



# Financial Stability Report

May 2020

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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 macro-prudential policy instruments.

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# Financial Stability Report in pictures

May 2020



## New Zealand's financial system in good position to support recovery

The economic disruption associated with COVID-19 will present challenges to the financial system. Banks have good capital and liquidity buffers and need to use these to support customers and contribute to the economic recovery.



*COVID-19 has caused an unprecedented shock to economic activity*



*Wage subsidies and easier monetary policy have cushioned the near-term financial impact*



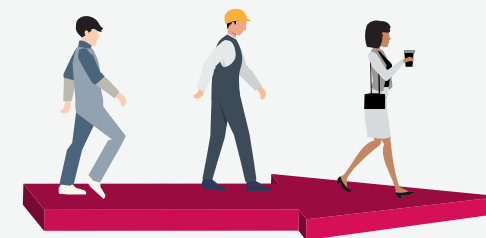
*But some household and business borrowers will still come under stress*



*Stress tests suggest banks can withstand loan losses under a broad range of scenarios*



*The Reserve Bank has adjusted policies to enable banks to keep on lending*



*Banks can support the economic recovery by continuing to lend to sound borrowers*

## ***COVID-19 has caused an unprecedented shock to economic activity***

Global economic activity has been severely disrupted as countries have taken public health measures to contain the COVID-19 pandemic. In New Zealand, border closures and economic lockdowns have led to an unprecedented decline in economic activity.

Economic activity has now restarted domestically as we have moved to Alert Level 2 and a number of other countries have made moves to open up their economies. However, economies are operating well below capacity and general economic conditions will remain weak as losses of income in directly affected sectors flow into a decline in overall demand. Unemployment will rise significantly.



## ***Wage subsidies and easier monetary policy have cushioned the near-term financial impact***

The Government and the Reserve Bank have worked together to cushion the losses of income associated with the economic lockdown. The Government's Wage Subsidy Scheme has provided short-term support to firms that have lost income, and has allowed them to retain staff.

The Reserve Bank has acted in a number of ways to lower borrowing rates in the economy, helping to reduce debt servicing costs for borrowers. We cut the Official Cash Rate to a record low, and began purchasing central and local government bonds in large scales to reduce interest rates. We also provided funding to banks when markets were volatile to ensure banks remained able to support customers.



## ***But some household and business borrowers will still come under stress***

Despite the broad range of support measures, some households and firms will face a significant loss of income. Firms in the tourism, accommodation and hospitality sectors are particularly affected, and will face longer recoveries as border restrictions and social distancing measures affect sales and operating models. Household incomes will also come under pressure as staff cutbacks and firm failures lead to rising unemployment.

Loss of income will mean that some borrowers have difficulty repaying their loans. As a result, banks are likely to experience more loan defaults and losses.



## ***Stress tests suggest banks can withstand loan losses under a broad range of scenarios***

Banks have strong buffers of capital and liquidity. These have increased substantially in the past ten years in response to increased regulatory requirements. Bank resilience will be tested in the coming months as loan losses rise materially from current low levels.

The Reserve Bank undertakes stress tests to understand banks' ability to absorb losses. While there remains considerable uncertainty about the economic outlook, stress tests suggest that banks can withstand a broad range of adverse economic scenarios while retaining sufficient capital to continue lending.



## ***The Reserve Bank has adjusted policies to enable banks to keep on lending***

Maintaining access to credit is crucial to ensure that households and businesses that are facing temporary losses of income are able to meet their financial obligations. The Reserve Bank has worked alongside the banking industry and the Government to ensure credit markets remain open.

To enable this, the Reserve Bank has delayed increasing capital requirements, relaxed rules on how much of banks' funding needs to come from long-term sources, and temporarily removed restrictions on low deposit loans. This helps to free up banks to continue supporting customers.



## ***Banks can support the economic recovery by continuing to lend to sound borrowers***

Banks will also have to play their part in supporting their customers. Banks have offered household and small business customers loan deferrals, to help them manage short-term financial stress. They have also offered business customers working capital facilities to help them manage cashflow while incomes have been low.

Maintaining the flow of credit to sound borrowers will contribute to the long-term stability of the banking system by reducing borrower defaults and preventing large falls in property prices and other asset values. Maintaining credit will also play a strong role in supporting the upcoming economic recovery.



# *Financial Stability Report*

May 2020



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# Chapter 1

## Financial stability risk and policy assessment

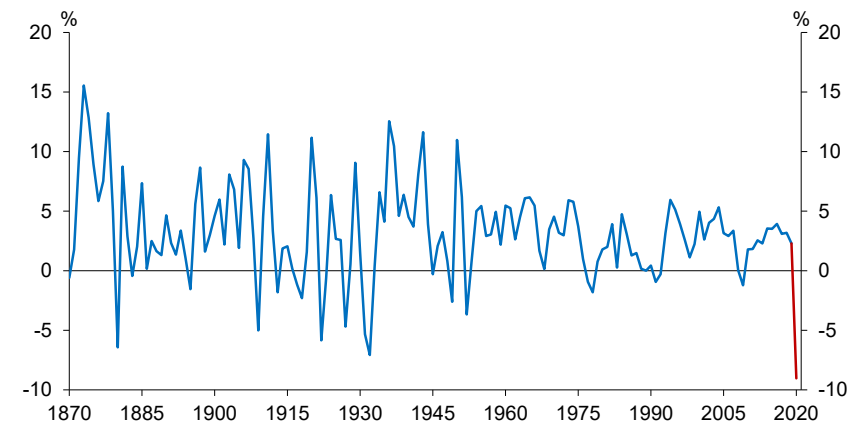


The financial system is well positioned to weather the economic impacts of the COVID-19 pandemic, and has been supported by a range of Government and Reserve Bank policy responses. The banking system has built up capital and liquidity buffers in the past decade as economic conditions have been favourable, and in response to increased regulatory requirements. Now is the time to use these buffers to support households and businesses, and enable an economic recovery. While there remains considerable uncertainty about the economic outlook, stress tests suggest that banks can withstand a broad range of adverse scenarios while retaining sufficient capital to continue lending.

### *COVID-19 has led to unprecedented economic disruption.*

The rapid spread of COVID-19 and associated public health measures to contain the outbreak has caused substantial disruption to global economic activity. In New Zealand, border closures and economic lockdowns have led to an unprecedented decline in economic activity. Even accounting for an expected recovery in the second half of the year, this year's projected decline in annual GDP is the largest in at least 160 years (figure 1.1). The associated losses in income will cause financial distress for a significant number of households and businesses.

**Figure 1.1**  
**Annual GDP growth**  
*(Baseline scenario from May Monetary Policy Statement)*



During the first phase of the COVID-19 response, the Government and the Reserve Bank have worked together to cushion the impact of business disruption caused by the economic shutdown. The Wage Subsidy Scheme and other fiscal policies have helped to mitigate some of the income loss during this period.



The Reserve Bank established a number of measures to ensure ample liquidity while financial markets were volatile, cut the Official Cash Rate to a record low, and began purchasing central and local government bonds in large quantities. These actions have lowered interest rates for borrowers, helping to minimise debt servicing burdens.

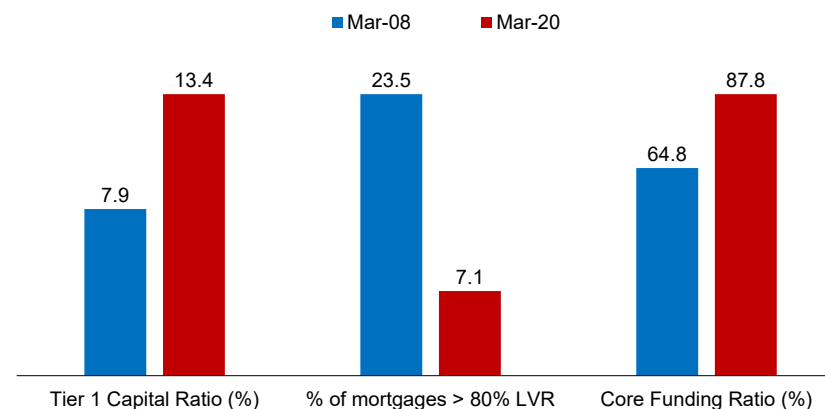
*The banking system has an important role in supporting recovery.*

Reflecting the critical role that the financial system plays in supporting borrowers facing income shortfalls, the Reserve Bank and the Government have also been working closely with the financial system to ensure that it can continue to support its customers. The banking system entered this crisis in a good position. Tougher prudential requirements have seen capital ratios increase to much higher levels than those prior to the Global Financial Crisis, as banks have retained a proportion of their high profits. Banks’ funding and liquidity positions are also much stronger, leaving them more resilient to the disruption that has occurred in financial markets in recent months.

To enable lending to continue to flow to households and firms, the Reserve Bank and the Government have been working with industry on a number of initiatives.

- Banks have offered household and small business customers that have suffered income losses as a result of COVID-19 deferrals of loan payments for a period of up to six months. This has been facilitated by an appropriate capital treatment of these loans by the Reserve Bank.

**Figure 1.2**  
**Measures of banking system soundness**



Source: RBNZ Capital Adequacy Survey, RBNZ LVR Lending Positions Survey, RBNZ Liquidity Survey, registered banks' Disclosure Statements.

- The Government has introduced the Business Finance Guarantee Scheme, which provides small and medium firms with partially Government-guaranteed loans at a low interest rate to manage short-term income disruption.
- The Reserve Bank has introduced term funding facilities for banks and has eased bank core funding requirements to alleviate liquidity and funding pressure on banks.
- The Reserve Bank has delayed implementation of planned increases to bank capital requirements by at least 12 months and imposed dividend restrictions to ensure that banks can use current capital buffers to support lending.

In addition, banks have continued to support existing customers by extending lending facilities and granting payment relief. Taken together, these initiatives have had a significant impact on supporting the short-term financial needs of households and businesses. This is important to limit failures of businesses with good long-term income prospects, and prevent mortgage defaults and foreclosures for borrowers facing short-term income declines. Ultimately, maintaining the flow of credit to sound borrowers will contribute to the long-term stability of the banking system by preventing large scale borrower defaults and disorderly corrections in asset markets.

### *Weaker economic activity will lead to loan losses.*

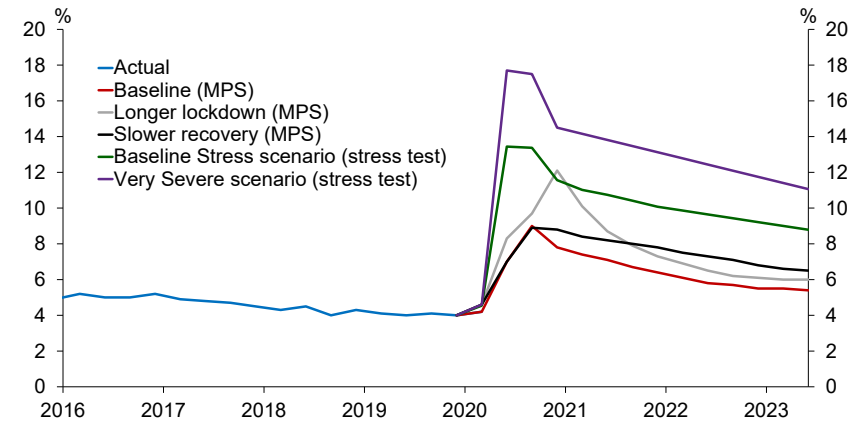
Nevertheless, banking system resilience will be tested in the coming months. COVID-19 will have prolonged and sustained effects on some parts of the economy and it is inevitable that some firms will fail. In the near term, pressure appears to be most acute in parts of the tourism, accommodation and hospitality sectors. Many firms in these sectors will face longer recoveries than others as border restrictions and social distancing measures will affect sales and operating models. Compounding difficulties, firms in these sectors often hold relatively low financial buffers.

Household incomes will come under pressure as staff cutbacks and firm failures lead to rising unemployment. For some households, particularly those that have high debt relative to their incomes, this is likely to lead to difficulty in servicing their mortgages. House prices are likely to fall, although strong equity buffers as a result of loan-to-value ratio restrictions will limit the number of borrowers who face negative equity.

### *Stress tests suggest banks are resilient to all but the most severe scenarios.*

Loan losses for banks will rise materially from current low levels. This could weaken banks' capital positions. The Reserve Bank has recently initiated stress tests of banks to assess their resilience to a significant worsening in the economic outlook. Preliminary desktop modelling suggests that, under a scenario featuring a larger increase in unemployment and a slower recovery than the most severe scenario published in the *Monetary Policy Statement* (figure 1.3), banks are likely to maintain capital ratios above minimum requirements.

**Figure 1.3**  
Unemployment rate under *Monetary Policy Statement* and RBNZ stress test scenarios



Source: Stats NZ, RBNZ estimates.

However, there remains considerable uncertainty about the future trajectory of the pandemic, and how this will affect the New Zealand economy. Under severe enough scenarios, the viability of banks would come into question. To illustrate this, a second stress scenario (broadly based on the Treasury's third worst economic scenario)<sup>1</sup> assessed the impacts of a further period of economic lockdowns that resulted in unemployment rising to nearly 18 percent and house prices falling by almost half. Initial modelling suggests that, without significant and timely mitigating actions, banks would fall below minimum capital requirements under this scenario. The Reserve Bank is working with industry to better understand the impacts that these scenarios would have on banks and to assess appropriate mitigating actions.

*Vulnerabilities exist in some parts of the financial system.*

Some parts of the financial system entered this crisis in an already vulnerable position. Some non-bank deposit takers (NBDTs) have low profitability and are operating with low financial buffers. There has been consolidation in the NBDT sector in recent years and this is expected to continue. Some life insurers have also been operating with low solvency buffers, some of which have been adversely affected by falling interest rates. In the past six months the Reserve Bank has applied licence conditions to these insurers to require stronger capital buffers, to mitigate the impacts of further reductions in interest rates.

More generally, COVID-19 is likely to affect insurers in a number of ways. For now, containment measures have been effective in limiting the disease outbreak in New Zealand, reducing the risk of significant life claims for insurers. However, a number of insurers are exposed to investment losses as a result of movements in interest rates, bond spreads and equity prices. Further, some providers of credit insurance appear vulnerable to a significant increase in unemployment.

