Financial Stability Report

May 2021

RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

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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

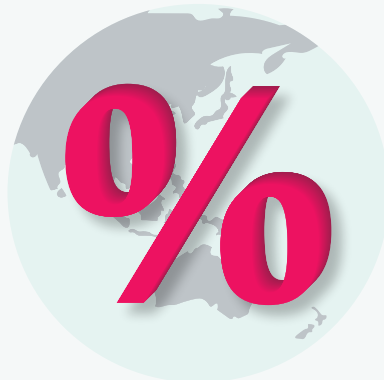
May 2021

New Zealand's financial system is sound but vulnerabilities remain

New Zealand's financial system has coped well with the COVID-19 pandemic, but risks associated with the housing market are accumulating.

New Zealand has done better than feared but some businesses remain vulnerable.

Low global interest rates are supporting economic recovery, while contributing to higher asset prices.



Tighter LVR requirements will help rein in high-risk mortgage lending.

Capital and liquidity buffers have protected the financial system, but further resilience is needed.

New Zealand has done better than feared but some businesses remain vulnerable.

Global economic and financial outcomes have so far turned out more favourable than anticipated in the early days of COVID-19. New Zealand's key export prices have been resilient, with dairy prices at their highest level in several years. However, supply chain disruptions and border restrictions have significantly affected some businesses.

In parallel, substantial domestic fiscal and monetary policy support, along with successful public health measures, has helped to prevent many business failures and a larger rise in unemployment, which could have stressed the financial system. However, New Zealand's economic prospects ultimately depend on the global containment of the pandemic and on the recovery of trading-partner economies.

Low global interest rates are supporting economic recovery, while contributing to higher asset prices.

In response to the pandemic, central banks around the world eased monetary policy to stimulate investment and employment. The low global interest rate environment has also contributed to higher asset prices.

In New Zealand, low interest rates along with easier borrowing requirements, ongoing supply constraints, and a resilient labour market contributed to a rise in house prices over the past year. The sustainability of this increase is in question as these factors could prove temporary. Also, the effects of recent housing policy changes are still to be seen.

Tighter LVR requirements will help rein in high-risk mortgage lending.

Mortgage lending has increased against the backdrop of rising house prices, both to investors and owner occupiers. Also, many borrowers are taking bigger loans with more risk. In response, the Reserve Bank has tightened loan-to-value ratio (LVR) requirements. Since 1 May, almost all new loans to investors need to be less than 60 percent of the property value. Additionally, most new loans to owner-occupiers need to be less than 80 percent of the property value. With these restrictions in place, the Reserve Bank expects new lending to investors to slow.

Additional lending restrictions could be implemented by the Reserve Bank if needed to lean against housing market risks.

Capital and liquidity buffers have protected the financial system, but further resilience is needed.

The pandemic has so far had only limited impacts on financial system soundness, partly because of government support and also because of strong capital and liquidity buffers. Non-performing loans are at low levels and remain well below the peak seen after the global financial crisis. Solid profitability and dividend restrictions have allowed banks to build their capital, providing a buffer to absorb any future losses.

Overall, banks are in a strong position to keep supporting their customers and the economy. More capital remains necessary to support resilience in the future.

Financial Stability Report

May 2021

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Chapter 1
Financial stability risk and policy assessment

- New Zealand has coped with the COVID-19 pandemic better than initially feared, but vulnerabilities in the financial system remain and some continue to increase.
- Low global interest rates are supporting spending and investment, partly by encouraging risk taking and contributing to higher asset prices. In this environment, New Zealand house prices have increased from already elevated levels and appear more vulnerable to a decline.
- A growing proportion of new lending has been at high debt-to-income and loan-to-value ratios. This indicates that more new borrowers are vulnerable to an increase in mortgage rates or a decline in house prices. Recent tightening in lending requirements will help rein in high-risk mortgage lending, particularly to investors.
- Parts of the economy appear more vulnerable to future downturns than before the pandemic. While businesses have generally recovered well, with many benefiting from fiscal support, some sectors have faced an extended period of weak demand due to border restrictions. Also, government debt is higher and expected to increase.
- Bank capital and liquidity remain strong but higher capital ratios are needed to support the resilience of the financial system over the medium term.

Low global interest rates are supporting spending and investment, while contributing to higher asset prices.

