Box A of the November 2020 *Financial Stability Report*). The Large Scale Asset Purchase (LSAP) programme created bank deposits, lowered funding costs, and increased banks' liquid assets, including Exchange Settlement Account System (ESAS) balances. The Funding for Lending Programme (FLP) continues to offer low-cost funding that indirectly lowers term deposit rates, and provides incentives for banks to grow their lending book. While the Monetary Policy Committee has reduced the level of stimulus by halting additional purchases under the LSAP programme, the large stock of liquid assets in the banking system will remain for some time (figure 3.8).

Banks are gradually normalising their funding profile by re-entering wholesale markets

The composition of bank funding has shifted from term deposits to call deposits (figure 3.9). The low rates offered for term deposits have seen depositors transferring maturing funds into transaction or on-call savings accounts. While this has helped to lower banks' average funding costs, banks also need to hold greater liquid assets to manage the associated liquidity risks from a shorter deposit funding profile.

Figure 3.8

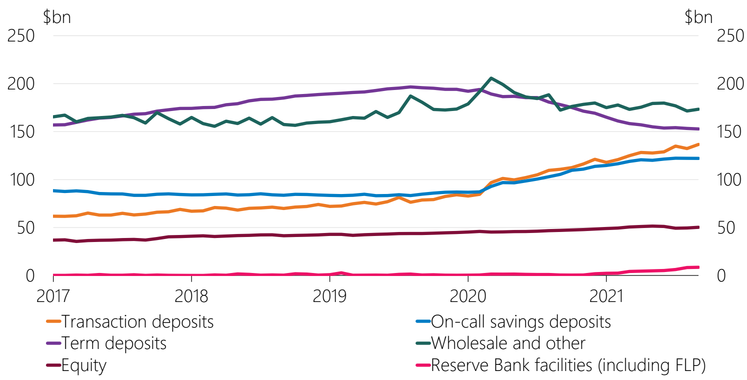
Net monthly cash influence from Reserve Bank support measures, and total outstanding ESAS balances



Source: RBNZ.

Figure 3.9

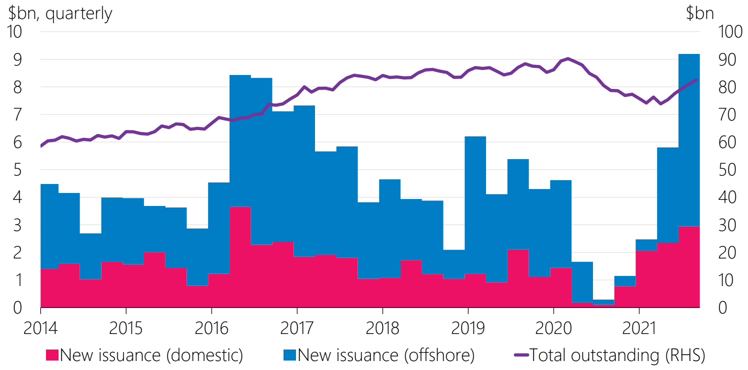
Funding composition of registered banks



Source: RBNZ *Bank Balance Sheet survey.*

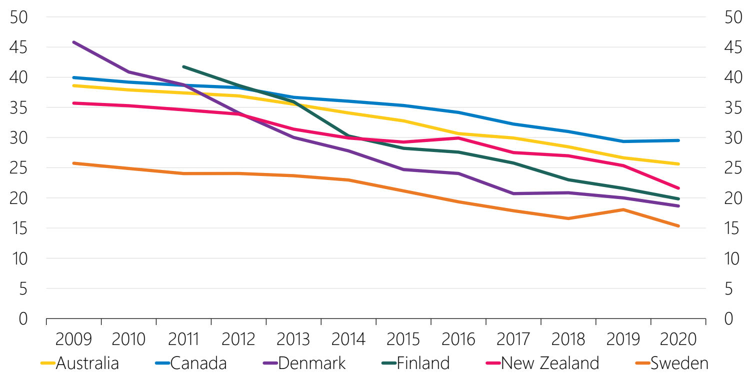
With deposit growth slowing, banks are resuming their issuance of long-term wholesale funding to normalise their funding composition (figure 3.10). Larger banks have returned to offshore wholesale markets as they seek to take advantage of currently favourable pricing conditions. Smaller banks have generally maintained their share of term deposits, and large banks may seek to rebalance some of their deposit funding to term products by offering more attractive interest rates.

Figure 3.10
Registered banks' issuance of long-term wholesale funding
(>2 year initial maturity)



Source: RBNZ *Liquidity survey.*

Figure 3.11
Number of commercial bank, credit union, credit cooperative, and other deposit taker branches
(per 100,000 adults, selected countries)



Source: IMF *Financial Access Survey.*

Lenders are facing stronger responsible lending requirements

On 1 December 2021, the Credit Contracts Legislation Amendment Act 2019 will be fully implemented. The Act makes changes to the current Credit Contracts and Consumer Finance Act (CCCFA), including prescriptive new minimum standards for lenders' assessment of the affordability and suitability of loans to consumers (including mortgage and personal lending). For many lenders, this means reviewing and updating existing systems and controls relating to serviceability assessments. Stricter verification of customers' income and expenses is expected to tighten credit availability at the margin for some borrowers. Looking ahead, improved systems for assessing debt serviceability will support the potential future use of macroprudential debt servicing restrictions on mortgage lending.

The pandemic has accelerated banking service model changes, but financial inclusion remains an important social objective

As with many other business sectors, the pandemic has seen banks adapt their operating models to allow more flexible working arrangements for staff, and more ways in which customers can access services. Against this backdrop of a continuing trend towards digital banking, Alert Level restrictions and reduced demand for in-person transactions during the pandemic have accelerated the ongoing decline in banks' physical branch networks. Trends in New Zealand bank branch networks mirror those seen in other comparable countries (figure 3.11). While a large majority of customers now choose to undertake their day-to-day banking online, it remains important that banks are accessible to rural, digitally excluded, and other vulnerable communities. Box B outlines efforts we are making to support financial inclusion in New Zealand.