**Mahi tahi: working together to ensure cash-flow and confidence<sup>2</sup>**



<sup>1</sup> See [treasury.govt.nz/publications/tr/treasury-report-t2020-973-economic-scenarios-13-april-2020](https://www.treasury.govt.nz/publications/tr/treasury-report-t2020-973-economic-scenarios-13-april-2020) for the set of economic scenarios the Treasury developed and published in April.

<sup>2</sup> See [rbnz.govt.nz/covid-19](https://www.rbnz.govt.nz/covid-19) for more detail on our response to COVID-19.

# Chapter 2

## Macroeconomic developments and vulnerabilities

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The rapid escalation of COVID-19 has led to major declines in economic activity around the world. Government-imposed containment measures to suppress the spread of the virus saw closures of a broad range of commercial activities. Social distancing, travel restrictions, and income losses mean that global economic activity will remain depressed for some time.

The immediate and direct consequences for the New Zealand economy of the measures taken, both globally and at home, have been massive. The Government, the Reserve Bank, and banks have responded to the sudden shock to household and business incomes in several ways. These have focused on providing temporary liquidity support, particularly to the most affected firms and individuals. Monetary and fiscal policy settings are also supporting overall demand in the economy.

While the initial shock from moving to Alert Level 4 has now passed, the New Zealand economy is operating well below its productive capacity. General economic conditions will remain weak as losses of income

in directly affected sectors flow into a decline in overall demand, and unemployment will rise significantly. High debt in some parts of the economy present a vulnerability that could be tested the longer and deeper the economic downturn is. However, the banking system remains in a strong position to continue supporting the economy through this downturn, and low government debt means that the Government is well positioned to provide fiscal support for the recovery.

### Economic impacts of COVID-19

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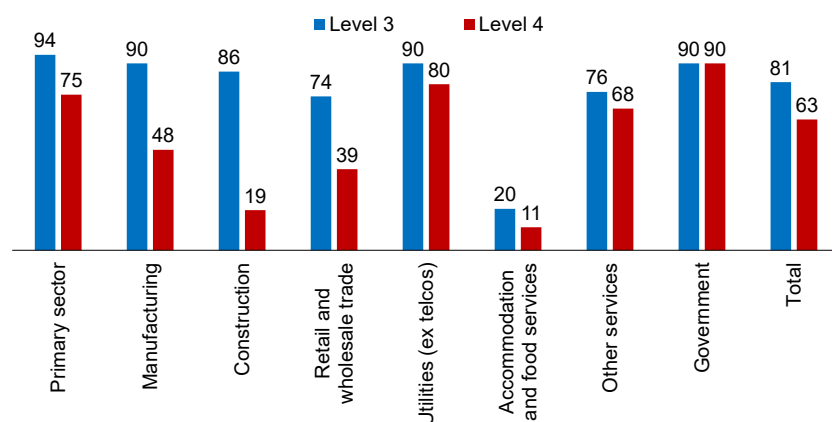
*The impact of the shock, and resilience to the shock, vary widely across sectors...*

The immediate impacts of the shock from COVID-19 varied across sectors, depending largely on the impacts of restrictions imposed to mitigate the spread of the virus on their business activities.

Under Alert Level 4 restrictions, entire industries were required to completely shut down in a short space of time (figure 2.1). Revenues are expected to only gradually pick up in a number of consumer-facing sectors, such as retail trade, food services, and domestic tourism, depending on the public health measures that are required to remain in place. Firms whose viability depends on inbound tourism face a more prolonged and challenging outlook. The export education sector also faces a challenging outlook, depending on how soon border restrictions can be relaxed.

Looking ahead, businesses' vulnerability to a recession varies widely as well, depending on their strength coming into this economic downturn as well as the extent of their exposure to the different channels of the shock.

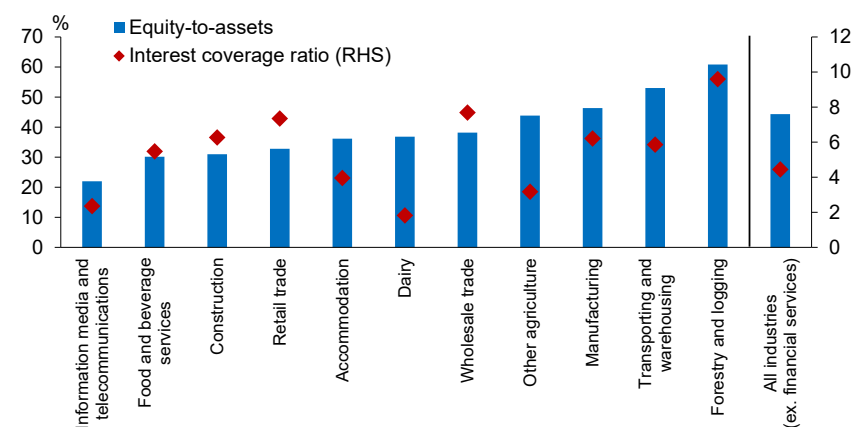
**Figure 2.1**  
Estimated feasible GDP by industry during Alert Levels 3 and 4  
(as % of counterfactual)



Source: RBNZ estimates. See Reserve Bank Analytical Note AN2020/04 for methodology.

Interest coverage ratios measure firms' ability to service their debts. These are low in some sectors, making them more vulnerable to losses of income (figure 2.2). Firms in some other sectors, such as retail trade, food service, and construction, went into the crisis with relatively better debt serviceability positions, but are still exposed to failure due to the severe drops in income they have experienced. They also tend to be more leveraged, with few tangible assets with which to secure ongoing funding, putting them at risk of insolvency during a prolonged downturn. Moreover, some of these vulnerable sectors faced particularly acute effects from the COVID-19 lockdown measures.

**Figure 2.2**  
Firm balance sheet and debt servicing vulnerability by sector



Source: RBNZ estimates based on Stats NZ *Annual Enterprise Survey* data.

Note: Figure shows the historical average from 2013 to 2018. Equity-to-assets ratio is calculated as shareholders' funds or owners' equity divided by total assets. Interest coverage ratio is calculated as the total income less total expenditure (excluding interest and donations) divided by interest and donations using aggregate industry values.

*...with the retail and hospitality industries severely affected...*

From 2013 to 2018, the average business in New Zealand could cover 85 percent of its near-term cash outflows from existing cash and accounts receivable (its 'quick ratio'). However, this ratio is lower in the accommodation (66 percent), retail trade (64 percent) and food services sectors (55 percent). This reflects a reliance on regular cash inflows to cover costs. The restrictions on business activity have severely reduced these cash inflows, placing significant liquidity pressures on businesses in these sectors.

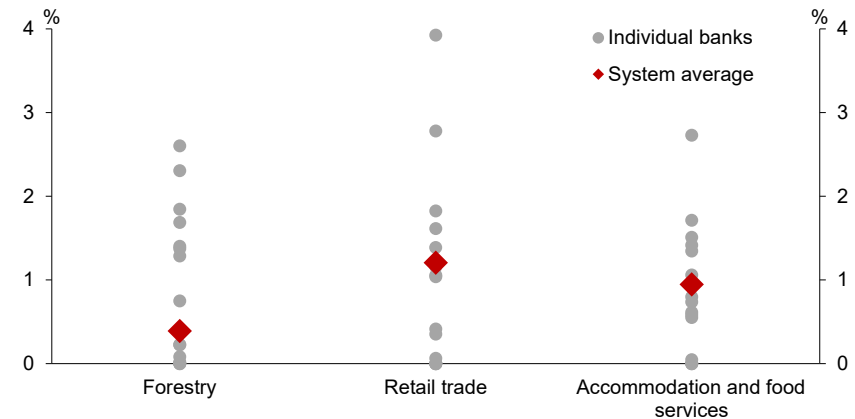
The collapse in the number of international arrivals has significantly affected businesses in sectors that are reliant on tourism. Many of these businesses are unlikely to recover in the short term, as some forms of border restrictions are likely to be maintained for the duration of the global pandemic. While some substitution of domestic tourists for international tourists is likely, overall demand for tourism and travel services will be weakened by economic conditions both domestically and abroad, including dampened domestic demand for business travel.

Many businesses in these sectors should be able to service long-term debt as economic conditions normalise and public health measures ease. Near-term liquidity shortfalls can therefore be met with further borrowing. However, those that do not have strong long-term outlooks may struggle to access sufficient credit and are at risk of failing from these liquidity pressures.

*...and some primary industries faced a relatively immediate shock, with longer-term uncertainty.*

Some sectors with large export markets in China were severely affected by disruptions in trade during the early phase of COVID-19. The forestry and logging sector in particular saw around a 30 percent fall in the value of exports in February and March, compared to the same months in 2019. Commodity volumes are expected to show some resilience; however, prices now face downward pressure as global economic conditions deteriorate.

**Figure 2.3**  
**Bank exposure by sector**  
*(lending by sector as a proportion of total lending)*



Source: RBNZ Bank Balance Sheet Survey.

*Banks' direct exposures to the most affected sectors are generally small...*

While many of these businesses were affected severely by the initial impacts of COVID-19, the lending to these sectors makes up a modest proportion of the banking system's total assets (figure 2.3). Forestry and logging makes up only 0.4 percent of the banking system's credit exposures, retail trade 1.2 percent and accommodation and food services 0.9 percent. Although concentrations on some individual banks' balance sheets are higher, losses on loans to businesses in these sectors are unlikely to undermine the stability of the financial system as a whole.

*...with the principal impact of the crisis on banks being the decline in overall economic conditions.*

Although banks' exposures to businesses in directly affected sectors are modest, the loss of income from these sectors will lead to a deterioration in broader economic conditions. Housing and personal consumer lending account for around 61 percent of banks' total lending, meaning banks are vulnerable to the combination of prolonged high unemployment and losses of household income, and a downturn in the housing market. Banks' general business lending, and lending for commercial property, are also expected to face stress from the broader downturn in conditions.

*Government and bank initiatives have supported businesses.*

Several schemes and policy initiatives have been introduced to cushion income losses during the decline in economic activity needed to effect the public health response to COVID-19. In limiting business failures and mortgage defaults, these initiatives in combination have also mitigated the cyclical feedback effects of economic downturns. Declining business

activity, rising unemployment, and mortgage foreclosures can exacerbate falls in asset prices and worsen income shocks to households and businesses. Without effective policy intervention, this in turn could lead to further business failures and households defaulting, which could ultimately undermine the stability of the financial system.

The largest fiscal response has been the Government's Wage Subsidy Scheme, with more than \$10.7 billion having been paid to employers by mid-May. To date, the scheme has helped to cover 12 weeks' worth of wage costs for 1.7 million employees. An eight week extension to the scheme is available to employers whose revenue remains low following the move down from Alert Levels 4 and 3. The Government has also made changes to business tax rules that will offset losses made in the current year, and lower tax burdens in future years.

Banks have supported business customers facing temporary income declines by offering loan restructuring options, including payment deferrals, switches to interest-only terms, and extensions to existing facilities. The Government and the Reserve Bank have supported banks' assistance to small and mid-sized businesses through the Business Finance Guarantee Scheme, and the Government has offered additional direct lending to smaller businesses through its Small Business Cashflow Scheme.

These initiatives have provided liquidity to many businesses while revenue streams have been severely diminished by the public health response to COVID-19. This has allowed many businesses that otherwise would have been profitable to avoid failing due to liquidity constraints, and remain viable as the economy begins to recover. Some of the policy responses, such as the wage subsidy and tax changes, have also partially offset business losses, mitigating some of the immediate solvency pressures.



## *Monetary policy will also help in the medium term.*

Broad economic responses have also reduced debt servicing burdens. Since February, monetary policy has been materially eased, with the OCR being reduced by 75 basis points (bps) and the Reserve Bank implementing Large Scale Asset Purchases to lower wholesale interest rates over longer terms. As these actions flow through to lower lending rates, debt-servicing costs across the economy will reduce, providing relief for households and businesses.

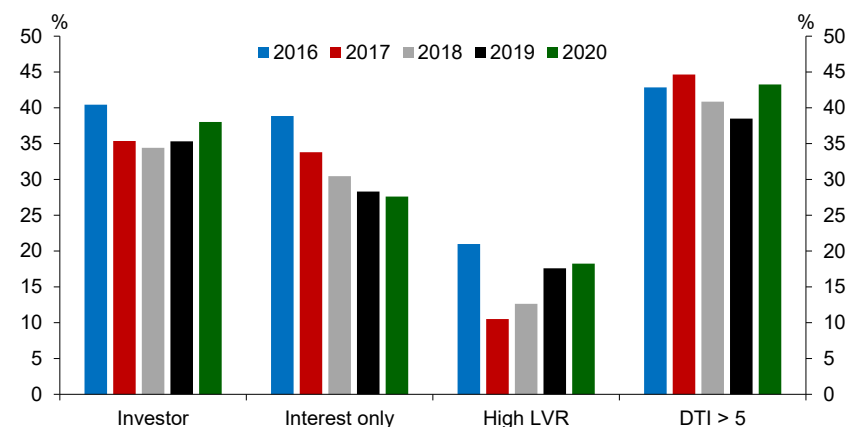
## Household balance sheets

### *Rising unemployment will put some households under financial stress.*

Households face income shocks through two key channels: an increase in unemployment from redundancies and business failures in sectors most directly affected by COVID-19; and reductions in pay as firms across a range of sectors look to offset pressures they face during the period of reduced revenue. The support packages for businesses, in particular the Wage Subsidy Scheme, have meant firms have been able to maintain more employees through the lockdown period than they could have otherwise.

For the household sector as a whole, debt-servicing burdens are not very high by historical standards, reflecting historically low interest rates. However, a high proportion of recent entrants to the housing market has taken on debt at high debt-to-income ratios (figure 2.4). These households will have less resilience to absorb declines or losses of income, and are more likely to be left in positions of being unable to service their mortgages.

**Figure 2.4**  
**Risk characteristics of new mortgage lending**  
*(% of new mortgage lending, three months to March)*



Source: RBNZ LVR New Commitments Survey, RBNZ DTI New Commitments Survey.

Note: High LVR is defined as LVR greater than 80 percent for owner occupiers and LVR greater than 70 percent for investors. DTI > 5 refers to new lending at debt-to-income ratios greater than 5.