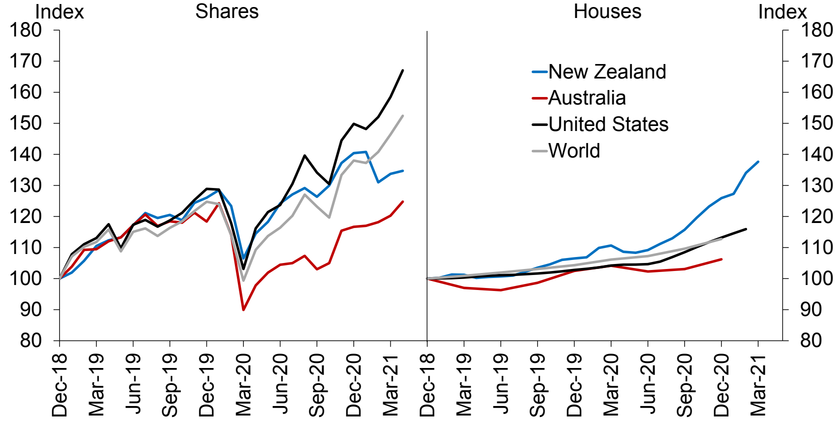
New Zealand is a small open economy affected by economic and financial market developments in the rest of the world. Events abroad affect demand for New Zealand's exports and the availability of external funding for New Zealand banks.

Global economic and financial outcomes have so far turned out more favourable than anticipated in the early days of COVID-19. The economic impacts of social distancing restrictions have been less severe, helped by substantial monetary and fiscal support. New Zealand's key export prices have also been resilient, with dairy prices at their highest level in several years. However, supply chain disruptions and border restrictions have significantly affected some businesses.

During the early stages of the pandemic, central banks around the world reduced policy interest rates and enacted asset purchase programmes to support their economies, alongside unprecedented global fiscal stimulus. These central bank actions contributed to record-low interest rates during 2020 in most major economies and in New Zealand. Recently, as downside risks to economic growth appear less likely and inflation expectations have lifted, long-term interest rates have recovered somewhat.

Notwithstanding the recent rise, low interest rates have led investors to seek out better returns. This search-for-yield behaviour and generally low interest rates have contributed to higher asset prices (figure 1.1). Global equity prices have increased considerably compared to expected earnings. Further increases in long-term interest rates could expose vulnerabilities in asset valuations and drive greater market volatility.

Figure 1.1
International asset prices



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

Note: Share prices are capital indices. House prices for OECD members serve as a proxy for world prices.

New Zealand house prices have increased rapidly.

New Zealand house prices have risen, mirroring the trend in global asset prices. Low interest rates have compelled some of this rise but several other drivers have also lifted housing demand. The resilient labour market and the temporary removal of loan-to-value ratio (LVR) restrictions have contributed. Households continue to invest a large share of their wealth in houses.

Supply constraints – including land-use restrictions and barriers to the provision of infrastructure – have seen increased demand for housing translate into higher rents and house prices. While supply remains constrained, construction activity has increased and is expected to remain high. With border restrictions reducing migrant inflows, new housing supply is starting to outstrip population growth.

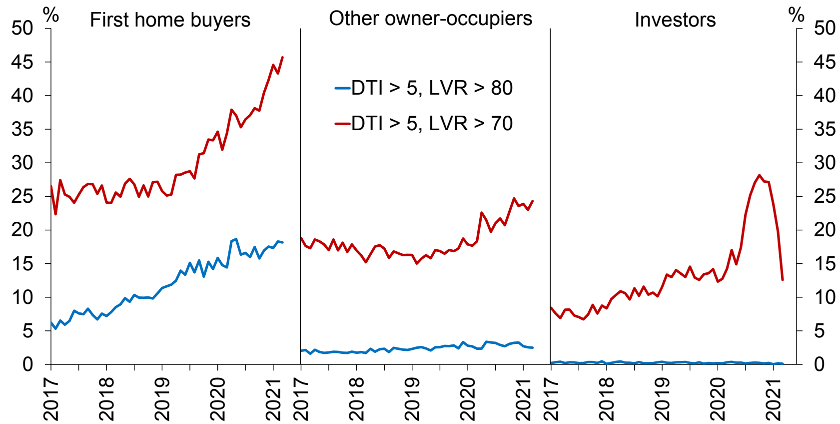
House prices seem less sustainable than before the recent rise for several reasons. Larger house deposits are needed to get into the market and this is making it difficult for first home buyers (FHBs). The Government's recent changes to the bright-line property tax and to interest deductions from rental income will dampen investor demand for housing over time. While the interest costs on mortgages are low and interest rates have generally fallen more than rental returns, interest rates could rise if the economy continues to strengthen and inflationary pressure builds.

Mortgage lending has accelerated, including more high-risk lending.

Bank mortgage lending has increased with the rise in house prices, particularly to investors but also to owner-occupiers. Borrowers have taken on more risk, with a higher proportion of lending at high debt-to-income (DTI) and loan-to-value ratios (figure 1.2). This lending is more vulnerable to rising interest rates and falling house prices. For highly indebted buyers, higher interest rates would push up debt-servicing costs significantly and reduce the income remaining for consumption. Highly indebted borrowers are also more likely to sell their properties in fire sales and fuel the perception of a housing market downturn.

However, the vulnerability in overall mortgage lending remains low when including existing loans. The share of outstanding mortgage lending with high LVRs has gradually declined since the implementation of LVR restrictions in 2013. It would take an extended period of new high-LVR lending to materially increase this share. Additionally, for existing owners the recent rise in house prices has inflated housing wealth and reduced their LVRs. Stress testing conducted by the Reserve Bank in 2020 showed banks would be resilient in a range of scenarios with high unemployment and lower house prices.