Table 3.1
Key metrics for registered banks

Metric	Value (%, end of September)					Regulatory minimum (%)	Comment
	2017	2018	2019	2020	2021		
Tier 1 capital ratio	12.6	13.5	13.3	13.8	15.4	8.5*	Tier 1 capital ratios have increased over the past 12 months, as banks have retained their earnings.
Mismatch ratio (one month)[1]	6.1	4.8	5.2	6.5	6.2	0	Mismatch ratios remain elevated, reflecting the high level of settlement balances in the system.
Core funding ratio	87.6	88.0	87.4	88.6	87.3	50	Banks are well placed to comply with the return to a 75 percent minimum, set to take effect from 1 January 2022.
Annual return on assets (after tax)	1.02	1.10	1.03	0.67	1.01		Nominal profits have returned to pre-COVID levels, though balance sheet growth due to increased settlement balances has lowered return on assets slightly.
Annual return on equity (after tax)	14.2	14.4	13.4	9.0	12.9		Banks' equity has grown as they have retained their earnings, lowering return on equity despite a recovery in profits.
Net interest margin (quarterly, annualised)	2.10	2.10	1.97	1.85	1.98		Net interest margins have stabilised around their long-term levels, following declines in lending and funding rates over 2020.
Non-performing loans ratio	0.48	0.48	0.6	0.71	0.45		Non-performing loans have returned to pre-COVID levels as the economy recovered.
Annual credit impairment expense (% of average loans)	0.03	0.06	0.08	0.32	-0.06		Banks are writing back provisions made in the early stages of the pandemic, as credit losses have been lower than expected.
Cost-to-income ratio	42.0	40.0	41.6	46.7	42.3		Operating expenses have been relatively stable over the past 12 months.

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

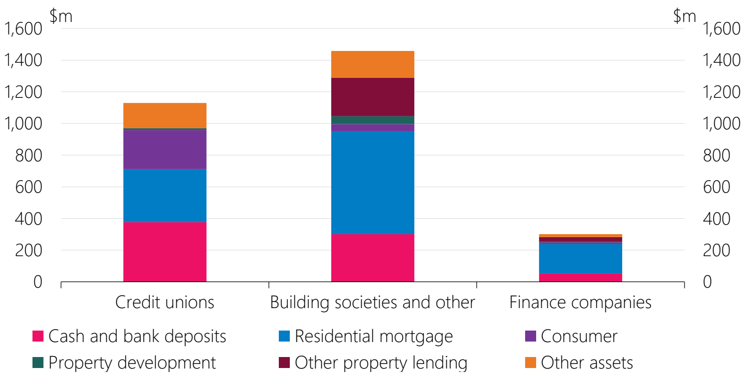
1 Mismatch ratio (one month) is presented as a three-month moving average to remove short-term volatility.

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

Non-bank deposit takers (NBDTs)

There are currently 18 NBDTs operating in New Zealand, 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 lending by NBDTs is around $2 billion, making up a relatively small part of the New Zealand financial system.

Figure 3.12
NBDT assets by type (August 2021)



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

The NBDT sector has shown resilience throughout COVID-19

Most entities have experienced stable asset performance and profitability over the past 18 months (table 3.2). As a result, capital ratios have been stable for most entities. Return on assets for all types of NBDTs has improved since the latter half of 2020, with both deposit-taking finance companies and building societies recovering from a decline at the onset of COVID-19.

NBDTs have experienced increased demand for some loan and investment products, particularly residential mortgages. Building societies grew their mortgage lending by 15 percent in the year to August 2021, with finance companies growing 50 percent.

The sector has seen also increased activity in agriculture, business, and small property development lending. Many NBDTs use their member and/or local ownership, and focus on regional communities, to position themselves as an attractive proposition for their customers.

As with banks, regulatory changes will require further investment...

Ongoing regulatory and technological changes will place additional operational demands on NBDTs. Some smaller credit unions and many deposit-taking finance companies do not operate with the same economies of scale as larger lenders, which weighs on their profitability and ability to meet compliance costs in some instances.

The new Deposit Takers Act (DTA) will introduce a deposit insurance scheme that will protect up to $100,000 per depositor, per institution in the event of a failure (see Box A). It will also create a single regulatory regime for all deposit takers, with standards that entities will be required to comply with. In addition, NBDTs will be subject to changes brought about by the aforementioned amendments to the CCCFA, which may limit some lending growth at the margin.

...and some business models may need to adapt to be sustainable in the long term

There remains significant diversity within the NBDT sector, with some entities adapting to the changing landscape and others struggling more. Scale is an issue for some, with 12 of the 18 currently operating NBDTs having total assets of less than $100m. As details of the future Deposit Takers framework become clearer, some business models may need to be reviewed for their long-term viability. As has been seen in recent years, the small scale of some players creates a challenge for their ability to adapt as needed, and further consolidation in the sector may occur over time as firms merge to achieve scale economies and build resilience.

Table 3.2

Key metrics for NBDTs (as at end June)

Metric	Segment	2018	2019	2020	2021
Total assets ($m)	Finance Companies[1]	220	270	218	296
	Credit Unions	1,149	1,131	1,152	1,127
	Building Societies and Other[2]	1,084	1,217	1,303	1,400
Capital ratio (%)	Finance Companies	20.3	18.5	17.8	15.7
	Credit Unions	14.9	14.7	14.1	12.9
	Building Societies and Other	11.0	11.6	12.4	13.7
Non-performing loan ratio (%)	Finance Companies	7.8	6.3	10.3	1.9
	Credit Unions	2.6	2.5	3.3	2.9
	Building Societies and Other	0.3	0.1	0.2	0.1
Return on assets, before tax (%)	Finance Companies	2.5	1.7	1.9	1.8
	Credit Unions	0.1	-0.6	0.0	0.4
	Building Societies and Other	0.8	0.9	0.9	1.2
Number of operating entities	Finance Companies	7	7	6	6
	Credit Unions	13	9	9	8
	Building Societies and Other	4	4	4	4

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

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

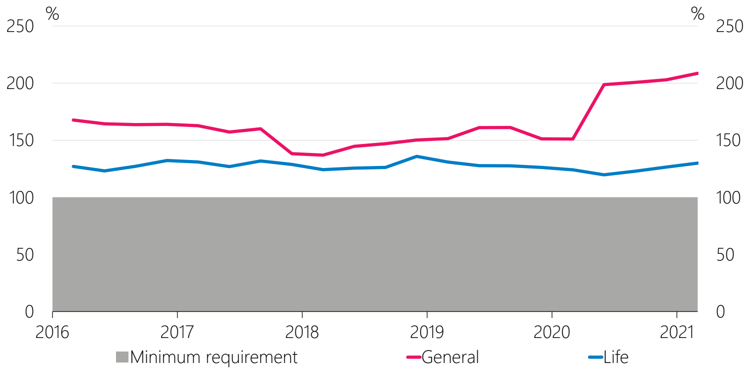
2 Other NBDTs includes Christian Savings Limited.