Banks have supported mortgage and consumer credit borrowers with options to switch to interest-only terms or defer payments for up to six months, allowing them time to adjust to temporary income shocks without entering into arrears. As at mid-May, banks have reported granting payment reductions or deferrals on 13 percent by value of total household lending. However, by shifting loan repayments to future dates, payment deferrals ultimately increase households' debt servicing burden over the remaining term of their borrowing. If current pay reductions and elevated unemployment persist for a longer period than expected, households and banks may find that more substantial loan restructuring or remediation is necessary when deferral periods end.



### *The housing market is vulnerable to a downturn.*

Household stress could be accentuated by declining house prices. After nearly two decades of house price growth generally exceeding the growth rate of incomes (figure 2.5), the current economic downturn could bring a significant correction. Declining international arrivals, as well as the departure of temporary workers from New Zealand, may weigh further on housing demand. With the ratio of the median house price to median income near an all-time high, a major correction would test the resilience of households and lenders.

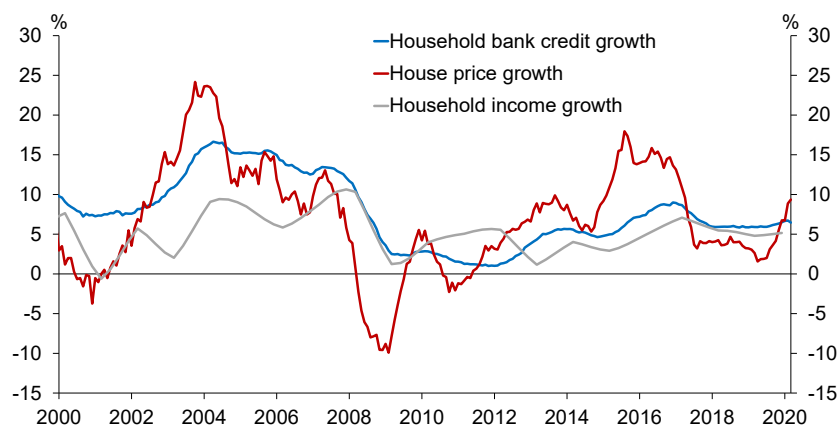
### *LVR restrictions have contributed to improved household balance sheets.*

However, most households have strong equity positions, and the introduction of loan-to-value ratio (LVR) restrictions has contributed to strengthened

household balance sheets. The proportion of households with low equity buffers has declined substantially since 2013, and is well below the Reserve Bank's estimates of what it would have been in the absence of LVR restrictions.

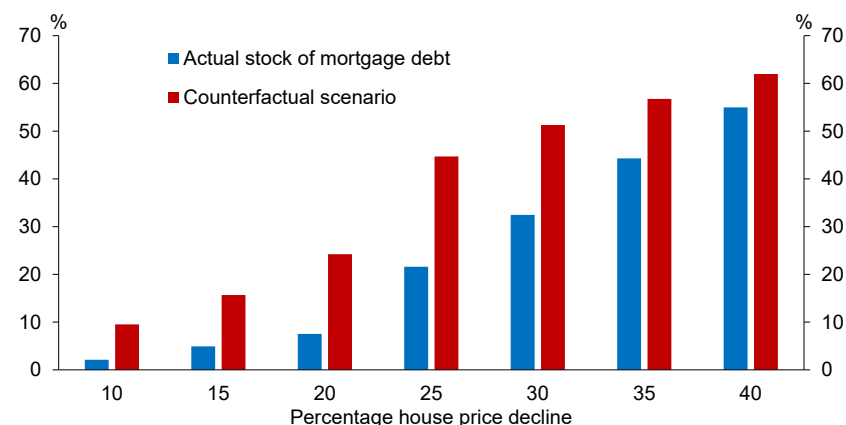
While LVR restrictions have had distributional impacts, overall they have been positive for financial stability. Household balance sheets are generally now able to absorb a greater decline in house prices without going into negative equity (figure 2.6). This leaves most borrowers in a position where they would be able to restructure debt to withstand temporary income losses. As a result, there will be fewer non-performing housing loans and fewer mortgagee sales, which reduces the chance of a negative feedback loop causing a more severe decline in house prices.

**Figure 2.5**  
Annual income, house price and bank household credit growth



Source: RBNZ Bank Balance Sheet Survey, Real Estate Institute of New Zealand, RBNZ Household Assets and Liabilities Survey.

**Figure 2.6**  
Housing debt at risk of negative equity, given declining house prices  
(% of housing debt)



Source: RBNZ LVR Lending Position Survey, RBNZ estimates.

Note: The counterfactual scenario estimates the LVR distribution that would have been likely to occur in the absence of LVR restrictions since 2013. This data is indicative and uncertain. Furthermore, the actual LVR distribution of the current stock of housing debt is reported by banks using the value of houses at the time of their last credit event, e.g. when a mortgage was last topped up, rather than the current house value.

From May, LVR restrictions were removed for a period of 12 months, at which time the policy setting will be reviewed. This was done so that banks would not be inhibited in assisting customers who may be experiencing temporary stress, and is not expected to result in banks materially easing their lending criteria in the current environment. The removal of the policy now does not undo the resilience benefits that have been made since 2013. The benefit of the LVR policy comes from having the restrictions in place while the housing market is rising, so that subsequent corrections will be less severe.

## Commercial property

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*The commercial property sector is vulnerable to the COVID-19 crisis...*

Commercial property – especially accommodation, hospitality, retail, and some office properties – was immediately affected by international travel restrictions and the Alert Level 4 measures. Many property owners have proactively offered rent reductions to support tenants during the downturn, but a prolonged economic slump will put downward pressure on rents and lead to increases in vacancy rates. Current development pipelines also indicate that an above-average volume of retail and accommodation

space is due to be delivered over the next 12 months in the Auckland and Queenstown markets. Demand may therefore struggle to keep pace with this increased supply, and the viability of some commercial property loans will be called into question.

*...and the financial system is exposed to risks in the sector:*

Commercial property has historically been a source of significant credit losses for banks, including in New Zealand. Banks' total exposure to commercial property is around \$40 billion, representing 8 percent of total bank lending, with around \$5 billion of this related to property development. In recent years banks have tightened lending standards to the sector: pre-sale requirements have increased; LVRs are more conservative; and banks have applied increased scrutiny around the quality of construction companies. Overall, this has improved the quality of bank lending to the sector. Problems in the commercial property sector are therefore unlikely to threaten financial stability on their own, but could exacerbate the downturn and weaken the financial system's resilience.

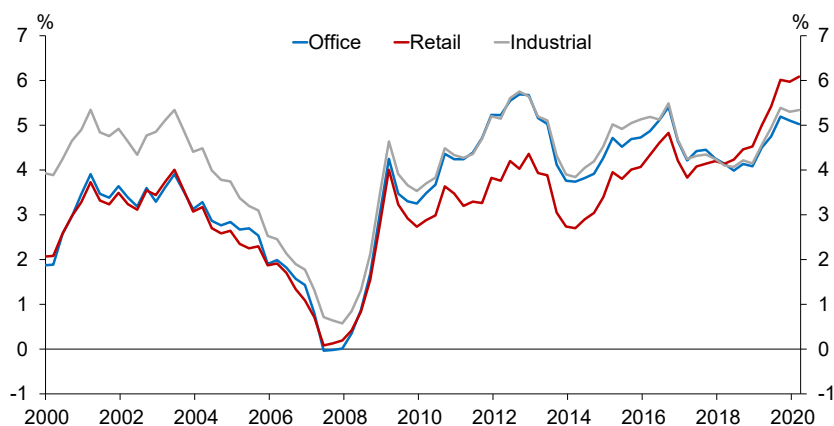
A number of characteristics of the commercial property sector contribute to its pro-cyclicality. Many investors are leveraged, with significant maturity mismatches on their balance sheets, and rely on rental income to service debt. Investors also tend to have relatively undiversified portfolios, and face single-tenant risk.

In recent years, commercial property yields have fallen significantly. Yield compression often signals increased risk tolerance, and heightens the risk of a price correction. Much of the recent yield compression, however, can be attributed to the fall in long-term interest rates. Risk premiums for commercial property have remained relatively stable in recent years (figure 2.7), suggesting that commercial property was not overvalued relative to other asset classes prior to COVID-19.

*COVID-19 may accelerate longer-term trends in the commercial property sector.*

Occupier demand for retail space may be permanently stunted as social and physical distancing measures accelerate existing trends towards online shopping. For office space, the recent experience of remote working may encourage firms to extend their flexible work arrangements, decreasing demand.

**Figure 2.7**  
**Commercial property yield**  
*(spread over 10-year swap rates)*



Source: Bloomberg, JLL, RBNZ estimates.

## Agriculture

*Agriculture has fared relatively well, but vulnerabilities in the sector remain.*

Lending to the agriculture sector is a key concentration of risk for the banking system, accounting for around 13 percent of bank lending, of which around two thirds is to the dairy sector. The sector is vulnerable to income shocks given its dependence on global commodity prices, and pockets of dairy lending have yet to recover from the 2015 downturn.

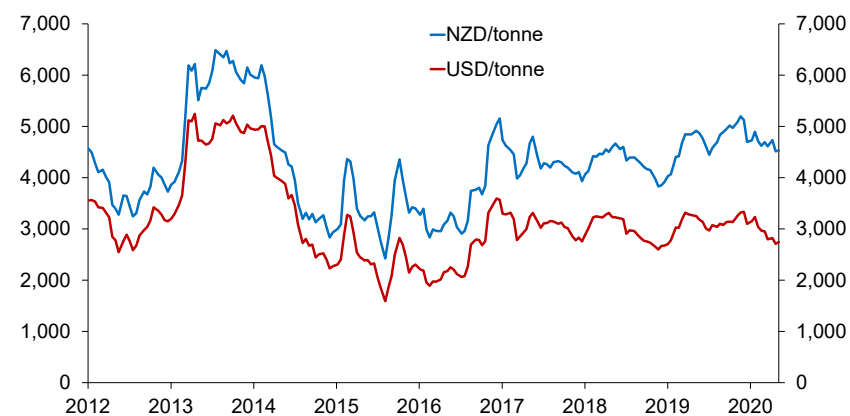
Low serviceability metrics indicate the agriculture sector has entered this crisis with a limited ability to take on more debt to absorb temporary falls in income. Areas in Northland, Auckland, North Waikato and Hawke’s Bay have also faced persistent drought conditions since December, creating further stresses. Some highly indebted dairy farms could face solvency and liquidity pressures were milk prices to fall materially.

Before the outbreak became a pandemic, commodity prices for the agriculture sector were stable, allowing the sector to avoid much of the initial economic impacts. Businesses in the primary sector were also generally able to operate under Alert Levels 4 and 3, unlike many sectors of the economy.

However, since COVID-19 became a global pandemic, the outlook has worsened somewhat. New Zealand dollar (NZD) dairy prices have fallen by around 8 percent since January (figure 2.8), while milk price futures for the 2020/21 season have fallen to around \$6 per kilogram of milk solids (kgMS) in May. This is still above the low prices of the 2015 dairy downturn, when the payout including dividend for farmers fell below \$5/kgMS. However, there remains a tail of highly indebted dairy farmers from that downturn, who generally require payouts above \$6/kgMS to break even. These farms could face significant stress if commodity prices continue to fall.

Border restrictions will also place pressure on labour costs for sectors reliant on seasonal migrant workers such as horticulture, although rising unemployment in the domestic workforce may partially offset this. Further borrowing to manage cashflows during a downturn in prices could also pose a further long-term risk to these sectors' ability to service debt.

**Figure 2.8**  
**Whole milk powder prices**



Source: Global Dairy Trade.

# Chapter 3

## International developments and bank funding



As a small open economy that borrows from abroad, New Zealand is vulnerable to disruptions in international trade and global financial markets. Offshore credit markets are a key source of funding for New Zealand banks, representing close to a quarter of their total funding, and facilitate the ongoing flow of credit to New Zealand households and businesses.

While offshore funding markets have exhibited stress with the escalation of COVID-19, steps taken in the past decade to improve the resilience of New Zealand banks' funding profiles have given them breathing space. The Reserve Bank has supported the functioning of domestic credit markets, and banks have reported elevated levels of liquidity. As a result, banks have been readily able to support the immediate liquidity needs of households and businesses despite the deterioration in global conditions.

### International financial market impacts of COVID-19

*Financial institutions and markets have provided lifeline support for affected businesses and households.*

Weaknesses in the balance sheets of major international financial institutions were the proximate cause of the breakdown of credit intermediation and the downturn in the global economy during the Global Financial Crisis (GFC). Entering this crisis, steps taken by regulators in the past decade have significantly improved financial institutions' capital and liquidity positions. This means that the global financial system is now better placed to support households and businesses to manage through the decline in economic activity that is necessary to suppress the pandemic. As well as using their own balance sheets, banks and other financial institutions are acting as conduits of substantial fiscal and monetary policy support, alleviating the economic impacts of COVID-19.

The rapid escalation of COVID-19 brought significant liquidity constraints, asset price corrections, and volatility to global financial markets. Further, depending on the depth and duration of ongoing containment measures, financial institutions face unknown impact, on their own financial positions, through increases in non-performing loans. In response, central banks and fiscal authorities have implemented extraordinary measures to ensure the continued operation of financial systems.

### *Volatile financial markets have brought sharp equity price corrections...*

After more than a decade of broadly uninterrupted expansion, world equity markets experienced a rapid decline in the space of a few weeks as the COVID-19 virus began to spread more rapidly outside Asia. From the end of February to mid-March, sharp price corrections erased more than a year's worth of gains in equities in advanced and emerging economies alike, before recovering some ground.

### *...with elevated uncertainty reflected in widening offshore funding spreads.*

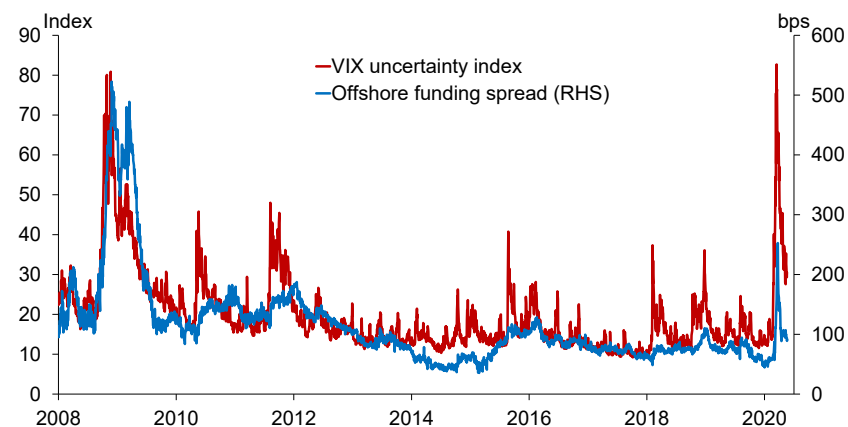
Volatility in equity markets reflects investors' weighing of the substantial decline in economic activity that will be experienced in the short term against the extraordinary measures monetary authorities are taking to lower risk-free interest rates across a long time horizon.