Figure 1.2
High-risk shares of new mortgage lending by buyer type



Source: Reserve Bank *DTI New commitments survey*.
Note: Investors covers all lending to borrowers where at least one investment property secures the loan.

However, in more severe scenarios, banks' capital fell below the regulatory minimums and would require significant mitigating actions, including capital injections, to continue lending. This reinforces and supports the decisions that were made as part of the Capital Review to increase bank capital levels.

Tighter LVR requirements are in place to ease housing risks.

In response to higher risk lending against the backdrop of rising prices and to ensure the vulnerability in mortgage lending remains low, the Reserve Bank has tightened LVR requirements. Since 1 May 2021 a maximum of 5 percent of new lending to investors can be at LVRs above 60 percent. Additionally, a maximum of 20 percent of new lending to owner-occupiers can be at LVRs above 80 percent. With these restrictions in place, new lending to investors at high LVRs is slowing. In addition, the recent government housing policy changes could further reduce investor demand.

The Government issued a direction to require the Reserve Bank's financial stability policy to have regard to "support[ing] more sustainable house prices, including by dampening investor demand for existing housing stock which would improve affordability for first home buyers". Supporting more sustainable house prices aligns with the Reserve Bank's objective of promoting the maintenance of a sound and efficient financial system (Box A).

Additional policy options are available within the Reserve Bank's regulatory powers and could be used to support house price sustainability if further action is needed.[1] Any response would need to align with the Reserve Bank's mandate to promote the maintenance of a sound and efficient financial system. The criteria the Reserve Bank is using to assess policy options include to:

- promote financial system soundness by strengthening bank and household balance sheets and moderating boom-bust credit cycles;
- promote efficient allocation of credit, for example by not excessively restricting credit access to otherwise creditworthy borrowers;
- impose low additional administration costs, including the ease (or difficulty) of implementing and enforcing the policy;
- support more sustainable house prices; and
- dampen investor demand, which may improve affordability for first home buyers.

The policy options could also have impacts on dynamic efficiency in the long term, for example by shifting the incentives to invest in housing. The risks of steering lending into unregulated sectors would also need to be assessed. This will be considered further in subsequent analysis.

A summary of our preliminary assessment of the main policy options is set out in table 1.1. In assessing the policy options, the Reserve Bank has considered absolute impacts against the status quo as well as relative impacts between the different tools. The list of policies is not exhaustive and other options could be considered in future.

If further tightening in policy settings is needed in the short term, the most straightforward approach would be to tighten LVR restrictions further. However, the marginal benefits (with respect to financial stability and house price sustainability) are likely to decline as LVR restrictions tighten further while efficiency costs would rise. In terms of new tools, our assessment is that a debt serviceability tool would be the best option for supporting financial stability and sustainable house prices over the medium term. Restrictions on interest-only lending would likely have less impact on overall lending conditions than alternatives, while being challenging to implement and enforce.

Our analysis of these options is still being completed. Additionally, the appropriate policy response depends on economic and financial conditions and may change with circumstances. Implementing new tools such as restrictions on debt serviceability or interest-only lending is complex and would take time to work through.

1 Before their use, the Reserve Bank would seek to add some of the tools to the Memorandum of Understanding on Macroprudential Policy with the Minister of Finance.

Table 1.1

Potential financial policy instruments to support more sustainable house prices

Policy option	Preliminary assessment against criteria
Further LVR tightening	**Financial soundness** – Past Reserve Bank analysis indicates that LVR restrictions have significantly improved the resilience of the financial system.[1] However, the marginal benefits to financial stability are likely to reduce if LVR restrictions are tightened further from current levels, while efficiency costs will increase. **Allocative efficiency** – Allocative efficiency costs arise from restricting credit access to otherwise creditworthy borrowers. These are partly mitigated by the existing exemption regime and speed limits. **Administrative costs** – Implementation and enforcement costs are low as LVR restrictions are an established tool with reporting and compliance regimes in place. The lead time for adjusting settings is two to three months. **House price sustainability** – Past Reserve Bank analysis has found that LVR restrictions can be effective in moderating house price inflation and reducing credit growth.[2] However, with rising house prices LVR restrictions become less constraining over time. **Investor demand** – The LVR framework allows settings to be adjusted in line with underlying risk characteristics. The current LVR settings are tighter for investors, and this differential could be maintained or increased if restrictions are tightened further. Speed limits and exemptions also help to reduce impacts on first-home buyers.
Restrictions on debt-to-income (DTI) or other measures of debt serviceability	**Financial soundness** – Reserve Bank analysis and international evidence suggest that debt serviceability restrictions are an effective tool for stabilising housing cycles as they link credit growth to income. DTI restrictions strengthen borrowers' financial position and focus on a different dimension of risk (ability to service loans) than LVR restrictions (loan losses in case of default). **Allocative efficiency** – Allocative efficiency costs arise from restricting credit access to otherwise creditworthy borrowers. These can be partly mitigated through design and calibration, including the use of speed limits and exemptions. **Administrative costs** – A data collection process for DTIs is already in place, but further work would be needed to finalise the design of the tool and update bank systems. The estimated lead time is six months. **House price sustainability** – As noted above, evidence suggests that debt serviceability restrictions are an effective tool for moderating house price cycles. Their effectiveness is likely to be sustained over time to a greater extent than LVR restrictions. **Investor demand** – DTI caps would tend to impact more on investors and higher-income owner occupiers, who borrow at higher DTI ratios on average (figure 2.8). The impacts on access to credit for first-home buyers could be further mitigated with speed limits.