Insurers

Insurers play a vital role in the financial system as they allow businesses and households to manage their risks. In doing so, the availability of insurance also reinforces financial stability by protecting the value of assets and cashflows that secure the banking system's loans. General insurers account for the largest part of New Zealand's insurance sector, with around 59 percent of total gross premium revenues, life insurers around 29 percent, and health insurers around 12 percent.

Figure 3.13

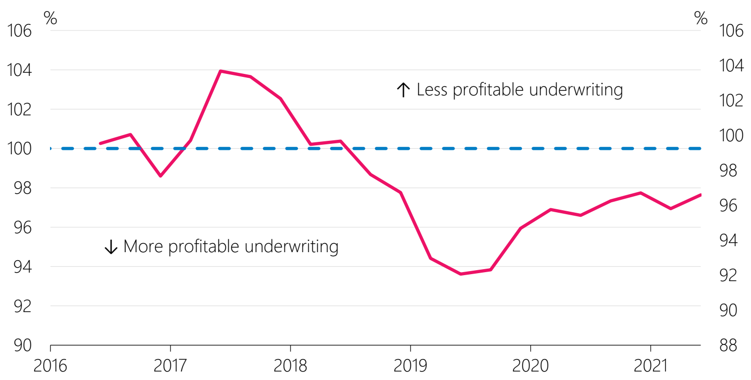
Solvency ratios of New Zealand life and general insurers



Source: RBNZ *Insurer Solvency Return.*

Figure 3.14

Non-life insurers' net combined ratio



Source: RBNZ *Quarterly Insurer Survey.*

Note: The net combined ratio is the sum of the non-life insurance sector's claims and expenses divided by its revenue, net of reinsurance claims and premiums, for the 12 months to the end of the given quarter. A net combined ratio of below 100 percent indicates broadly profitable underwriting. Data in this figure may differ from industry-reported data, in part due to the treatment of outward reinsurance commissions.

Insurers have retained capital during the period of economic uncertainty

Even though the worst case economic scenarios envisaged earlier in the pandemic in early 2020 have not materialised in New Zealand, it is our expectation that insurers have appropriate contingencies in place at all times to mitigate significant stresses on their businesses and protect the interests of policyholders.

The solvency ratio for general insurers increased materially during 2020 due to dividend restrictions and remains higher at March 2021 (figure 3.13). This has also been supported by broadly stable earnings (figure 3.14). By March 2021 only some insurers have been through a reporting cycle since the lifting of dividend restrictions, and so it is not yet clear whether the higher solvency will prove temporary or permanent. The solvency ratio for life insurers is lower but has been more stable. The solvency ratio for health insurers has remained above 300 percent.

Stress tests are improving our understanding of risks

In 2021 we expanded our regulatory stress test programme to include insurers for the first time. The first exercise was recently published on our website, and involved the five largest New Zealand incorporated general insurers, representing around 70 percent of the sector. The stress test is not a pass or fail exercise, but rather is intended to develop our and the industry's capabilities, engage with insurers on their approaches to stress testing, including consideration of mitigating actions, and to improve understanding of potential vulnerabilities to four adverse scenarios. The scenarios include an economic downturn, a series of major weather events, significant impairment of reinsurance markets, and a combined scenario. The exercise highlighted insurers' reliance on reinsurance arrangements, and challenges for the insurance market in New Zealand if these arrangements were to be disrupted. The recent history in New Zealand of natural disasters, severe weather events, and pandemics helps to inform stress test design, thereby ensuring that insurers are better prepared to withstand any future shocks.

Climate change risks for insurers and policyholders are materialising

In recent years, the cost of weather-related catastrophes in New Zealand has been rising. New Zealand has experienced its most costly tornado (Auckland in 2021), floods (in Buller, Marlborough, and Wellington), hailstorm (in Timaru in 2019), and fire (at Lake Ōhau in 2020). There has also been an increase in the frequency of higher-cost weather events (figure 3.15).

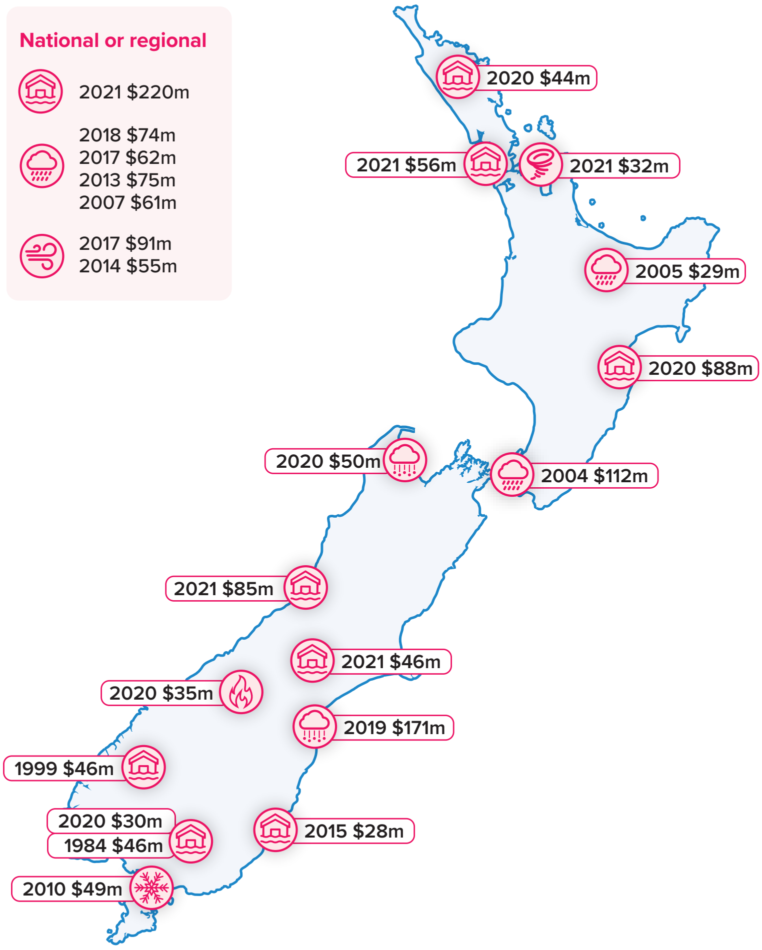
Climate change will impact future weather events to varying degrees, and is expected to affect future insurance premiums. In some locations where adverse weather events become more frequent or intense, insurance cover might become more expensive or unavailable, as it would no longer be commercially viable. This has material implications not only for insurers, but also households and businesses (e.g. property values and ability to manage risk), banks (e.g. availability of mortgages), and governments (mitigation and relocation).