High levels of uncertainty regarding the nature and duration of the pandemic, as well as the effectiveness and impacts of containment responses, make it difficult to quantify the extent of economic decline

that will take place in the near term. Despite concerted global efforts, much is still unknown about COVID-19 and how best to fight it. As a result, financial markets have become volatile and sensitive to daily news on the outlook for COVID-19.

Uncertainty about the outlook is also reflected in offshore funding spreads, which represent the cost New Zealand banks would have to pay if they were to access term funding from international markets. Offshore funding spreads materially increased during March, although to a lesser extent than observed during the GFC (figure 3.1). This is a result of the extraordinary actions central banks have taken, including substantial liquidity programmes and loan guarantees, as well as the comparatively stronger financial positions of financial institutions entering this crisis.

**Figure 3.1**  
Offshore funding spreads and market uncertainty



Source: Bloomberg.

Note: The offshore funding spread is the cost of an AA-rated financial institution issuing a five year bond in the US relative to the five year US swap rate, accounting for the cost of swapping into NZD. The VIX index is an indicator of the market's expectation of the 30-day volatility in the S&P 500 equity index.

*Flexible exchange rates have helped to cushion the effects of COVID-19 for New Zealand commodity exporters.*

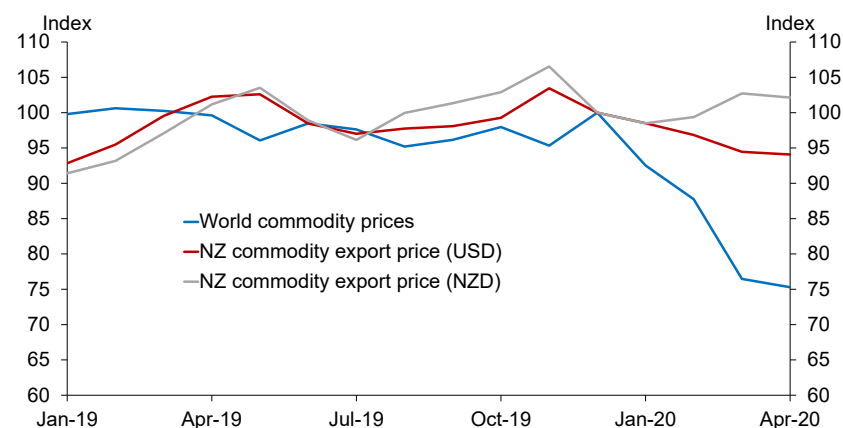
New Zealand's economy is also exposed to international developments through trade links and exchange rates. Over a quarter of New Zealand's output is exported, and international events such as COVID-19 affect the demand for New Zealand's exports.

While containment measures, including border closures, mean the near-total shutdown of the international tourism and education sectors is likely to persist for an extended period, New Zealand's commodity export prices have performed considerably better than other global commodity classes. The exchange rate has depreciated and partially insulated New Zealand commodity exporters from the deterioration in international conditions, albeit less than in previous crises. Globally, there has been a rebalancing of investors' portfolios towards US-dollar denominated assets. Combined, commodity export prices have increased modestly in NZD terms since the escalation of COVID-19 (figure 3.2).

*Government stimulus is an important lever despite structural challenges.*

COVID-19 has resulted in a simultaneous shock to aggregate demand and supply. Measures to contain the spread of the virus constitute a severe supply shock, disrupting global supply chains and national production capacities. At the same time, declining incomes and the deterioration in the global outlook have significantly dampened aggregate demand, weakening the capacity and confidence of the private sector to sustain

**Figure 3.2**  
Relative performance of New Zealand commodity export prices  
(index, December 2019 = 100)



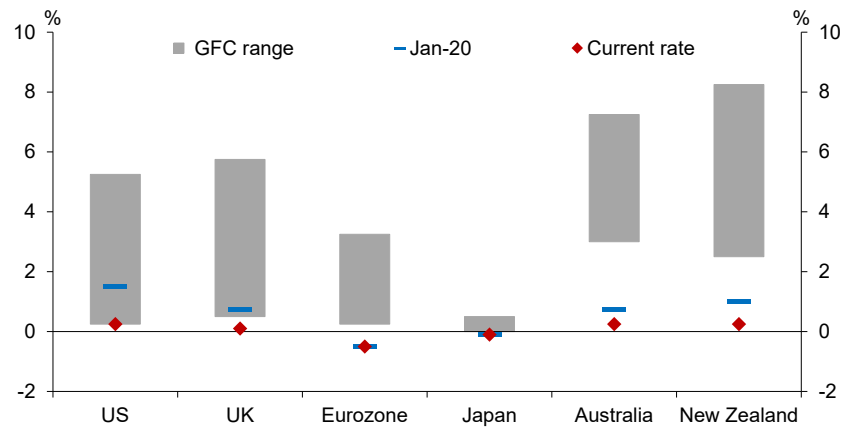
Source: Bloomberg, ANZ.

Note: The ANZ Commodity Price Index covers the prices of New Zealand's main commodity exports: dairy, meat and fibre, horticulture, forestry, and aluminium.

pre-crisis spending trends. To alleviate these immediate negative economic impacts, governments around the world have rapidly introduced substantial fiscal policy packages, including income support measures, changes in tax settings, and lending programmes to support household and business liquidity. However, many countries entered this crisis with limited fiscal and monetary headroom to further stimulate the economy. If containment measures need to be in place for a prolonged period, some governments may not be able to extend these support packages, presenting further risk to the global economic outlook.

Many central banks now have policy rates at historical lows, leaving little room to cut further, with some already in negative rate territory (figure 3.3). As the conventional monetary policy tools approached their lower bound, monetary authorities restarted or expanded previous crisis measures to ease conditions. These include purchasing a wider range of government and corporate bonds, ensuring debt servicing costs remain low for a wider range of borrowers.

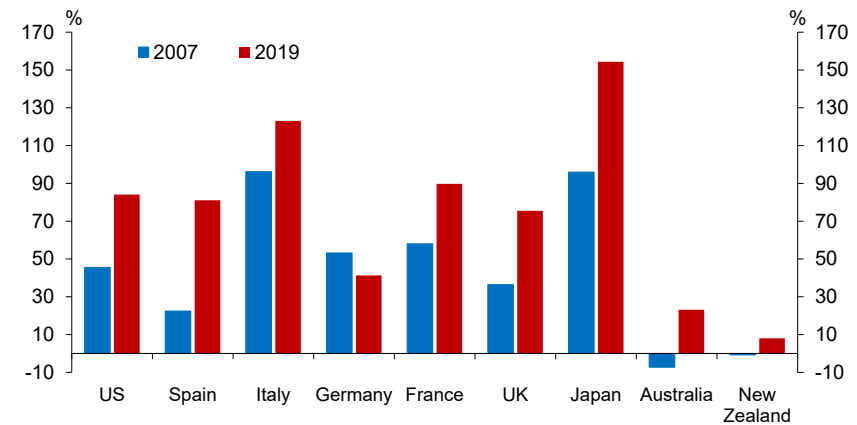
**Figure 3.3**  
Central bank policy rates



Source: US Federal Reserve, Bank of England, European Central Bank, Bank of Japan, Reserve Bank of Australia, Reserve Bank of New Zealand.

On the fiscal front, government debt ratios coming into this crisis were well above pre-GFC levels (figure 3.4). For advanced economies in particular, average net debt ratios reached 77 percent of total output in 2019, an almost two-thirds increase since 2007. The scale of current fiscal support, combined with ongoing national output losses, may mean that some countries face unsustainable public debt paths in coming years, which could slow the recovery in global demand.

**Figure 3.4**  
Net public debt  
(% of GDP)



Source: IMF Fiscal Monitor (2020).

Note: Net public debt (% of GDP) is defined as "gross debt minus financial assets corresponding to debt instruments. These financial assets are: monetary gold and SDRs, currency and deposits, debt securities, loans, insurance, pension, and standardised guarantee schemes, and other accounts receivable. In some countries the reported net debt can deviate from this definition on the basis of available information and national fiscal accounting practices".

Figures for New Zealand differ from the net core Crown debt published in the Budget, which excludes student loans and New Zealand Superannuation Fund assets.



## New Zealand banks' funding and liquidity

*New Zealand banks have strong liquidity buffers to draw upon to support households and businesses...*

New Zealand banks entered the crisis having built up strong liquidity positions in the prior decade. Prudential standards introduced since the GFC to address liquidity risks aim to ensure that banks support their lending with stable funding bases and have buffers of liquid assets available to meet their expected cashflow needs. The Reserve Bank now expects banks to draw on these liquidity buffers to support the ongoing provision of credit to households and businesses during the current period of stress.

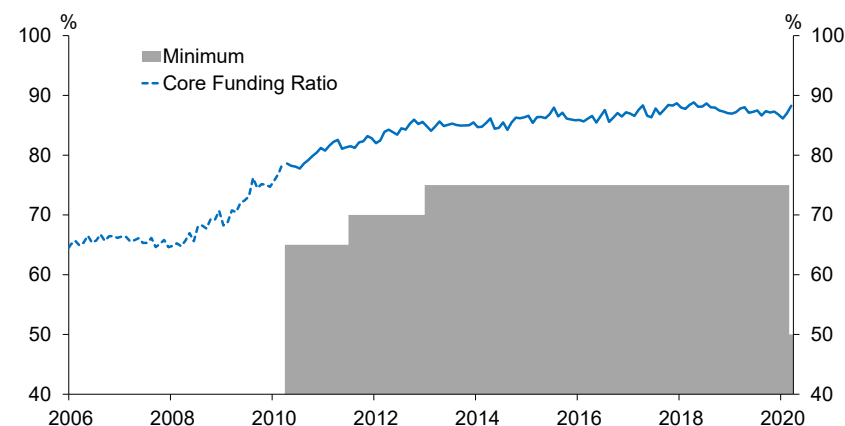
*...and banks' funding profiles are more robust than they were prior to the Global Financial Crisis.*

In the years prior to the GFC, New Zealand banks grew reliant on offshore, short-term wholesale funding. Wholesale funding is often quickly withdrawn from banks at the first sign of stress, or is only available at elevated cost. When the GFC hit, a dislocation in offshore funding markets caused significant liquidity problems for New Zealand banks, as it became difficult for them to roll over maturing market funding.

Since the GFC, banks have improved the resilience of their funding profiles by shifting towards more 'sticky' forms of funding. Under the Reserve Bank's liquidity policy, the Core Funding Ratio (CFR) requirement sets a minimum proportion of banks' lending that needs to be funded by retail deposits or long-term wholesale funding – so-called 'core funding'. The banking system's aggregate CFR peaked at 89 percent in April, well above pre-GFC levels (figure 3.5).

Having a more stable funding profile at longer maturities has allowed New Zealand's banks more breathing space to manage temporary disruptions in offshore funding markets. During March, funding conditions in wholesale markets deteriorated. Credit spreads widened, substantially increasing the cost of banks' access to wholesale funding. However, since February no New Zealand bank has needed to issue term funding in these markets, as the extension to the average term of their funding in recent years now allows banks to wait out the market turbulence, and only return to these markets when they have normalised.

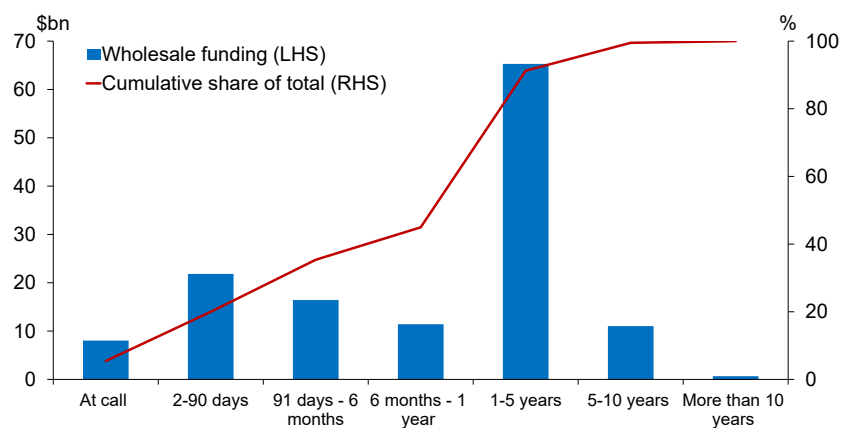
**Figure 3.5**  
**Banking system core funding**  
*(% of loans and advances)*



Source: RBNZ Liquidity Survey, RBNZ Standard Statistical Return.

Around \$46 billion of banks' wholesale funding is either at call or will mature by the end of September (figure 3.6). In total, this represents around 34 percent of wholesale funding, but less than ten percent of system-wide non-equity funding. Banks' stable funding positions have also been supported by strong net deposit inflows since the escalation of the crisis. This is mainly attributed to Government schemes such as the wage subsidy, but has also been supported by growth in household transaction and savings account balances. Credit growth in turn has been subdued, and negative in some categories, as borrowers have looked to pay down existing debts in the short term. Combined, these two factors have led to banks reporting increased CFRs for the time being.