1 www.rbnz.govt.nz/research-and-publications/analytical-notes/2019/an2019-07

2 www.rbnz.govt.nz/-/media/reservebank/files/publications/discussion%20papers/2018/dp18-05.pdf

Table 1.1 *(continued)*

Potential financial policy instruments to support more sustainable house prices

Policy option	Preliminary assessment against criteria
Restrictions on interest-only lending or amortisation requirements	**Financial soundness** – Evidence suggests that banks normally carry out credit assessments on a principal and interest basis, even for interest-only loans. Interest-only restrictions are therefore unlikely to have a significant impact on credit availability, but could have financial stability benefits by deterring credit demand from some higher-risk borrowers. **Allocative efficiency** – This may have higher allocative efficiency costs than other tools, as interest-only lending is used for a range of purposes, many of which may be positive for economic welfare (for example, to manage temporary income loss, free up cashflow for maintenance, or for business investment secured by residential property). **Administrative costs** – Complex rules may be necessary to limit opportunities for avoidance (for example, by using revolving credit and mortgage top-ups). Initial analysis suggests that targeting interest-only lending with LVR requirements or adjustments to risk-weights may be easier to implement and enforce than a ban, but more work is needed. The estimated lead time is at least six months. **House price sustainability** – This is likely to be less effective in moderating housing cycles than LVR and DTI restrictions, given that banks already undertake lending assessments on a principal and interest basis. The share of interest-only lending (as a proportion of total lending) has not increased in the recent housing upswing (figure 2.9). **Investor demand** – Investors make more use of interest-only lending, particularly at loan origination, and hence some may be deterred from new borrowing by interest-only restrictions. Investor demand for interest-only lending may also decline in response to the Government's recent announcement on tax deductibility.
Changes to sectoral capital requirements, e.g. through risk-weight settings or a capital overlay	**Financial soundness** – This could have some financial stability benefits, but capital requirements for mortgage lending in New Zealand are already relatively high by international standards. **Allocative efficiency** – This can improve allocative efficiency if risk-weights are well aligned with risk, but if not aligned it can lead to misallocation of capital. **Administrative costs** – The capital adequacy framework is well established and hence adjustments would be relatively straightforward to implement and enforce. The estimated lead time is three months. **House price sustainability** – Capital settings are relatively slow acting in comparison to other tools and hence are less likely to be effective in leaning against short-term housing cycles. **Investor demand** – Current risk-weight settings are higher for investment property. This differential can be maintained or increased if restrictions are tightened further.

Economic recovery has supported businesses, but some remain vulnerable.

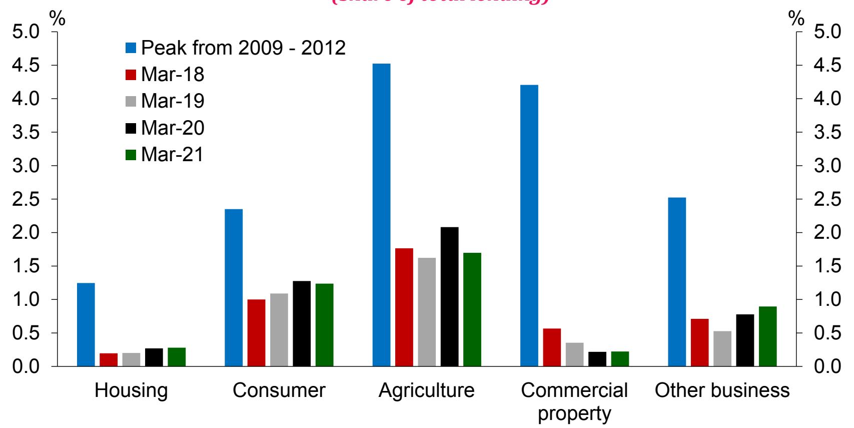
The spread of COVID-19 in New Zealand has been suppressed by border restrictions, periodic Alert Level changes, and an effective public health response. Business activity has been able to recover, and confidence in the economic outlook has increased. Construction activity continues to expand while robust export prices have supported agricultural incomes. While service sector employment has declined, other sectors have retained or expanded employment, with only a moderate rise in unemployment to date.