We anticipate that insurers will respond to climate change with risk-based pricing models, which will in part be driven by the cost of obtaining reinsurance for these risks. While New Zealand's property insurance market is relatively concentrated, competitive dynamics mean that as some insurers develop more granular (i.e. address-specific) pricing and underwriting, other insurers will need to follow in order to not end up with the remaining higher-risk properties. These changes in pricing and coverage will come on top of changes already being introduced for updated assessments of earthquake risks.

Figure 3.15

Insurance costs of recent weather events

Weather events with material insurance claims



Source: Insurance Council of New Zealand.

Note: Figure shows recent weather events that have caused at least $25m in insurance claims locally or $50m regionally or nationally. Figures in nominal terms.

Business interruption claims during COVID-19 have not been material in New Zealand so far...

We continue to maintain a close watching brief on multiple overseas rulings regarding COVID-related business interruption (BI) claims being lodged against overseas-based insurers. To date, no class action or legal challenges like those seen overseas have been initiated in New Zealand. Insurers believe the definition and interpretation issues assessed by courts overseas are not applicable for most New Zealand BI policies. However, the risk remains that as the size of overseas claim costs becomes clearer, overseas parent insurers may potentially look to reduce financial support for their New Zealand-based businesses.

...but other classes of insurance may still face COVID-19 related challenges for some time

Overall, the insurance sector remains resilient and has coped well with the current COVID-19 outbreak, aided by the previous lockdown experiences gained in 2020. Insurers remained open for business and transitioned well to remote and virtual working practices during lockdown, although they have reported greater operational burdens including supply chain issues.

Insurers offering credit protection, loan repayment, and redundancy insurance products remain exposed to greater claim costs if the New Zealand economy deteriorates, but claims on those products to date still appear to be at normal levels. There remains a risk that further, persistent outbreaks could lead to significantly greater mortality rates and higher levels of claims on life insurance policies. However, life insurers overall believe that mortality risk is not materially increased given the public health strategy.

Table 3.3

Key metrics for New Zealand's insurance sector

Metric	Value (%, March year)				Regulatory minimum (%)	Comment
	2018	2019	2020	2021		
General insurers						
Solvency ratio	137	151	151	209	100	Solvency ratios increased significantly in early 2020 when general insurers ceased paying dividends and retained capital.
Profit margin	6.4	6.5	17.1	6.9		The year ended March 2020 had fewer than average major weather events.
Expense ratio	14.6	13.8	12.8	13.2		Non-commission expenses have grown slower than premiums, causing the expense ratio to decline.
Life insurers						
Solvency ratio	124	131	124	130	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	16.8	18.5	19.1	12.6		Profit margins materially decreased during the year ended March 2021.
Expense ratio	20.9	20.6	21.2	23.3		Non-commission expenses have been increasing.
Health insurers						
Solvency ratio	356	344	339	324	100	Health insurers generally have stronger capital buffers than general insurers, reflecting the fact that many are mutual companies with restricted access to capital.
Profit margin	1.6	2.9	1.4	3.3		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	10.7	11.1	11.0	12.0		Expenses have increased in the year ended March 2021.

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

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

Financial Market Infrastructures (FMIs)

FMIs are the systems that enable clearing and settlement of payments, securities, derivatives, and other financial market transactions. Their importance to the stable operation of the financial system makes it crucial they are managed properly and are reliable.

FMIs showed preparedness and flexibility to the new working environment under COVID-19

While there were some operational challenges during last year's lockdown, the experience gained meant that FMI operators were well prepared when Alert Level 4 restrictions were reintroduced in August this year and switched to their business continuity plans without issues. The volume of transactions has stayed relatively stable over recent months with no repeat of the spike in volumes experienced in March and April last year.

As with last year's lockdown, major banks have responded to the current outbreak by waiving fees and reducing the cost of contactless payments for merchants. An increased limit of $200, introduced since last year's lockdown, for contactless payments without the need to touch the keypad on payment terminals is still in place and continues to support hygiene protocols.

$200

An increased limit for contactless payments without the need to touch the keypad remains in place to support hygiene.

NZClear experienced an outage in July

The two Reserve Bank-operated systems, the Exchange Account Settlement System (ESAS, used for high-value payments between banks) and NZClear (a settlement system for security transactions), have generally performed satisfactorily in recent months, with only one disruption to normal operations. ESAS is regulated by our Supervision Department, while we jointly regulate NZClear with the FMA.

On 26 July 2021, NZClear experienced processing issues, which led to the system not being fully operational. The standard management processes were invoked immediately and resolved the problem. As a result, start-of-day settlement opened with a delay of two hours.

It is a key priority for us to operate ESAS and NZClear safely and effectively, and whenever there is an incident we work closely with software vendors and other stakeholders to minimise the risk of future events that could pose a threat to the smooth operation of the systems. Our Supervision Department and the FMA continue to closely monitor the risk management and mitigation strategies of ESAS and NZClear.

Significant global projects driven by the industry are under way

SWIFT's adoption of the ISO 20022 standard for interbank payment instructions means that, globally, financial institutions, including New Zealand SWIFT users, need to modify their systems to be able to process payment messages in a new format. The ESAS system also needs to be modified.

The new message format introduces the ability to send richer text messaging and creates opportunities for improved anti-money laundering procedures. The new standard becomes effective in November 2022 with a three-year coexistence period when both the existing and the ISO 20022 messaging standards will be in use. However, banks in New Zealand must be able to receive messages in the new format by November 2022, as EU and UK banks will only use the new messaging format from that time.