**Figure 3.6**  
Residual maturity of New Zealand banks' wholesale funding  
(as at 31 March 2020)

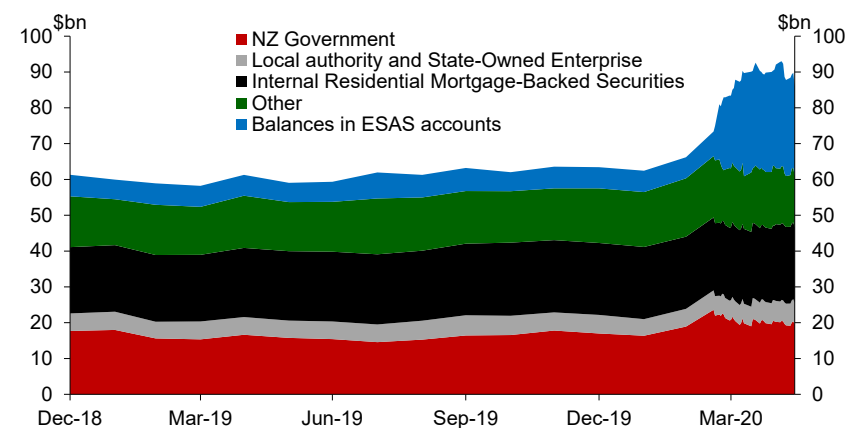


Source: RBNZ Liquidity Survey.

*Banks hold substantial reserves of liquid assets to meet customers' funding needs.*

Liquidity buffers refer to banks' stocks of liquid assets such as cash, central bank reserves, or government debt, which can be easily used to meet unexpected cash outflows (figure 3.7). Banks are inherently vulnerable to liquidity risk due to the maturity transformation role they play. To address this, the Reserve Bank sets 'mismatch ratio' requirements on banks. Banks are required to have sufficient liquid assets available to at least match their projected net cash outflows during hypothetical one-week and one-month periods of liquidity stress.

**Figure 3.7**  
Primary liquid assets of locally incorporated banks



Source: RBNZ Liquidity Survey.

Note: Value of liquid assets after applying liquidity policy haircuts. Daily data from 19 March 2020 onwards is reported by banks on a best endeavours basis.

Supported by the Reserve Bank’s Large Scale Asset Purchases the growth in banks’ liquid assets has seen mismatch ratios reach historically high levels, with the system-wide one-week and one-month ratios reaching peaks of 9.1 percent and 10 percent, respectively. Having these substantial reserves of liquid assets means banks are well placed to accommodate an increase in demand for liquidity from their customers.

In the coming months, the loan payment deferral programmes that banks have offered their customers are expected to contribute to a decline in banks’ mismatch ratios. Banks will see lower volumes of cash inflows as payments are deferred, while their cash outflows may increase as customers draw down on new and existing lending facilities. Mismatch ratios are therefore likely to decline from their recent highs.

## Reserve Bank action to support market functioning and liquidity

*During March domestic funding markets came under significant pressure...*

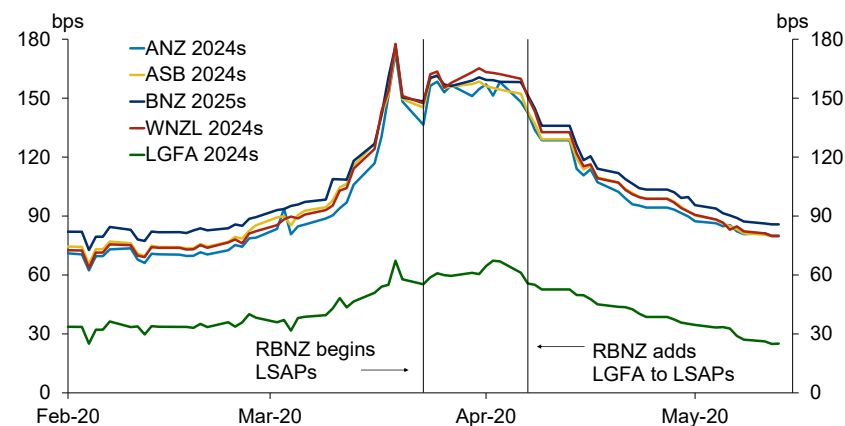
Conditions in domestic funding markets deteriorated throughout March. Heightened risk aversion and liquidity stresses caused investors to lose their appetite for New Zealand bonds, with interest rates on long-term New Zealand Government bonds rising substantially. This quickly permeated through funding markets, causing spreads to benchmark rates to widen.

*...and the Reserve Bank responded by easing monetary policy and announcing a suite of facilities to support market functioning.*

To offset the tightening in financial conditions the Reserve Bank moved to ease monetary policy and introduced a number of facilities to ensure the ongoing liquidity of the financial system. These actions sought to facilitate market functioning and reduce any pressure on banks’ ability to provide credit.

The Government bond yield curve has fallen and flattened as long-end yields declined. Yields on Local Government Funding Agency (LGFA) bonds, an important market benchmark, have decreased from highs reached in March. This has spilled over into wholesale funding markets, contributing to a material decline in credit spreads on bonds issued by New Zealand banks, albeit settling at slightly more elevated levels (figure 3.8).

**Figure 3.8**  
Long-term New Zealand bank bond yields, spread to swap rates



Source: Bloomberg.

To support the provision of liquidity to the non-financial corporate sector the Reserve Bank introduced a weekly Corporate Open Market Operation facility. The facility allows banks to use corporate debt instruments as collateral when borrowing cash from the Reserve Bank. This gives banks confidence to buy these debt instruments, secure in the knowledge they can be exchanged at the Reserve Bank for cash.

*...and liquidity facilities were established to help banks access cash.*

In its role as 'banker to the banks', the Reserve Bank introduced a number of liquidity facilities to allow banks to transform their assets into cash in the event that they are unable to access wholesale funding markets. These facilities range from daily market operations to ensure there

is sufficient cash in the money system, to the Term Auction Facility offering collateralised loans for up to 12 months. To complement the Government's Business Finance Guarantee Scheme (BFGS) the Reserve Bank also announced the Term Lending Facility offering loans for a term of three years. The facility provides a stable source of funding that aligns with the BFGS lending profile.

These facilities have worked to alleviate pressure in funding markets and provide banks with additional access to cash so they can continue to meet the liquidity needs of households, businesses, and other parts of the financial system. The existence of these liquidity facilities also provides banks with the confidence needed to operate for an extended period below the level of liquidity they would normally expect to maintain under business-as-usual circumstances.

# Chapter 4

## New Zealand's financial institutions

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*New Zealand's financial system is in a strong position, but its capacity to absorb shocks is not unlimited.*

During an economic downturn, a sound and efficient financial system acts as a shock absorber by supporting the many households and businesses that may face temporary losses of income but are viable in the long term.

In order to play this shock-absorbing role, financial institutions must build their capital and liquidity buffers during the good times so they can be drawn upon in the bad. In this respect, New Zealand's financial institutions have entered this economic downturn in a stronger position than in previous crisis episodes.

However, financial institutions' capacity to absorb shocks is not unlimited. COVID-19 has caused a fundamental change to the viability of businesses in many sectors of the economy and credit impairments will rise significantly. Initial results from stress tests suggest banks will be able to absorb losses associated with a broad range of adverse scenarios. However, there are limits to this resilience, and banks' capital positions could come under stress if the downturn in economic activity is more severe or prolonged than expected.

COVID-19 will also present a challenge for some insurers. For now, containment measures have been effective in limiting the disease outbreak in New Zealand, reducing the risk of significant life claims for insurers. However, a number of insurers are exposed to investment losses as a result of movements in interest rates, bond spreads, and equity prices. Further, some providers of credit insurance appear vulnerable to a significant increase in unemployment rates.

### Banks

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*Banks are well positioned to withstand the economic downturn caused by COVID-19.*

New Zealand's financial system is dominated by the banking sector. This means that the vast majority of small and medium-sized businesses are funded by a combination of owners' equity and bank lending.

Banks have substantially strengthened their capital and liquidity buffers since the Global Financial Crisis (GFC). While their credit losses were relatively modest, New Zealand's banks were exposed to severe liquidity challenges during the GFC as overseas funding markets froze. Following the GFC, the Reserve Bank imposed strict liquidity requirements on banks. Combined with banks' own moves to adopt more prudent funding profiles, these requirements have meant banks now have a higher share of longer and more stable forms of funding, such as domestic deposits and long-term wholesale debt. This has reduced their susceptibility to short-term funding market shocks.

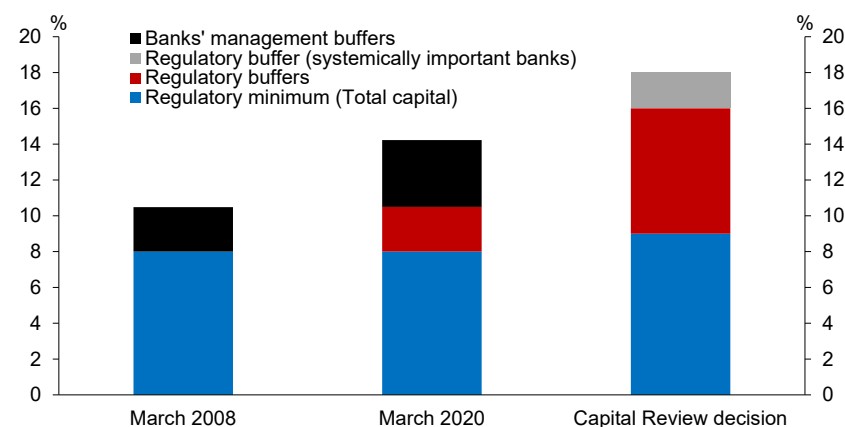
Banks' capital buffers have increased significantly in the past decade, in response to actual and forthcoming increases in regulatory requirements (figure 4.1). Larger capital buffers allow banks to absorb the credit losses that occur in an economic downturn while continuing to supply credit to the economy. Banks currently operate with an average Total capital ratio just above 14 percent of risk-weighted assets, up from about 10.5 percent in 2008. Furthermore, higher-quality Tier 1 capital now makes up a much greater proportion of banks' total capital.

In December 2019, the Reserve Bank finalised decisions in its review of the capital adequacy framework for locally incorporated banks, including confirming the proposed increase in regulatory capital requirements from current settings. The current events underscore the importance of significant capital buffers, and banks would be in a stronger position to withstand a further deterioration in economic conditions had they been implemented prior to this downturn. However, the transition to these higher levels of capital would be challenging for banks facing material but as yet uncertain credit losses. Facing declining earnings and lower

internal capital generation in the coming period, requiring banks to meet the previous transition timetable may have led them to ration credit availability unnecessarily. As such, the Reserve Bank has deferred the implementation of its Capital Review decisions for a period of at least 12 months, with a future decision to resume the transition dependent on economic conditions.

Since early April, the Reserve Bank has prohibited banks from paying dividends to their shareholders, or redeeming non-CET1 capital instruments, until the economic outlook has sufficiently recovered. This move will further support the capital positions of New Zealand banks.

**Figure 4.1**  
Capital ratios of locally incorporated banks



Source: Registered banks' disclosure statements, RBNZ *Capital Adequacy Survey*.

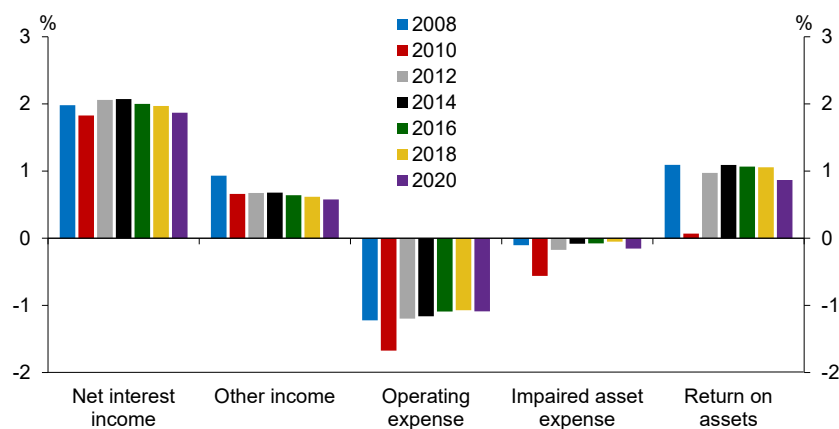
*Banks' profitability will be affected by rising non-performing loans in the downturn.*

New Zealand's banks are highly profitable by international standards. Their profitability is broad-based and has been stable over recent decades, supported by benign credit losses and a continued focus on cost efficiencies in their operating models (figure 4.2). Strong profitability has allowed banks to build their capital buffers over the past decade, and gives them room to withstand substantial credit losses in a downturn. For example, the sector's annual profit remained above zero throughout the GFC.

In March, non-performing loans represented 0.6 percent of banks' loan portfolios. Housing and business non-performing loans have come down considerably from their post-GFC highs (figure 4.3); these sectors represent more than 80 percent of bank lending.

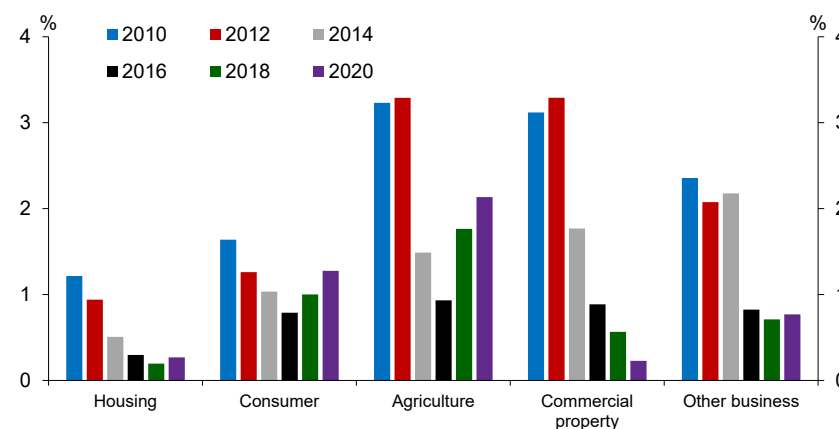
Agriculture loans, which make up 13 percent of bank lending, have seen higher rates of non-performing loans in the past year. These are concentrated among dairy farms, many of which became highly stressed during the dairy downturn in 2015 and 2016, and whose long-term viability remains uncertain in the absence of substantial restructuring of their balance sheets.

**Figure 4.2**  
Banking system profitability  
(% of total assets, year ending March)



Source: RBNZ Income Statement Survey.

**Figure 4.3**  
Non-performing loans by sector  
(% of gross loans, March quarters)



Source: RBNZ Bank Balance Sheet Survey.