Businesses have been cautious and reduced their investments owing to uncertainty in the economic outlook. While this can have negative implications for future productivity and output growth, businesses have continued to repay bank debt. These repayments provide flexibility should economic activity slow, or make it easier to invest as the economy strengthens.

Demand remains subdued in the tourism and education sectors because of border restrictions. Businesses in these sectors continue to struggle and signs of stress are likely to increase over time. Also, many businesses continue to face supply chain issues. An ongoing risk is a widespread outbreak of COVID-19 in New Zealand. More restrictions would strain businesses, and for some the impacts of another outbreak would be severe.

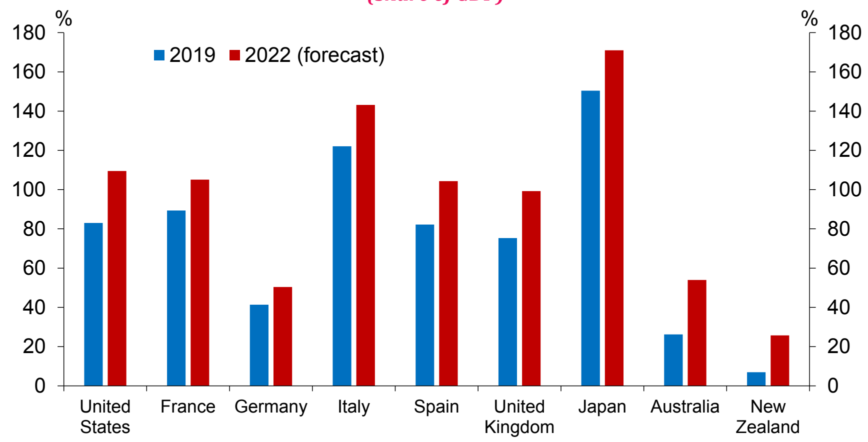
Substantial government support has helped to mitigate the economic impacts of the pandemic. As a result there have been limited negative impacts on financial system soundness to date. Banks' non-performing loans are at low levels and remain well below the peak seen after the global financial crisis (figure 1.3). The end of insolvency relief and other support measures may see non-performing loans increase over coming months. However, the businesses most affected by the pandemic have tended to rely less on borrowing, partly because capital intensity is lower in the service sector. While the economic outlook remains uncertain, recent developments suggest near-term stress in the financial sector will remain low.

Figure 1.3
Non-performing loans by sector
(share of total lending)



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

Figure 1.4
Net public debt
(share of GDP)



Source: International Monetary Fund.

Other longer-term vulnerabilities have risen.

Across most economies, considerable fiscal support has meant that government debt has increased (figure 1.4). Higher government debt may constrain fiscal support in some economies during future economic downturns. New Zealand government debt has increased and, while it remains low compared to other developed economies, the Treasury projects government debt to increase further (see *Half Year Economic and Fiscal Update 2020*).

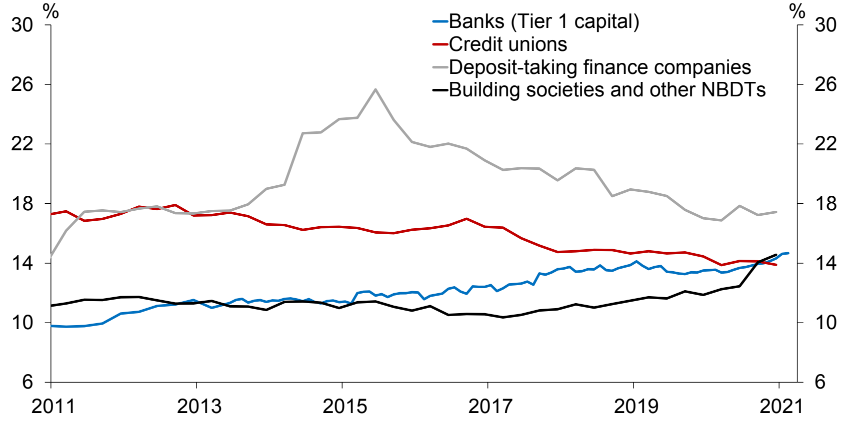
Climate change presents a longer-term risk to financial stability, with the physical impacts of climate change likely to increase. Transitioning to a low-carbon economy will reduce financial stability risks in the long term, but there are costs for some sectors. The Reserve Bank supports efforts to assess, manage, and disclose climate-related risks, and recently submitted a response to the Climate Change Commission's draft advice. The Reserve Bank is developing capability in this area with the aim of better understanding climate-change related risks in the New Zealand financial system.

Institutional resilience remains strong but needs to increase.

The unpredictable nature of future stress makes it important that financial institutions are resilient. Bank capital ratios have increased as bank profitability has recovered over the past six months and dividend restrictions have remained in place, albeit with some easing recently (figure 1.5). Banks are in a strong position to keep supporting their customers and the economy.