This is a worldwide project which is of high importance for the New Zealand financial system. We intend to closely monitor banks' implementation of system changes needed to allow them to process messages in the new format.

Regulatory initiatives are supporting improved customer outcomes

Regulatory initiatives led by the Ministry of Business, Innovation and Employment will affect New Zealand's payment system.

The Retail Payment System Bill currently before Parliament will enable regulation of merchant fees (fees payable to their bank by businesses that accept card payments). Ultimately, the aim of the Bill is to address a lack of competition in payment services and to reduce merchant fees to support consumers and merchants by fairly distributing costs. The Bill is planned to be enacted by the end of the year.

Additionally, the Government has agreed to establish a framework for a consumer data right (CDR) in New Zealand. A CDR requires data holders to share data with a third party on request from the consumer to whom that data relates. The aim of a CDR is to ensure data sharing is easy and direct, but only with the consumer's consent and with certain safeguards in place on the business's side. The proposal is to roll out requirements on a sector-by-sector basis to oversee the process and adapt requirements as needed. In the financial sector, it is expected that the establishment of a CDR will encourage innovation in open banking and the development of new payment instruments.

The FMI Act passed, setting a new regulatory baseline, and supporting proactive supervision

The Financial Market Infrastructures Act (FMI Act), passed in May 2021, establishes a new regulatory regime for FMIs. We are working with the FMA to transition to the new regime and have recently completed two important parts of the transition process.

The two agencies have added a new schedule to their Memorandum of Understanding – Schedule 3 Oversight of Financial Market Infrastructure. The schedule strengthens the ability to work together in areas of common interest and to act jointly as the 'regulator' for the purposes of the FMI Act.

In July, the agencies released consultation papers setting out proposed policy frameworks for determining what regulatory requirements (standards) will apply to FMIs designated under the new Act, and for assessing the systemic importance of FMIs.

Future workstreams include considering feedback on the consultation papers and publishing updated versions by the end of this year. The transition period to the new Act is expected to run until December 2022. Over this period, we will work with the FMA on completing the detailed policy framework and transitioning the settlement systems currently designated under the Reserve Bank of New Zealand Act 1989 to being designated FMIs under the FMI Act. We intend to continue to engage stakeholders with further consultation and sharing of information.

The Financial Market Infrastructures Act (FMI Act), passed in May 2021, establishes a new regulatory regime for FMIs. We are working with the Financial Markets Authority to transition to the new regime. The transition period is expected to run until December 2022.

Box B

Reserve Bank initiatives to support financial inclusion

Toitū te Ōhanga, Toitū te Oranga

The Reserve Bank works to enable economic well-being and prosperity for all New Zealanders.

This means making sure that our actions to promote financial stability consider everyone. A fully participative system is a stronger system. It reinforces the social licence under which we operate and supports understanding of our work by all in society.

Financial inclusion improves the well-being of individuals and improves the efficiency of the system. A financial system that is fully inclusive better mobilises savings and investments in the productive sector, and reduces information, contracting, and transaction costs across the economy, with clear efficiency gains.

Financial inclusion is demonstrated by:

- broad access to banking and insurance services;
- wide availability of accessible and safe financial products; and
- people understanding the benefits of financial products and being sceptical about harmful conduct such as irresponsible lending, pyramid schemes, or other financial scams.

We work to increase financial inclusion in a variety of ways, including removing barriers, supporting financial education, and working with our stakeholders.

Removing barriers and creating opportunities

Regulatory requirements are designed to promote financial stability and protect customers, but they should not make it unnecessarily difficult for people to gain access to financial products, for small firms to operate, for new competitors to enter the market, or for community organisations to provide innovative services to meet community needs.

We take a proportionate approach to our work, with fewer requirements and less intensive supervision on smaller, less risky entities. We are working with other members of the Council of Financial Regulators (CoFR) to make it easier for fintech innovators and entrepreneurs to navigate the regulatory system, breaking down the barriers they may face.

We aim to maintain high standards that support the integrity of the financial system. In general, our regulatory tools apply to the institutions we regulate, rather than imposing a direct customer or distributional impact. However, we recognise that some regulatory settings may inadvertently contribute to financial exclusion, for example through the 'know your customer' requirements in the AML/CFT Act. Financial services providers may not always have a commercial imperative to offer services to everyone or to offer the type of services that people want.

We are working with Pacific Island central banks and international organisations to make remittances to the Pacific more accessible, safe and cost-effective. In doing so we hope to maintain financial corridors and services to enable Pacific countries' recovery and growth, which in turn will support the stability and prosperity of our regional economy.

Domestically, the availability of in-person banking services has been declining in regional New Zealand, some parts of our population are under-served, and the risks associated with climate change may make insurance cover unavailable or unaffordable in certain areas.

We are committed to working with financial services providers to better understand these challenges and to address concerns or break down barriers where they negatively impact New Zealanders, particularly our most vulnerable communities. This includes considering innovative solutions and how they could support wider financial inclusion and well-being efforts.[5] Our work on the future of money includes developing our role as a steward of the cash system – given the important role that access to cash plays in the lives of many New Zealanders – and considering how a central bank digital currency could support wider financial inclusion and well-being efforts.

Financial education

We want New Zealanders to be informed about money. The Reserve Bank supports the National Strategy for Financial Capability, which seeks to 'demystify money'. As part of our contribution to this, we have been sponsoring 'Smart $' – a programme of financial education in schools run by the Life Education Trust. This supports our overall approach to financial education, which also includes regular public communications across different channels, including social media, and the development of our Bank Financial Strength Dashboard, which will soon be extended with a version in te reo Māori.

Working with our stakeholders

We are working with our stakeholders to identify challenges relating to access to capital across the financial system with an initial focus on Māori capital seekers, following the publication of the Māori Economy report, Te Ōhanga Māori.[6] We continue to build strong and collaborative strategic relationships with iwi and hapū collectives, Māori-owned businesses, representatives of Māori banking, and other central banks around the world, specifically through the Central Bank Network on Indigenous Inclusion. This enables us to develop a common approach to financial inclusion and share and identify challenges and solutions.

More broadly, we are working with other agencies in CoFR and elsewhere to ensure we integrate our individual actions and identify initiatives that we can pursue collectively to support financial inclusion.