Non-performing loans are expected to increase from these low levels during the next year. Many firms whose business models have been disrupted by COVID-19, and mortgage borrowers who face decrease in incomes, will struggle to make their loan repayments. The initial support packages that have been offered to borrowers mean it is likely to be some time before large volumes of non-performing loans begin to materialise.

In the near term, changes to accounting standards in recent years mean that banks are required to take a more forward-looking approach to provisioning for credit losses. Banks have reported significant increases in their credit impairment expenses in March 2020. This, and the coming months' data, will reflect banks' initial modelling and management judgements about future loan impairments. Impairment expenses will remain elevated, and potentially volatile, until banks have a clearer view of the ultimate level of loans that will become non-performing during the course of the current downturn.

### *Banks are supporting their customers in several ways...*

An immediate effect of moving to Alert Levels 4 and 3 was a decline in many borrowers' incomes. Where such declines are anticipated to be temporary, it is in both banks' and borrowers' interests to agree to renegotiate payment terms until the customers are in better positions to service their debt.

In March, the Reserve Bank worked with industry to facilitate a mortgage repayment deferral scheme, under which borrowers could apply to move to interest-only payments, or defer loan repayments entirely for up to six months. The Reserve Bank provided guidance to banks on how to apply the regulatory capital framework in these cases. This ensures that, in the short term at least, banks do not face mechanistic increases in capital requirements, which are typically required for loans restructured under

borrower distress. The Commerce Commission has also published guidance on the steps lenders should take to ensure their customer support packages meet responsible lending obligations. So far, banks have reported that around seven percent by value of household lending has moved onto interest-only payments, and a similar proportion has had full deferrals of repayments. Banks have also extended similar payment deferral options to small businesses and other consumer lending customers. For larger corporate borrowers, banks have taken a more case-by-case approach, working with clients to assess their short- and medium- term needs, and granting extensions of, or increases to existing facilities.

For small and medium-sized businesses, the Government's \$6.25 billion Business Finance Guarantee Scheme (BFGS) provides further options for borrowers to access medium-term working capital, on top of their existing facilities with banks. Under the scheme the Government is underwriting 80 percent of the credit risk of the lending, and the Reserve Bank is providing matched funding through the Term Lending Facility (TLF), priced at the OCR. Combined, the BFGS and TLF aim to further ensure the availability and pricing of credit to viable small and medium-sized businesses facing temporary challenges due to COVID-19.

### *...but the long-term viability of borrowers is uncertain.*

The support packages that banks have offered to viable borrowers ease debt servicing burdens at the current time. This helps to buy time for both banks and borrowers, on the basis that the borrowers' incomes will return in the future, and the additional debt burden will be sustainable. However, if the present economic downturn turns out to be deeper or more prolonged than banks and borrowers expect, banks will need to exercise caution not to 'extend and pretend' if the prospects of full repayment are diminished.



The Reserve Bank is undertaking a stress testing exercise with industry to assess the banking system's resilience to a more sustained and severe economic downturn than in the scenarios considered in the May 2020 *Monetary Policy Statement* (box A). Loan losses in the stress test scenarios would be substantial. The Reserve Bank's initial results suggest that while banks have sufficient capital to withstand a substantial downturn, the most severe scenarios could result in a number of banks failing to meet their minimum capital requirements without significant mitigating actions and capital injections from their shareholders.

### *The Reserve Bank has eased some of its prudential requirements.*

The Reserve Bank has delayed the implementation of the final decisions it made on its review of bank capital requirements, supporting banks' ability to provide credit to the economy during a period of lower earnings.

Banks' Core Funding Ratio (CFR) requirement has the objective of building up the resilience of their funding profiles to short-term funding market disruptions. As these funding market risks have crystallised in recent months, their strong funding profiles have meant banks have been able to draw on this resilience, and continue providing credit at a stable cost. The Reserve Bank reduced the CFR from 75 to 50 percent to ensure that the requirement does not constrain the provision of credit.

As discussed in chapter 2, the Reserve Bank has also removed LVR restrictions for 12 months. This will ensure that banks are not inhibited in supporting customers facing temporary stress.

### *Banks have adapted well to working from home.*

Like many New Zealand businesses, banks engaged their business continuity plans as the country moved to Alert Level 4 restrictions. Aside from relatively minor teething issues, banks' non-branch functions have largely been able to operate as normal. While most bank staff may continue working from home for a period, bank branches are expected to be open for longer hours with the country operating at less restrictive Alert Levels. To support financial inclusion it is important that banks keep their services accessible to vulnerable customer groups at this time.

Having a high proportion of staff working remotely may expose banks to heightened operational risk, from both increased IT disruptions and cyber-attacks. Two large banks experienced major system outages in April and May, affecting customers' access to online banking and payments for several hours. The banking system has not been affected by a major cyber-attack to date, but banks must work continuously to strengthen their resilience to ensure this remains the case.

**Table 4.1***Key metrics for New Zealand's banking system*

Metric	Value (%) Current	Value (%) 1 year ago	Regulatory minimum (%)	Comment
Tier 1 capital ratio	13.5	13.6	8.5*	Banks' capital ratios remain above regulatory minimums. The Tier 1 capital ratio has been stable over the past year, and is high by historical comparison.
Mismatch ratio (one month)	7.4	6.0	0	All banks are compliant with their minimum mismatch requirements and are therefore expected to be resilient to both one-week and one-month periods of liquidity stress.
Core funding ratio	88.3	87.8	50	Banks have high levels of stable funding. This helps to protect them against a disruption in funding markets. The core funding ratio requirement has been eased to allow banks to use the funding buffers they have built up.
Return on assets (after tax)	0.9	1.1		Banks remain profitable relative to most OECD countries' banks. Strong profitability supports the resilience of New Zealand's banking system.
Net interest margin	2.0	2.1		Banks' gross profits from their borrowing and lending activities are high by international standards. These have been relatively stable over the past year.
Non-performing loan ratio	0.62	0.62		Banks' non-performing loan ratios have entered this economic downturn at low levels. It will take time for the effects of the COVID-19 downturn to flow through to non-performing loans for banks.
Cost-to-income ratio	44.5	39.5		The banking system's costs are low relative to its income when compared to other countries, although the cost-to-income ratio has risen over the past year.

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

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

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

## Box A

# Stress testing New Zealand banks' resilience to COVID-19

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The Reserve Bank is currently undertaking stress test exercises to assess the banking system's resilience if the economic downturn becomes very prolonged. The two scenarios developed to test the banking system have similar economic projections to the Treasury's COVID-19 scenarios 2 and 5 during the peak of the recession in the first 18 months (table A.1).<sup>3</sup> In the subsequent recovery phase, as the virus world-wide is brought under control, the bank stress test scenarios assume a protracted global slowdown and a slower recovery for the New Zealand economy than the Treasury's scenarios. Both scenarios are significantly more adverse than the scenarios published in the May 2020 *Monetary Policy Statement*.

The Reserve Bank is assessing the impacts of these scenarios in two stages. In the first, the Reserve Bank is modelling the scenarios using the prudential data that banks are required to regularly report. In the second the Reserve Bank will collaborate with stress testing staff at the five largest banks in the coming weeks.

Results from the Reserve Bank's modelling indicate that banks can maintain capital above their minimum capital ratios in the Baseline Stress scenario. Banks are projected to fall into their capital conservation buffers, meaning they would be meeting their regulatory requirements but also required to develop plans to repair their capital positions over time.

Preliminary results from the Very Severe scenario illustrate that there are limits to the economic shocks that New Zealand's banks would be able to withstand with their current capital positions. In this scenario, the Reserve Bank's modelling shows that banks would likely fall below several of their minimum regulatory capital requirements. In this situation, banks would have to undertake significant recovery responses such as raising new capital from shareholders to avoid resolution options.

Some of the economic scenarios produced by the Treasury in April are significantly more severe than the scenarios the Reserve Bank is assessing, in terms of the level of unemployment and decrease in economic activity. Under these more extreme (and less likely) scenarios, additional capital and other mitigating actions would be required to avoid widespread failure in the banking system.

This conclusion is in line with those of previous Reserve Bank stress tests, which indicate that New Zealand's banks are resilient to a broad spectrum of downturn events, although not all tail scenarios. Results from these exercises will be further refined as the Reserve Bank works with banks' staff to understand and model how these scenarios would affect their institutions.

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<sup>3</sup> See [treasury.govt.nz/publications/tr/treasury-report-t2020-973-economic-scenarios-13-april-2020](https://treasury.govt.nz/publications/tr/treasury-report-t2020-973-economic-scenarios-13-april-2020) for the set of economic scenarios the Treasury developed and published in April.

**Table A.1***Scenario parameters for Reserve Bank COVID-19 stress test*

<b>Stress parameter</b>	<b>Baseline Stress scenario</b>	<b>Very Severe scenario</b>	<b>Baseline scenario (May MPS)</b>
<b>Peak unemployment rate (%)</b>	13.4	17.7	9.0
<b>Unemployment rate in December 2022 (%)</b>	9.2	11.8	5.5
<b>Cumulative house price decline (%)</b>	36	48	9
<b>Recovery of real GDP to its December 2019 level</b>	June 2023	June 2024	March 2022

## Non-bank deposit takers

Non-bank deposit takers (NBDTs) include building societies, credit unions, and finance companies. The NBDT sector is small, representing 0.6 percent of total deposits, and has been regulated by the Reserve Bank since 2010. There are currently 20 licensed NBDTs, of which one is in receivership.

Some NBDTs have low profitability and are operating with low prudential buffers. Although the Reserve Bank's regulations are conservatively calibrated, the Reserve Bank does not operate a 'zero failure' regime, and it is possible for NBDTs to fail. A finance company, FE Investments, was placed into receivership in April. FE Investments' financial position was weak prior to COVID-19 due to impairments it faced on a concentrated loan portfolio. While failures of NBDTs have significant impacts on individual depositors, they are unlikely to threaten the stability of the financial system overall.

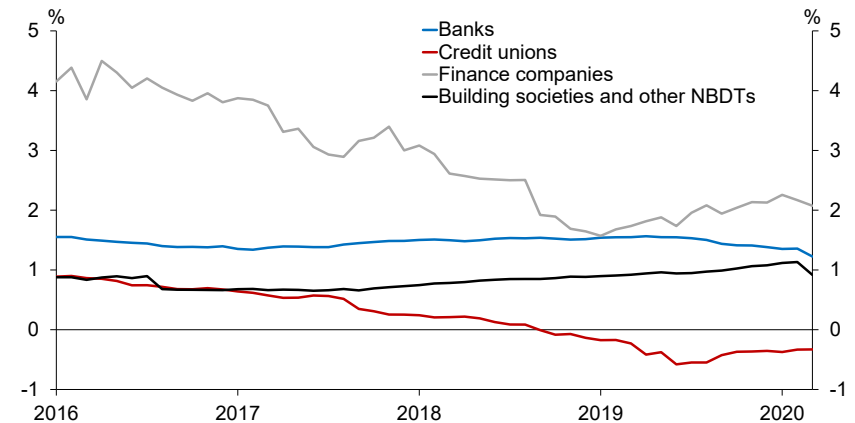
As in the banking sector, credit losses are likely to increase for NBDTs in the coming months as a result of COVID-19, particularly in higher risk segments such as consumer lending, where a number of NBDTs have a concentration of lending. This will put further stress on NBDTs' profitability and capital buffers. Although the profitability of some institutions has improved in the past year, the sector remains weak when compared to registered banks (figure 4.4), particularly in the case of credit unions.

Liquidity is also a risk for NBDTs. Many NBDTs are almost wholly funded by retail deposits, with around half of credit unions and building societies' retail funding at terms of less than 90 days. Reinvestment rates for some finance companies' term deposits have been lower than usual in recent months, at around 50 percent. This can be expected during an economic

downturn, as depositors may need access to their money if they experience losses of income and may look to place their funds at lower risk institutions in the current circumstances. Deposit funding at credit unions and building societies has been relatively more stable.

There has been consolidation in the NBDT sector in recent years and this is expected to continue. Many of the profitability challenges faced by the NBDT sector are due to lack of scale, with high operating costs relative to revenue. Some NBDTs that depend on customer transaction volumes experienced declines in revenues during Alert Levels 4 and 3, with a number of NBDTs and related entities having accessed the Government's Wage Subsidy Scheme. Several credit unions are dependent on a payments system provider, Co-op Money<sup>4</sup>, which has experienced declining revenue for some years, and required a capital injection from its clients late last year. Further consolidation may be necessary to improve both the efficiency and stability of the NBDT sector.

**Figure 4.4**  
Annual return on assets of banks and NBDTs, before tax



Source: RBNZ Income Statement Survey, RBNZ NBDT Prudential Return.

Note: Based on currently licensed NBDTs, including the contribution of predecessor NBDTs where relevant. Excludes UDC Finance. Building societies and other NBDTs includes Christian Savings Limited.

<sup>4</sup> Not to be confused with The Co-operative Bank.

**Table 4.2***Selected metrics for the non-bank deposit-taker sector*

Metric	March 2020			March 2019		
	Building societies and other NBDTs**	Credit unions	Finance companies	Building societies and other NBDTs	Credit unions	Finance companies
Total assets (\$m)	1,273	1,122	227	1,189	1,140	254
Capital ratio* (%)	12.3	13.9	16.9	11.7	14.8	15.3
Non-performing loan ratio (%)	0.1	2.7	7.0	0.1	2.8	5.5
Return on assets before tax (%)	0.9	-0.3	2.1	0.9	-0.2	1.7

Source: RBNZ *NBDT Prudential Return*.

Note: March 2020 data excludes FE Investments Limited (in receivership).

\* The minimum capital ratio is 8 percent for licensed NBDTs with a credit rating from an approved rating agency. For those without a credit rating from an approved rating agency, the minimum capital ratio is 10 percent.

\*\* Includes Christian Savings Limited.

## Insurance sector

Insurers have an important role in the financial system through their spreading of households' and businesses' risks. General insurers account for the largest part of the New Zealand insurance sector, with around 62 percent of total gross premium revenue. Life insurers account for around 25 percent, with health insurers around 13 percent.