As set out in the Reserve Bank's Capital Review, capital requirements for banks will progressively increase from 1 July 2022. This will ensure that the sector is resilient to all but the most severe economic risks. In addition, the Reserve Bank intends to increase the minimum core funding ratio (CFR) requirement to its previous level of 75 percent on 1 January 2022, subject to no significant worsening in economic conditions.

Figure 1.5
Capital ratios for banks and non-bank deposit takers
(share of risk-weighted assets)



Source: RBNZ *Capital adequacy survey*, *Non-bank deposit takers survey.*
Note: Capital ratios for NBDTs are a historic time series for currently licensed NBDTs and their predecessor organisations, and do not reflect NBDTs which are no longer licensed.

The resilience of non-bank deposit takers (NBDTs) is mixed. Non-performing loans have remained manageable across the sector over the past year. As a result, building societies have seen solid growth in their capital ratios as profits have remained strong. Credit unions and finance companies saw their capital ratios stabilise, although at a lower level after declining over previous years. High underlying costs for some credit unions and a focus on high-risk lending for finance companies suggest some institutions in these sectors may be vulnerable to adverse shocks.

Most insurers have also maintained or improved their capital positions over the past year. Health-related claims have not been severe in New Zealand and the cost of business interruption insurance remains low. To date, no legal challenges like those seen overseas have been initiated in New Zealand. The Reserve Bank's first formal insurance stress test is underway to assess the resilience of general insurers in severe but plausible scenarios (Box C).

For an overview of the developments in key vulnerabilities in the financial system, see table 1.2.

Table 1.2

Developments in key vulnerabilities

Vulnerabilities	Key developments
Asset price valuations	Low global interest rates are compressing yields on risky assets. Equity and bond markets are pricing in fairly optimistic economic scenarios. Domestically, housing demand has been strong, with house prices rising rapidly since the middle of 2020. Low mortgage rates, increased lending appetite, and ongoing supply shortages are underpinning house prices. The risk of a decline over the medium term has increased.
Business and household balance sheets	Bank mortgage lending has accelerated, increasingly with high LVRs and high-DTI ratios. Recent borrowers are exposed to rising interest rates or falling house prices. Re-imposed LVR restrictions will slow lending, especially to investors. Businesses continue to repay bank debt, including in the dairy sector, reflecting low investment intentions and strong cashflows in many sectors.
Funding and liquidity	Weak credit growth (outside housing), strong deposit growth, and Reserve Bank facilities reduced the need for offshore funding by banks over the past year. However, deposit growth has slowed in recent months. Deposits continue to switch from term to call accounts due to declining relative returns, with banks less willing to pay for term funding given the availability of cheaper alternatives such as the Funding for Lending Programme.
Institutional resilience	The economic recovery is supporting asset quality and preserving interest income, stabilising banks' earnings. Previously reported developments in other regulated sectors (NBDTs, insurance, and financial market infrastructures) have continued, including the stabilisation of NBDT solvency and improvements in insurer solvency.

Box A

Interpretation of the Section 68B housing direction

In February, the Minister of Finance issued a direction under Section 68B of the Reserve Bank Act for the Reserve Bank to have regard to house price sustainability when making its financial stability policy decisions.[2] The direction aligns well with the Reserve Bank's objective to promote the maintenance of a sound and efficient financial system. Unsustainable asset price growth can lead to a sudden correction in prices, which would have negative implications for the financial system and the broader economy. Housing equity makes up about half of household net worth, and mortgage lending 62 percent of total bank loans.

The direction frames the Reserve Bank's role in the context of a broader set of government policies, which is important because a wide range of factors affect the housing market and various government agencies will need to work together to achieve what is set out in the policy.

Historically, the Reserve Bank has regularly monitored, assessed, and reported on the risk of a downturn in the housing market and on the vulnerabilities of household and lender balance sheets. The results of these assessments factor into macroprudential policy settings aimed at both leaning against boom-bust cycles and building up financial system resilience to a downturn.[3]

The Reserve Bank is now expanding this framework by defining and explicitly incorporating the concept of house price sustainability. In terms of the Reserve Bank's financial stability approach, this means developing our understanding of what contributes to sustainable house prices, and integrating this into decisions on financial policy. The work involved will call for a more active engagement with other public organisations on housing policy.

The Reserve Bank's working definition of a sustainable house price is the level that the price would be expected to move towards over several years, given the outlook for fundamental drivers. The sustainable price level itself can change when the outlook for the drivers changes. For example, the decades-long decline in global interest rates has gradually lifted sustainable price levels. Similarly, the recently announced tax changes may cause a decrease in sustainable price levels. When house prices deviate significantly from a sustainable level the risk of a correction is elevated. This definition reflects that distributional or supply issues in the housing market cannot be resolved with financial policy tools, although they are important and need to be resolved.

At the core of the Reserve Bank's framework for assessing the sustainable level of house prices is the value that people derive from housing services (figure A.1). Everyone needs a place to live, whether that is through renting or home ownership, and a significant share of income is spent on housing. Therefore, one key group who have demand for houses is households who must decide whether they will own or rent. The other group is investors, who must decide whether to invest in housing and rent it out or to invest in other assets.