5 See our current work on the Future of Money – Te Moni Anamata, at https://www.rbnz.govt.nz/notes-and-coins/future-of-money.

6 See https://www.rbnz.govt.nz/research-and-publications/research-programme/te-ohanga-maori-2018.

Regulatory initiatives

CHAPTER 04

CHAPTER 4
Regulatory initiatives

New Zealand's financial institutions have been resilient to the effects of the COVID-19 pandemic so far, although uncertainties remain about the economic outlook. Under these conditions we are reinstating some regulatory requirements that were temporarily relaxed in 2020. We are also proceeding with previously suspended reviews and commencing new ones, as we seek to continuously improve our prudential frameworks.

This chapter introduces three new initiatives and provides an update on topics discussed in previous *Reports*.

We remain mindful of the quality and impost risks of moving ahead with too many initiatives simultaneously. As a consequence, alongside our CoFR partners, we have reviewed our programme and deferred or extended the timeline on some initiatives in order to spread the work programme over time. We see this as a necessary and temporary response to the current unusual circumstances. Nevertheless, over the medium term we expect industry to increase its resourcing to meet the demands of a regulatory framework that will be more demanding, and aligned with international practice, as it matures.

New regulatory initiatives

Debt Serviceability Restrictions

In May 2021 we reported to the Minister of Finance on policy options to support more sustainable house prices.[7] Our assessment shows debt serviceability restrictions (DSRs) as the most effective additional tool available that we could use to support more sustainable house prices, while also aligning with our primary objective of financial stability.

DSRs complement current restrictions on housing lending at high LVRs and would provide an additional way for us to address financial stability risks related to the housing market. LVR limits lower the likelihood that a borrower would be in negative equity following a house price decline, while DSRs build borrowers' buffers against serviceability shocks, such as a rise in interest rates.

7 See https://www.rbnz.govt.nz/-/media/ReserveBank/Files/News/2021/Policy-options-to-support-sustainable-house-prices.pdf.

Following consideration of this analysis, the Minister agreed in July to add DSRs to the Memorandum of Understanding (MoU) on macroprudential policy.[8] The Minister's agreement was on the condition that we design and implement DSRs to avoid negative impacts on first-home buyers as much as possible, to the extent consistent with our purposes and functions under Part 5 of the Reserve Bank Act.

We intend to begin consulting on DSRs in late November. The consultation will cover debt-to-income (DTI) limits and regulatory floors on the test interest rates that banks use in their debt serviceability assessments. Banks have said that implementation of a DTI limit could take at least six months following completion of the design and calibration of the tool, but a floor on test interest rates could be implemented sooner.

Review of policy for branches of overseas banks

We have recently launched 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 approximately eight percent of banking system assets. Unlike banks that are incorporated in New Zealand, branches are part of a bank that is incorporated overseas. As a result, branches are not subject to many of the requirements that apply to banks incorporated in New Zealand.

8%

Of the 27 registered banks operating in New Zealand, 12 are branches, accounting for approximately eight percent of banking system assets.

A consultation paper was published in October, seeking feedback on the problem definition, assessment principles, and some high-level policy issues and options. These issues include setting the appropriate threshold for branches to be required to incorporate locally; whether branches should be permitted to take retail deposits; whether dual registration should be permitted; and whether we should pursue greater regulatory and supervisory integration with overseas authorities.

The objective of the review is to create a simple, coherent, and transparent policy framework for branches that promotes financial stability. One of the central issues we will be addressing is that current policy is not applied consistently across branch banks.

Branches can provide valuable services to New Zealand households, businesses, and financial markets. They may provide benefits to New Zealand's financial system in terms of innovation, competition, and cheaper funding for businesses, as well as providing greater diversity to the banking system. However, the failure of a branch operating in New Zealand could undermine confidence in the financial system. It could also have knock-on effects for other registered banks, financial system participants, and New Zealand creditors. Branches may also expose the financial system to pro-cyclical risks that we cannot mitigate due to our limited ability to set comprehensive requirements for branches. An example of this is the pro-cyclical allocation of capital and liquidity by and within overseas banks, particularly in times of crisis. Encouraging efficiency must therefore be considered alongside concerns for financial stability.

8 See https://www.rbnz.govt.nz/news/2021/06/debt-serviceability-restrictions-added-to-policy-toolkit and https://www.rbnz.govt.nz/regulation-and-supervision/banks/macro-prudential-policy/mou-between-minister-of-finance-and-governor-of-rbnz.

Of the 12 registered branches, seven are ‘dual registered’, which means that the New Zealand banking group comprises both a locally incorporated subsidiary and a branch of the overseas parent bank that are registered as banks in New Zealand. This interconnectedness creates additional complexity for us as regulator and supervisor.

The current consultation will run until March 2022. Once we have considered submissions to this consultation, the policy approach will be developed. A second consultation paper is expected to be published, setting out our proposed policy approach, in 2022.

Liquidity thematic review and policy review

In September 2021 we completed a thematic review of banks’ compliance with our Liquidity Policy (BS13 and BS13A). The review was also an opportunity to gain a deeper insight into banking industry practices relating to the management and monitoring of liquidity risk.[9]

All locally incorporated banks participated in the review, with the final report focussing on the 10 largest, who were chosen to participate in on-site interviews.

This was the first in-depth review of compliance with the Liquidity Policy since we introduced it in 2010. The review found that banks are currently maintaining liquidity ratios above the regulatory minimums. However, the review had a large number of adverse findings related to the qualitative aspects of the policy, highlighting gaps in banks’ risk management frameworks. In particular, banks need to resolve system limitations and enhance their frameworks for managing model risk.

Compliance with the policy varied amongst banks. In general, compliance reflected the maturity of internal risk management frameworks, and was unrelated to bank size. Areas of non-compliance suggested widespread underinvestment in systems and assurance processes.

A range of weaknesses was also identified in bank systems, internal controls, and risk management, as well as areas of good practice that the industry can learn from.

The 10 largest locally incorporated banks were provided feedback and required to form remediation plans to address their findings. All locally incorporated banks have been required to undertake a self-assessment against the findings and recommendations outlined in the final report. Reserve Bank supervisors are monitoring the remediation plans and self-assessments.