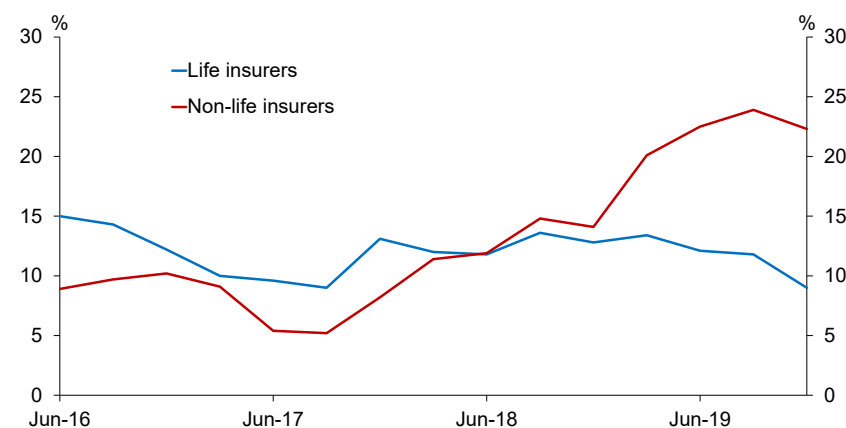
### *General insurers have experienced elevated profitability in the past two years.*

Gross premium revenue has grown steadily in the past two years for all types of insurers, although net premium growth for the life insurance sector has been lower due to increased reinsurance for a couple of large insurers. Claims costs for general insurers have been relatively stable, assisted by few large claim events. As a result, general insurers have reported relatively healthy profitability in the past 18 months (figure 4.5).

### *Some insurers have been affected by falling interest rates.*

The solvency positions for some insurers is adversely affected by a fall in interest rates. In the past six months the Reserve Bank has applied licence conditions to these insurers to require a stronger capital buffer to mitigate the impacts of further reductions in interest rates. Other insurers' solvency positions are improved by a fall in interest rates.

Figure 4.5  
Annual return on net assets



Source: RBNZ Quarterly Insurer Survey.

### *COVID-19 is expected to affect insurers in a number of ways.*

There is considerable uncertainty as to how COVID-19 and the associated economic downturn will affect New Zealand insurers. The Reserve Bank has undertaken preliminary stress testing of insurers' exposure to a range of channels through which COVID-19 could affect their financial soundness.

*Direct impacts as a result of COVID-19 are likely to be modest...*

Death and disability claims to life insurers resulting from COVID-19 do not currently pose a threat to their solvency, as a result of the strong public health response to the initial spread of the virus in New Zealand. However, COVID-19 could play out in a number of ways, and it remains possible that a second or further wave of the pandemic will occur in New Zealand. The Reserve Bank's life insurance solvency standard requires reinsurance and capital to meet the cost of pandemic death claims for 0.1 percent of insured lives, which equates to at least several thousand deaths in total in New Zealand.

The initial response to COVID-19 created major disruptions to economic activity, particularly the travel industry. Claims on travel insurance have been high, and a significant backlog was created at a number of insurers. Business interruption claims applications were also elevated as a result of New Zealand's move to Alert Level 4, however most policies have exclusions for pandemics.

*...while claims for credit insurance policies and investment losses will rise as the economic downturn deepens.*

As unemployment rises, claims will increase for credit insurances (e.g. credit card repayment insurance and loan repayment insurance). A number of credit insurers associated with banks, NBDTs and finance companies provide payment insurance to borrowers from these institutions. The Reserve Bank estimates that some of these insurance providers would come under stress from increasing redundancy claims if unemployment reached 10-13 percent.

More broadly, insurers are exposed to economic conditions through the value of their investment portfolios. Most insurers operate conservative investment portfolios, and solvency stresses at insurers do not primarily arise from losses on their investments. However, life insurers with higher risk investment portfolios including large equity investments that are not part of investment-linked insurance products are exposed to further declines in equity prices. Corporate bond defaults and increased credit spreads on a scale larger than observed during the GFC would see stresses spread to several insurers.

General and health insurers are likely to be resilient to all but the most catastrophic of scenarios, and many will see reduced claims in the short-term due to the decreased economic activity.

*Insurers are supporting customers through COVID-19.*

The experience and learnings from the Christchurch and Kaikoura earthquakes have served insurers well so far, with most reporting successful functioning of their business continuity planning systems and processes during Alert Levels 4 and 3.

Sales volumes of new policies slowed as New Zealand moved to Alert Level 4. Insurers have reported that cancellations and surrenders of policies have been elevated, and increasing numbers of customers have applied for financial hardship offerings. A mix of approaches has been taken by insurers, including suspension of premiums and cover for a period, premium discounts or rebates, and deferrals of premium increases.

The insurance industry has an important contribution to make to the economic recovery through a continued focus on customer needs, as the availability and affordability of insurance is important for many business activities.



**Table 4.3***Selected metrics for the insurance sector*

Metric	Value (%)		Reg. min. (%)	Comment
	Current*	1 year ago*		
<b>Non-life insurers</b>				
Solvency ratio – general	191**	151	100	All general insurers are currently meeting the Reserve Bank’s solvency requirements. Buffers have improved.
Solvency ratio – health	422	344	100	Health insurers have stronger capital buffers than general insurers, reflecting the fact that many are mutual companies with restricted access to capital.
Profit margin	9.4	6.4		Profit margins appear to be in line with those of international peers. Margins for both general and health insurers have increased during the year.
Expense ratio	13.6	13.8		Expense ratios compare favourably with those of international peers. Expense ratios for health insurers are lower than those for general insurers.
<b>Life insurers</b>				
Solvency ratio	133	129	100	Life insurers are currently meeting the Reserve Bank’s solvency requirements. Buffers have improved slightly on average, but in some cases insurers are operating very close to their regulatory minimum.
Profit margin	11.9	17.9		Profit margins appear to be high relative to international peers, although they have decreased during the year. Bancassurers*** and mature traditional businesses tend to have higher profits than insurers that distribute through advisors.
Expense ratio	22.7	21.5		Bancassurers have expense ratios in line with international averages. Expense ratios for other types of life insurer are significantly higher.

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

\* Profit and expense figures – from quarterly insurer survey to December 2019 for current, and to December 2018 for 1 year ago. These cover just under 90 percent of the insurance sector by premium. Profit margin is profit after tax divided by gross premium (expressed as a percentage); 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 – current is from monthly return at March 2020 supplied on best endeavours basis, 1 year ago is from the latest available solvency return at financial year-end or half-year to March 2019.

\*\*\* Bancassurers are insurers that distribute products largely through banks.

## Financial market infrastructures

Financial market infrastructures (FMIs) – such as payment systems, settlement systems, central counterparties, central securities depositories and trade depositories – deliver services that are vital to the smooth functioning of the financial system. The services provided by FMIs enable payments for goods and services to be made, allow equities and securities to be held and sold, and facilitate risk management.

### *FMIs are resilient in the face of COVID-19.*

The Reserve Bank, in conjunction with the Financial Markets Authority, has closely monitored how New Zealand-domiciled FMIs have responded to COVID-19. These include designated FMIs (NZCDC, ESAS, NZClear), and other significant FMIs such as those processing debit and credit card transactions. The Reserve Bank has also engaged with the home regulators of overseas FMIs.

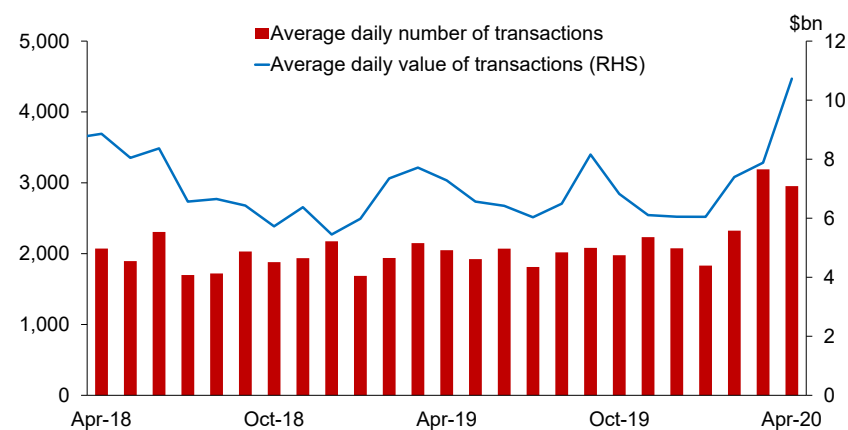
The Reserve Bank is satisfied that all the FMIs it has engaged with have implemented robust operational arrangements to enable them to continue to provide services. These measures have included some combination of the physical separation of key operational staff and having staff work remotely.

The Reserve Bank-operated FMIs, ESAS and NZClear, which are central to the functioning of the New Zealand financial system, have proved to be resilient to pressures arising from COVID-19 with no indication of a significant increase in the risk of disruption.

When the extent and likely consequences of the situation became apparent in early March, increased uncertainty and volatility in financial markets caused a significant increase in trading. Domestically this increased activity was reflected in much higher than normal volumes of trades to be cleared and settled through the NZCDC and NZClear systems (figure 4.6).

The NZCDC system, which settles and clears trades on the NZX exchanges, has experienced some disruptions caused by abnormal volumes, although all trades have been successfully processed, albeit with delays on some occasions. NZCDC is implementing measures to reduce the likelihood of on-going issues, including upgrading the software underlying the system to increase communication and trading capacity, and asking system participants to use the system more efficiently.

**Figure 4.6**  
NZClear transactions



Source: RBNZ.

To assist market participants to process higher volumes of securities transfers, the operators of the NZCDC and NZClear systems and the two securities registries have agreed temporary extensions to normal end of day deadlines.

### *The Reserve Bank has worked to ensure the smooth flow of cash.*

The Reserve Bank worked with banks and their service providers to ensure the functioning of the cash system through each Alert Level. There was a significant increase in demand for cash from banks, retailers and the public in the days leading up to the country's move to Alert Level 4. As an essential service, ATMs and other retail cash operations continued as normal, with no material disruptions reported. Currency in circulation rose by around \$800 million over the month of March, and it is expected that most of this will return to the Reserve Bank as New Zealand continues to move to lower Alert Levels.

### *The payments industry has also supported the response to COVID-19...*

The payments industry has also responded to COVID-19 by agreeing to increase the limit on contactless card payments from \$80 to \$200. The temporary increase applies to most contactless cards and means that a lot more transactions can be completed without the need for customers to touch the keypad on payment terminals. The speed with which this change was agreed and safely implemented is far from normal circumstances and represents a good outcome, and a welcome degree of co-operation between the various entities involved.

### *...but the longer-term impact of COVID-19 remains to be seen.*

Before the onset of COVID-19, the payments industry, largely under the auspices of the industry body Payments NZ, was working on a number of initiatives aimed at significantly enhancing the payments environment. These work streams included enabling interbank settlements to occur on every day of the year, instead of just on 'business days' as at present; investigating ways to further speed up retail payments; further improvements to the resiliency of card payments; and encouraging the development of applications that make use of standard Application Programming Interfaces (APIs) to allow bank customers to share account information with others and to make payments more efficiently.

At this stage, it is not clear what impact, if any, COVID-19 will have on these initiatives. There may be some delays due to disruption to normal work practices or the pandemic may highlight other issues that require attention. The Reserve Bank will continue to monitor developments with respect to these various innovations. While the Reserve Bank has encouraged the industry to progress work quickly, especially work to make use of APIs, it does recognise the challenges that the current circumstances bring.

### *New Reserve Bank systems have been successfully implemented.*

Over the last couple of years the Reserve Bank has been developing replacement systems for the two FMIs that it operates: the Exchange Settlement Account System (ESAS, a real time gross settlement system for interbank payments) and NZClear (a system for clearing and settling securities transactions). These systems are critical to the New Zealand financial system, allowing individuals, businesses and institutions to settle their financial obligations. It is a key priority for the Reserve Bank that these systems operate safely and efficiently. The old systems were approaching the end of their operational lives, and supplier support was ending. In February 2020 the new systems successfully went live, and have operated satisfactorily since then despite the added challenges presented by COVID-19. The new systems will ensure the ongoing reliability of ESAS and NZClear.

ESAS has had 100 percent availability since the new system was introduced. NZClear has had some minor operational incidents, including some short periods during which the system was unavailable. These incidents are considered initial 'teething issues' which have been resolved and were not a consequence of COVID-19. The system is now considered stable. Given the significant nature of the project, a post-implementation review will be conducted to ascertain if any lessons can be learned.

### *Westpac suffered a systems outage in May.*

Westpac New Zealand suffered a serious payments failure on 12 May that delayed transactions and access to accounts for a number of hours. The failure was not related to COVID-19 but resulted from a manual error by a key supplier that triggered a consequential lockdown of Westpac systems. Westpac is continuing to investigate the matter and build resilience to such events in future.

### *The FMI Bill has been introduced to Parliament.*

The FMI Bill was introduced into Parliament in late 2019, and passed its First Reading in early 2020. The Select Committee is scheduled to report back to Parliament in August this year.

The Bill provides that all systemically important FMIs will be mandatorily designated, and so become subject to supervision by the Reserve Bank (jointly with the FMA in the case of settlement systems), and gives the supervisors crisis management powers over these FMIs if continuity of service is under threat. Non-systemically important FMIs may voluntarily seek designation if they want the legal certainty in respect of settlement that designation ensures.

The supervisors have begun to prepare for the transition to the new regime introduced by the Bill and to consider in more detail how FMI supervision will be conducted in future. The precise timeline for this work remains unclear, particularly under current circumstances with COVID-19, and will depend to a large degree on how quickly the Bill completes its passage through the parliamentary process.

# Chapter 5

## Regulatory developments and initiatives



### Impacts of COVID-19 on regulatory initiatives

In March, the Reserve Bank announced that it would delay or slow down most of its regulatory initiatives for an initial period of six months. This action was taken to reduce the regulatory impost on financial institutions and free up Reserve Bank and industry resources to support the economy and tackle the challenges created by COVID-19.

In addition to deferring the start date of implementing its Capital Review decisions by at least 12 months, the Reserve Bank will defer external-facing work on the following regulatory initiatives, including planned public consultations, for an initial period of six months:

- the bank liquidity thematic review (and subsequent review of the liquidity policy);
- review of the Insurance (Prudential Supervision) Act 2010;
- standard terms for Residential Mortgage Obligations;
- cyber resilience guidelines for all regulated entities;

- revisions to banks' disclosure of regulatory breaches;
- review of the stress-testing framework;
- revising the process for approving banks' internal capital adequacy models for credit risk; and
- future of cash – standards for banknote-processing machines.