2 Hon Grant Robertson, 25 February 2021, **www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Information-releases/2021/ir-2021-01-b.pdf**

3 For an explanation of the principles and processes that underpin the Reserve Bank's use of macroprudential instruments, see Ovenden, P. (2019), "Macroprudential policy framework: mitigating the likelihood and severity of boom-bust cycles", **www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Background%20papers/Macroprudential-policy-framework.pdf**

When the expected costs, benefits, and constraints faced by households or investors shift, the interlinked markets for housing services and houses adjust through changes in rents, home prices, and household size. For example, anticipated changes in population growth, tax policy, interest rates or other factors can shift buyer decisions and by extension house prices.

Ultimately, the extent and persistence of price swings driven by shifts in demand depend on whether supply is able to respond to prices and how well market participants can anticipate the supply response. If supply can respond flexibly to prices, then upward pressure on prices will induce an increase in the total quantity of housing and prices will re-adjust. This should similarly occur in different parts of the market, where unbalanced price pressures induce a change in the mix of quality, size, and location of new builds. However, even if supply is eventually able to adjust, the response can take several years. If a supply response requires policy reforms to ease structural impediments, then the adjustment will likely be more delayed and the outlook for supply more uncertain.

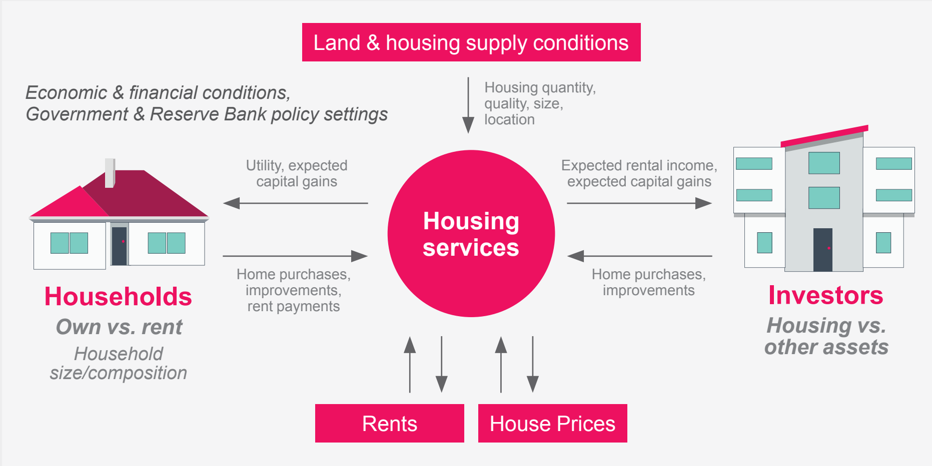
Taking a long-term view, prices are sustainable if the following conditions hold.

- For investors, the expected risk-adjusted returns of investing in housing should be comparable to other long-term investments.
- For renters and prospective owner-occupiers, the expected costs of owning should be comparable to the expected benefits of owning. For example, any difference between the cost of owning and renting should be explainable by fundamental drivers.
- Current housing demand from investors and owner-occupiers should be consistent with the outlook and risks around supply and demand for housing services, and their implications for future rents and house prices.

The Reserve Bank is in the process of refining a suite of metrics to indicate unusual or stretched prices based on the above conceptual framework. The Reserve Bank will consider these metrics when setting financial policy, potentially adjusting settings to steer prices toward a more sustainable level, while taking into account that market price changes take time and not every fluctuation warrants a policy response.

The Reserve Bank's financial policy tools can help address some of the challenges around housing, particularly when they relate to financial stability, but a broader response is needed to address more wide-ranging societal issues. For instance, the house price level may be sustainable in a market sense, even though rents may be high and deposits unaffordable for prospective first home buyers. In this case, there are social costs that go beyond the implications of house prices for the Bank's financial stability mandate and these call for a broader public policy response. The Reserve Bank is supportive of the Government's housing affordability goals, and intends to engage constructively in policy conversations on housing affordability as well as the narrower question of price sustainability.

Figure A.1
The market for housing services



Chapter 2
Financial system vulnerabilities

Asset prices in New Zealand and abroad

During the pandemic, global asset prices have surged...

Central banks responded quickly to the global economic shock from COVID-19. Authorities reduced policy interest rates, provided market and liquidity backstops, and in some cases intervened directly in corporate credit markets as well as ramped up purchases of government bonds. These policies aimed to avert a financial crisis and, more broadly, to complement the significant economic stimulus being provided by fiscal policy. The main channel by which monetary policy tools achieve these aims is bringing down both short- and long-term interest rates.