Informed by this thematic review, we will commence a review of our Liquidity Policy in the first half of 2022. The first consultation paper will propose the scope and principles of the policy review. Key issues we intend to consult on include whether New Zealand’s policy should move towards the Basel liquidity framework, how liquidity requirements should be applied across the spectrum of deposit takers, and which assets should qualify as liquid assets.

Banks that participated in the thematic review have provided some preliminary views on areas of the policy that they believe could be changed or given more guidance. This feedback and the findings from the thematic review will be considered as part of the policy review.

9 See https://www.rbnz.govt.nz/regulation-and-supervision/thematic-reviews/banking-thematic-reviews/liquidity-thematic-review.

Update on previously reported regulatory initiatives

Core funding ratio normalisation

As New Zealand experienced the initial outbreak of COVID-19 in March 2020, we were concerned that banks' core funding ratios (CFRs) – which require that banks fund a minimum proportion of their lending with stable long-term sources – could begin to decline, and see banks react by reducing lending to the economy. Accordingly, the minimum CFR requirement was lowered from 75 percent to 50 percent in April 2020.

In November 2020, we announced the CFR minimum requirement would only be increased if three conditions were met. These conditions related to wholesale funding availability, credit availability, and confidence that reverting to the previous minimum CFR requirement would not adversely affect credit availability.

In May 2021, we announced that the CFR minimum requirement would increase back to 75 percent on 1 January 2022, subject to no significant worsening in economic conditions. Notwithstanding the challenges posed by the COVID-19 outbreak since August, we remain satisfied the CFR normalisation conditions have been met, and we intend to increase the minimum CFR requirement to 75 percent on 1 January 2022.

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Implementation of the bank Capital Review

In December 2019 we announced final decisions on the comprehensive review of the capital adequacy framework for locally incorporated banks (the Capital Review).

Following consultation on exposure drafts of the new Banking Prudential Requirement (BPR) documents that implement the Capital Review decisions, in June we published the final BPRs along with a response to submissions. We also agreed to defer some steps in the implementation timetable.[10] Banks' conditions of registration were then updated on 1 October 2021 to bring the new capital BPRs into force from that date.

The new capital BPRs replace a number of existing documents from the Banking Supervision Handbook, and have been written and laid out to make the content clearer and more user-friendly. Eventually all other Handbook policy documents will be reorganised and rewritten in the new style.

One key element of the Capital Review is yet to be put in place, namely 'dual reporting'. Banks accredited to use internal models will be required to report both their modelled and standardised equivalent risk-weighted assets for credit risk. Dual reporting will begin for disclosure statements with a reporting date of 30 September 2022. We plan to consult on the detailed coverage of dual reporting early in 2022. Additionally, a range of other capital-related policy work remains on our agenda, including capital for operational risk, and the design of the countercyclical capital buffer.

10 See https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks and finalised BPRs at https://www.rbnz.govt.nz/regulation-and-supervision/banks/banking-supervision-handbook/capital-requirements-and-credit-risk-requirements.

Benchmark Rate Reform

31 December 2021 is the final day that the majority of London Inter-Bank Offered Rate (LIBOR) settings will continue to be published as representative rates. This follows years of preparatory work around the world, including by New Zealand institutions that use LIBOR benchmarks in their day-to-day business.

New Zealand will continue to be served by the Bank Bill Benchmark (BKBM) rate published by the New Zealand Financial Markets Association. Work is well advanced in strengthening this benchmark and an alternative risk-free rate, the OCR Compound Index, has been established. The International Swaps and Derivatives Association has been consulting on an additional fallbacks supplement that will include a New Zealand fallback for BKBM, the Official Cash Rate. The Supplement is currently set to be published later in 2021. The new Supplement follows the introduction of (and will be similar in format to) the IBOR Fallbacks Supplement 2020. The 2020 protocol was published in October last year, and has over 14,500 signatories across 90 jurisdictions, including the Reserve Bank.

We have been engaging with entities we regulate to understand their readiness for LIBOR cessation, and continue to reiterate our expectations that all regulated entities need to ensure they are well placed to manage the end of LIBOR. We have been encouraged by the progress to date. No financial stability concerns have been identified as entities complete their preparations and engage with their clients to ensure a smooth transition to post-LIBOR financial markets from 2022.

Insurance reviews

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

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

A public consultation on policyholder security was issued in August 2021, closing on 15 November 2021. The consultation considers:

- provisions in IPSA to ensure that insurers hold enough reserves to meet policyholders' claims;
- the necessary information for policyholders to assess insurers' financial soundness; and
- policyholders' access to funds in the event of an insurer failure.

We expect to issue the next consultation on enforcement and distress management in February 2022.

For the solvency standards review, an exposure draft of the proposed interim solvency standard was published in July. This interim standard incorporates changes to the structure of the standards and means that solvency rules will work effectively with incoming rules for insurance accounting (IFRS 17). Consultation closed on 1 October. We are currently analysing feedback and undertaking a quantitative impact study, working with insurers to determine the impact of the interim standard on insurers' capital levels. There was widespread concern about the proposed early start date of the interim standard. In order to give industry more time to adjust to the new interim solvency standard, and to allow more time to incorporate consultation feedback, the start date has been moved back by a year from 1 January 2022 to 1 January 2023. This also aligns with the date on which insurers will have to adopt the new IFRS 17 accounting rules.

Once the interim standard is finalised, we will go on to the second phase of the solvency standards review, which will involve calibrating the amount of capital insurers are required to maintain against different risks.

Box C

Uplifting financial sector cyber resilience and the role of the Reserve Bank in addressing system risks

Malicious attempts to exploit IT system vulnerabilities have risen substantially in recent years, and organisations face greater cyber threats than ever before. Cyber attacks have become more sophisticated, targeted and widespread, and cybersecurity is an increasingly important focus for financial institutions' management and boards. Additionally, the economic and operational disruption caused by the COVID-19 pandemic has increased both the motivation and opportunity for cyber attackers, who have looked to exploit the large-scale shift to remote working.

This rising trend in cyber attacks is especially noticeable in the financial sector, which is a prime target for cybercrime. Consumer fraud remains the top form of financial crime; however, other forms of cybercrime such as banking Trojans and distributed-denial-of-service (DDoS) attacks have also been increasing in frequency and sophistication in recent years. While the frequency of cyber incidents regularly rises and falls, recent activity suggests that the severity of attacks is increasing.