It is important to note that while external-facing work on the initiatives has been deferred, the initiatives themselves remain important for the Reserve Bank.

Alongside these deferrals, the Reserve Bank will be extending the transition period for its revised outsourcing policy by 12 months. Affected banks will now need to be fully compliant with the new requirements by 1 October 2023.

The medium- to long-term risks to financial institutions from climate change remain relevant through and well beyond the current crisis. These continue to be a priority for the Reserve Bank, and we will be looking to re-engage with banks and insurers over these risks and how they will adapt to them.

## Final Capital Review decisions announced in December 2019

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In December 2019 the Reserve Bank announced final decisions on a comprehensive review of the capital adequacy framework that applies to locally incorporated registered banks.

The Capital Review began in May 2017 and took part in three stages, consisting of four consultation papers, covering:

- The topics included in the scope of the Capital Review.
- The definition of eligible capital instruments.
- How banks measure risk for capital adequacy purposes.
- The composition and level of banks' minimum capital ratios and buffers.

The key decisions announced in December were that:

- The total capital requirement (including the Prudential Capital Buffer) will be set at 18 percent of risk weighted assets (RWA) for systemically important banks (D-SIBs) and 16 percent of RWA for non-systemically important banks (non-D-SIBs).
- Of the total requirement, 2.5 percent can be made up of Additional Tier 1 (AT1) capital, while Tier 2 capital can make up 2 percent.

- Contractual contingency features will be removed from the requirements of capital instruments. Redeemable Perpetual Preference Shares (RPPS) will be accepted as AT1.
- A number of changes were made to the calculation of RWA for internal ratings based (IRB) banks, increasing RWA outcomes for IRB banks to approximately 90 percent of what would be calculated under the standardised approach.
- Transition to the new capital ratios would take place over seven years.

Central to the Capital Review decisions are increases in regulatory capital buffers relative to current prudential settings. Strong capital buffers reduce the likelihood of bank failure, by increasing the capacity of banks to absorb losses while remaining a going concern.

Under the new framework the amount of capital in the banking system will increase by around 50 percent, relative to the levels when the decisions were announced. In practice, actual changes to the amount they operate with will vary for each bank. Most banks operate with significant buffers above the current regulatory requirements, and many had already acted to increase their capital levels in the past year in anticipation of the Reserve Bank's final decisions. The Regulatory Impact Assessment published alongside the final Capital Review decisions shows that the costs of moving to these higher capital levels are outweighed by the benefits.<sup>5</sup>

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<sup>5</sup> Information about the Capital Review can be found here: [www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks](http://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks).

### *The final Capital Review decisions incorporated a range of changes from initial proposals.*

The Capital Review proposals attracted significant and wide-ranging interest. Extensive consultation over two and a half years involved a submissions process that attracted more than 200 responses, many meetings with the public and industry groups, and an independent review by three international experts.

Taking into account feedback from submitters, international experts, and public focus groups, the Reserve Bank amended its initial proposals, including by allowing a greater scope for AT1 instruments, including RPPS, setting a higher DSIB buffer requirement, and extending the transition period from five to seven years.

### *In response to COVID-19 the Reserve Bank decided to delay implementation of the new capital framework.*

The Reserve Bank's modelling showed that banks would be able to meet the new capital requirements through retaining most of their earnings for a seven year period, while continuing to provide new credit to customers. Given the negative effect of COVID-19-related credit impairments on banks' earnings, the Reserve Bank does not want banks to seek to achieve higher capital ratios through reducing credit availability in the current environment. As such, the Reserve Bank has deferred the implementation of its Capital Review decisions for a period of at least 12 months, with a future decision to resume the transition dependent on economic conditions.

It is important to note that this decision is purely focused on the timing of the implementation of the Capital Review decisions. All Capital Review decisions remain in place, and will be important to help support the stability of the financial system for the longer term.

## **Phase 2 of the review of the Reserve Bank Act**

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The Government is reviewing the Reserve Bank of New Zealand Act 1989 to ensure that the Reserve Bank's legislative framework is up to date. Phase 1 focused on monetary policy arrangements and concluded on 1 April 2019. Phase 2 focuses on the Reserve Bank's institutional arrangements and financial policy framework.

Phase 2 involves three rounds of public consultation. The first two rounds of consultation were completed in January 2019 and August 2019. The third and final round of consultation was launched in March 2020 and will close in October 2020 (see further below).

Cabinet has made decisions on the institutional arrangements for the Reserve Bank, including that:

- A Governance Board will be established that will be responsible for the functions of the Reserve Bank (except those undertaken by the Monetary Policy Committee).
- The Reserve Bank will have an overarching financial stability objective, replacing the existing 'soundness' and 'efficiency' objectives. As a result, the Reserve Bank's main objectives will be:
  - » achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment; and
  - » protecting and promoting the stability of New Zealand's financial system (subject to final drafting).



- The Minister of Finance will be required to issue a Financial Policy Remit, providing matters that the Board should have regard to when pursuing the financial stability objective.
- The Treasury will act as monitor and the Reserve Bank's reporting requirements will be aligned with State Sector practice.
- The scope of entities subject to the Reserve Bank's information gathering power will be broadened to support the Reserve Bank's central banking and financial sector monitoring functions.
- The Reserve Bank's use of foreign exchange reserves will be subject to a Reserve Management and Coordination Framework agreed between the Reserve Bank and the Minister of Finance, providing greater transparency and accountability as to how reserves are managed and clarifying expectations between the Reserve Bank and the Minister.
- Coordination and cooperation among regulatory agencies will be enhanced through mandating the role of the Council of Financial Regulators.

The Government intends to introduce legislation implementing this institutional framework before the election this year. Drafting of the legislation is currently in progress.

Cabinet has also made a number of in-principle decisions in relation to the regulation of deposit takers, including that:

- Banks and non-bank deposit-takers (NBDTs) will be subject to a single prudential regime.
- Standards (rules set by the Reserve Bank but subject to parliamentary review) will be the primary tool for imposing regulatory requirements on deposit-takers.
- Accountability requirements on directors of deposit-takers will be increased.
- The Reserve Bank's supervision and enforcement powers will be strengthened, including an on-site inspection power and a more graduated enforcement and penalty framework.
- The crisis resolution framework will be enhanced and clarified.
- Deposits at licensed deposit-takers will be insured up to a limit of \$50,000 per depositor, per institution.

The third (and final) round of consultation was launched in March 2020, focusing on the prudential regime for deposit takers, including the development of an eventual Deposit Takers Act, and the introduction of a deposit insurance scheme.

This consultation has since been extended by six months, and will close on 23 October 2020, as a result of the challenges presented by COVID-19. Cabinet decisions will be required on these topics to progress the Deposit Takers Act.



# Appendix one

## Chronology of economic and financial responses to COVID-19



Date	Agency	Policy type	Measure	Objective
16 Mar	RBNZ	Monetary	<b>Official Cash Rate</b> reduced to 0.25 percent. MPC commits to keep the OCR at this level until March 2021.	To support price stability and maximum sustainable employment.
		Prudential	Implementation of the <b>Capital Review</b> delayed. To be reviewed July 2021.	To support the provision of credit to households and businesses.
17 Mar	Govt.	Fiscal	Announcement of the <b>Business Continuity Package</b> , including the wage subsidy scheme.	To cushion the income shock to businesses and keep workers connected to employers.
18 Mar	RBNZ	Prudential	Announcement of delays to <b>regulatory initiatives</b> for an initial period of six months.	To reduce regulatory impost and allow financial institutions to focus on supporting their customers.
20 Mar	RBNZ	Financial markets	<b>Term Auction Facility</b> introduced providing banks with collateralised loans with terms up to 12 months.	To provide liquidity to the banking system.
			Announcement to scale up provision of liquidity to the <b>FX swap markets</b> .	To ensure funding can be accessed at rates near the OCR.
			Re-establishment of \$30 billion <b>USD swap line</b> with the U.S. Federal Reserve.	To support the provision of USD liquidity to the New Zealand market.
			Removal of <b>allocated credit tiers</b> for Exchange Settlement accounts and repricing of other standing facilities.	To ensure short-term interest rates continue to trade near the OCR.

Date	Agency	Policy type	Measure	Objective
23 Mar	RBNZ	Monetary	Announcement of the <b>Large Scale Asset Purchase</b> programme to purchase \$30 billion New Zealand government bonds in the secondary market over 12 months.	To support the transmission of monetary policy and provide economic stimulus by lowering interest rates.
24 Mar	Govt., RBNZ, Banks	Prudential	Announcement of the principal and interest <b>payment deferral scheme</b> for mortgage holders and SMEs for periods up to six months.	To cushion the income shock to households and small to medium-sized businesses.
			Announcement of the \$6.25 billion <b>Business Finance Guarantee Scheme</b> providing loans to SMEs.	To provide short-term credit to financially stressed, but solvent, small and medium-sized firms.
	RBNZ	Prudential	<b>Core Funding Ratio</b> reduced from 75 percent to 50 percent.	To support the provision of credit to the economy
30 Mar	RBNZ	Financial markets	Announcement of weekly <b>open market operation</b> for corporate and asset-backed securities.	To support liquidity to the corporate sector.
2 Apr	RBNZ	Prudential	<b>Prohibition of dividends</b> on ordinary shares and redemption of non-CET1 capital instruments.	To ensure banks maintain higher levels of capital to support the provision of credit and absorb losses.
		Financial markets	<b>Term Lending Facility</b> announced to provide banks with collateralised loans with terms up to 3 years.	To provide low cost funding to banks on terms that complement the Business Finance Guarantee Scheme.
3 Apr	Govt.	Fiscal	Announcement of amendments to the Companies Act – including a business <b>debt hibernation scheme</b> .	To allow businesses and creditors to agree to place existing debt into hibernation for up to 7 months.
7 Apr	RBNZ	Monetary	Large Scale Asset Purchase programme expanded to purchase \$3 billion <b>Local Government Funding Agency</b> bonds in the secondary market over 12 months.	To support the transmission of monetary policy and provide economic stimulus by lowering interest rates.
30 Apr	RBNZ	Prudential	Removal of mortgage <b>loan-to-value (LVR) restrictions</b> . To be reviewed May 2021.	To support the provision of credit to households and support the mortgage deferral scheme.
	Govt.	Fiscal	Enactment of tax and regulatory changes – including a <b>tax loss carry-back regime</b> .	To support cashflow to small and medium-sized businesses.

Date	Agency	Policy type	Measure	Objective
1 May	Govt.	Fiscal	Announcement of <b>Small Business Cashflow Scheme</b> providing loans to firms with 50 or fewer employees.	To provide viable SMEs with access to cashflow to meet fixed costs.
13 May	RBNZ	Monetary	<b>Large Scale Asset Purchase</b> programme expanded to purchase up to \$60 billion NZ government bonds, Local Government Funding Agency bonds and NZ Government Inflation-Indexed bonds in secondary markets over 12 months.	To support price stability and maximum sustainable employment by lowering interest rates.
14 May	Govt.	Fiscal	<b>Budget 2020</b> released. Announcement of the \$50 billion COVID-19 Response and Recovery Fund, including a targeted extension of the wage subsidy scheme.	To support households and businesses recover and position the economy for long-term growth.

# Appendix two

## Regulatory compliance and enforcement

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### *Independent reports on ANZ's governance, risk management and internal controls, and risk capital models*

In June 2019 the Reserve Bank requested two reports from ANZ Bank New Zealand Limited (ANZ) under section 95 (s95) of the Reserve Bank of New Zealand Act 1989. ANZ engaged Deloitte, with the approval of the Reserve Bank, to prepare the reports. The Reserve Bank required a summary of each report to be published.

In December 2019, the first report on ANZ's Director Attestation and Assurance Framework was published. As a result of the findings from this first report, the Reserve Bank issued a further s95 notice, requiring ANZ to engage an external party to confirm before the end of 2021 that ANZ has implemented all of the recommendations set out in the December 2019 report. A summary of this subsequent report will be published when finalised next year.

In April 2020, the Reserve Bank received the second report, which assessed ANZ's compliance with the Reserve Bank's capital adequacy requirements. The report identified several factors that contributed to ANZ's use of unapproved credit and operational risk capital models. In summary, the report concluded that there had not been sufficient rigour in ANZ's processes which led to the failure of the issues being not identified.

The Reserve Bank continues to work with ANZ to address and gain assurance in the areas of non-compliance identified in both s95 reports.

### *Outsourcing*

Outsourcing requirements are set out in the Reserve Bank's Banking Supervision Handbook: Outsourcing Policy (BS11). In the past 12 months, the Reserve Bank has been carrying out a review of compliance with these requirements.

This review has identified a number of instances of non-compliance among the five banks that are in the scope of BS11 (banks whose net liabilities exceed \$10 billion), including information missing from the outsourcing compendium, and entering into or extending outsourcing arrangements without proper approval.

Each instance is relatively minor in isolation, but tends to be the result of poor processes. The Reserve Bank is continuing to monitor banks' compliance with outsourcing requirements, and is working with banks to improve their internal processes.

### *Prescribed Transaction Reporting*

Eight banks have self-reported minor breaches of the prescribed transaction reporting requirements under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. These all involved a small number of transactions, and were primarily due to minor technical issues that have been remediated. All affected transactions have since been reported to the Financial Intelligence Unit.

### *Insurers' reporting and disclosure*

Licensed insurers are required to provide the Reserve Bank with interim and full-year financial and solvency information. In the past six months, there have been a number of breaches of these requirements by insurers, with eight instances of insurers not providing the correct information, or providing information late. While minor on their own, the Reserve Bank monitors whether ongoing failure to meet these requirements suggests insurers do not have the necessary processes and controls in place to meet their regulatory obligations.

### *Other regulatory compliance issues*

Further to the above, where supervisors are concerned about an entity's non-compliance, for example the non-compliance is material, or there is a pattern of non-compliance, supervisors may refer the matter to the Reserve Bank's enforcement function. Enforcement investigates the matter and makes a recommendation as to what action to take, allowing the supervisor to continue to work with the entity to bring it into compliance. As at May 2020, three matters were being investigated by the enforcement function (table A2.1).

**Table A2.1**

### *Enforcement matters under investigation in May 2020*

Area	Number of matters under investigation
Banks	0
Insurers	1
NBDTs	0
AML/CFT	2