It is essential that financial sector entities continue to undertake proactive actions to further bolster their cyber resilience strategies wherever possible, working collaboratively with other entities, government departments, and regulators. The costs and consequences of disruption mean that institutions already have strong incentives to develop their cyber resilience. That said, cyber risk poses a threat to financial stability and, as such, financial institutions as well as prudential regulators are increasingly taking a proactive approach to building resilience.

Highlighting the increased sophistication of cyber attacks, several organisations were impacted by sustained and spreading DDoS attacks over a four-week period starting in September 2021, including two of the largest banks in New Zealand. The attacks resulted in some or all of the banks' online services being intermittently unavailable over the period. The overall impact of the DDoS attacks across the financial sector included significant operational disruption and customer dissatisfaction. The series of incidents affected customers' access to their digital services, but did not affect customer payments or access to physical cash.

Reserve Bank policy and supervisory response to growing cyber risks

We have increased our focus on cyber risks in recent years. This has included publishing guidance[11] and a cyber incident data collection plan. The guidance encourages financial institutions to consider governance, identification, protection, and third-party cyber risks.

We played a central role in coordinating and managing the financial sector response to the September 2021 cyber attacks. A cyber incident response team was set up: the Financial Sector Cyber Incident Response Team (FS-CIRT). This involved us collaborating with Computer Emergency Response Team (CERT NZ), National Cyber Security Centre (NCSC), New Zealand Treasury, and the Financial Markets Authority (FMA).

11 See Guidance on cyber resilience.

This experience provided an opportunity to highlight the guidance to regulated entities and to incorporate lessons learned from these attacks into future policy considerations.

We have also taken the opportunity to incorporate lessons from this series of incidents into future policy work. We continue to develop supervisory practices to monitor emerging risks with regulated entities. We have been progressing our work to build cyber resilience in the financial sector, including the development of the three-step work programme (figure C.1).

Further, we have been working closely and collaboratively with other relevant agencies, including NCSC and CERT NZ, to ensure that the work is well coordinated and does not create unnecessary compliance burdens for industry. There is an opportunity to develop a collaborative cyber incident response across New Zealand agencies and our trans-Tasman counterparts, and we have started to progress this. Collecting data will enable us to share meaningful information with our counterparts to help measure the impacts of cyber attacks over time.

We will continue to take a more proactive and collaborative regulatory stance, looking for opportunities to optimise policy and incorporate cyber considerations whenever relevant. Other workstreams include developing a specific cyber standard under the Financial Markets Infrastructures Act 2021 and future Deposit Takers Act.

Figure C.1

Reserve Bank policy incorporates a three-step approach to promote cyber resilience in regulated entities

Step 1

Cyber risk management guidance for Reserve Bank-regulated entities

Published Q2 2021

Step 2

Data collection and information-sharing guidance is being developed

Consultation planned for late 2021 or early 2022

Step 3

Enhanced coordination and response to cyber incidents protocols with relevant domestic and overseas agencies is also under way

Protocols are being developed; expect finalised and operational protocols from late 2022.

Regulatory enforcement and compliance

CHAPTER 05

CHAPTER 5
Regulatory enforcement and compliance

In the event of identified non-compliance, we have the discretion to take enforcement action, and to decide what form this might take. Enforcement action helps support our strategic priority of ensuring financial institutions comply with coherent and robust legislation and regulatory frameworks.

Following the launch of the standalone Enforcement Department in March 2021, the new department has been developing an enforcement framework. An Enforcement Committee has been established, which is overseeing the development of this framework, as well as the enforcement action taken by us in response to repeated and serious breaches of regulatory requirements.

This section of the *Report* provides information on recent non-compliance, and the enforcement activities recently undertaken by us to achieve our statutory purposes.

Areas of regulatory non-compliance

The number of instances of identified non-compliance with regulatory requirements over the past six months remained broadly steady compared with the previous six months. Most breaches, across both banking and insurance, related to reporting and notification requirements. There have also been instances of non-compliance with anti-money laundering and countering the financing of terrorism (AML/CFT) obligations; liquidity, capital and governance policies; and outsourcing requirements.

As noted in Chapter 4, our thematic review of banks' compliance with the liquidity policy identified a range of systems, controls, and risk management weaknesses, and instances of non-compliance with the policy. However, the review found that banks are currently maintaining liquidity ratios above the regulatory minimums.

Investigations

Where concerns about an entity's potential non-compliance arise, the matter may be referred to our Enforcement Department for formal investigation. The Enforcement Department will investigate the matter, and make a recommendation regarding enforcement action to the Enforcement Committee.

All of our current investigations relate to prescribed transaction reporting (PTR) requirements under the AML/CFT Act. Reporting entities are required to report prescribed transactions (including international wire transfers of $1,000 or more, and domestic cash transactions of $10,000 or more) to the New Zealand Police's Financial Intelligence Unit. Current investigations relate to failures to report prescribed transactions within the statutory timeframe and failures to accurately report required information.

Enforcement action

Westpac Banking Corporation

On 11 August, we issued a formal warning to the New Zealand branch of Westpac Banking Corporation (WBC) under section 80 of the AML/CFT Act.

WBC had designed and configured its systems for PTR in a way that failed to detect and report all eligible international wire transfers, resulting in it failing to report almost 8,000 corporate transactions to overseas recipients between July 2018 and February 2019. This underreporting has been remediated, and the transactions subsequently reported.

WBC was required to review its procedures, policies, and controls within its AML/CFT programme for PTRs, including its systems assurance processes, to identify and remediate any gaps or deficiencies, and ensure it is able to fulfil its PTR obligations.

TSB Bank Limited

On 27 August, the High Court ordered TSB Bank Limited (TSB) to pay a pecuniary penalty of $3.5 million for breaches of the AML/CFT Act.

We brought civil proceedings against TSB in May, and an agreed statement of facts was filed in which TSB acknowledged it had failed to have adequate and effective procedures, policies and controls for monitoring and managing compliance with its AML/CFT programme; to review and maintain its AML/CFT programme; to conduct a risk assessment in respect of its real estate operations; and to have regard to certain countries it deals with when reviewing its 2017 AML/CFT risk assessment.

These proceedings were an escalated regulatory response to continued non-compliance by TSB, and followed a formal warning we issued to TSB in 2016 for failures relating to its review and maintenance of its AML/CFT risk assessment.