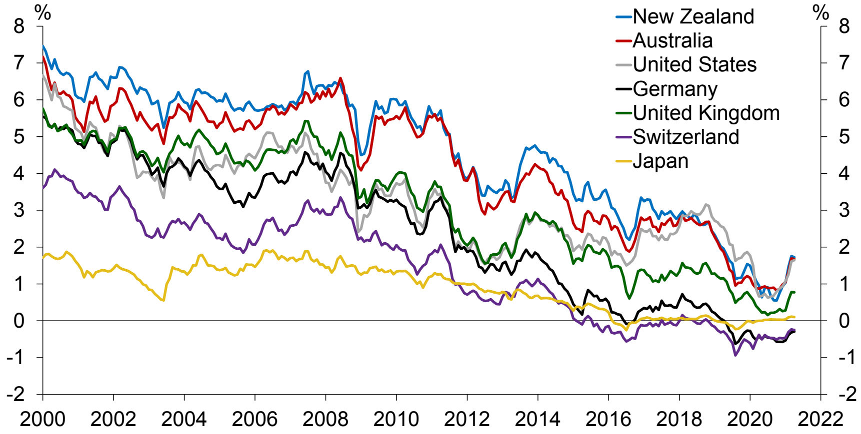
The policy interventions have been supportive, and the global economic and financial outcomes in the past year have turned out better than initially feared. However, from a financial stability perspective, these interventions also contributed to a build-up of vulnerabilities as asset prices climbed from already elevated pre-COVID levels and debt levels mounted.

In New Zealand, pockets of vulnerability increased in the household sector, in particular as some households leveraged up to buy homes at historically high prices.

...driven in part by ultra-low interest rates…

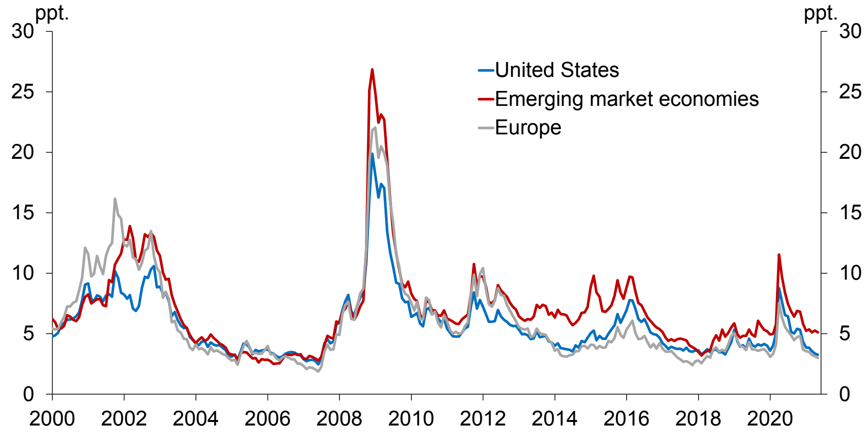
Long-term interest rates have trended down for decades, and the global monetary policy response to the COVID-19 pandemic brought them even lower (figure 2.1). The reduction in rates in the first half of 2020 further pushed up asset prices. For example, equity prices were boosted by lower discount rates being applied to companies' future earnings. This effect was especially strong for 'growth stocks' whose valuations are heavily influenced by expectations of their future earnings growth, notably in technology-related sectors. More recently, share prices for other sectors have been buoyed by the improved vaccine outlook and recovery in near-term earnings. For debt-financed assets, such as houses, lower global interest rates have a direct effect on prices by reducing purchasers' borrowing costs.

Figure 2.1
10-year sovereign bond yields



Source: Haver Analytics.

Figure 2.2
Credit spreads on high-yield corporate bonds



Source: ICE BofAML indices of spreads over risk-free rates, compiled by the Federal Reserve Bank of St. Louis.

Although the recent boost to asset prices from lower yields was partly a continuation of a long-term trend, this trend cannot continue indefinitely. Global long-term yields have already rebounded since mid-2020. In recent months there have been signs of this rebound strengthening due to rising inflationary expectations, putting downward pressure on elevated asset prices. A further pronounced rise in yields would pose a risk of a disorderly slide in global asset prices. On the other hand, should the global economic recovery slow – for example if governments pull back on their deficit spending too soon due to serviceability concerns – inflationary expectations would be less of a concern, but asset prices would likely be dragged down by deteriorating economic fundamentals.

4 The great majority of advanced economies had a nominal increase in corporate debt, while New Zealand's corporate debt levels decreased in the period. Source: Bank for International Settlements statistics on total credit to non-financial corporations, available at: **www.bis.org/statistics/totcredit.htm.**

...and the search for yield has intensified.

In the past year investors have stepped up their search for higher rates of return, driven by ultra-low risk-free interest rates. This intensified search for yield has added to pressure on asset prices, and has pushed down relative returns on even the riskiest corporate debt (figure 2.2).

The low pricing of risk around the world has aided companies with cashflow problems in getting through the pandemic. This has helped to avoid large numbers of bankruptcies and asset fire sales in the sectors hit hardest by the pandemic, such as travel, hospitality, and commercial property. As a result, corporate debt levels in advanced economies have increased markedly, rising from 90 percent of GDP in September 2019 to 101 percent of GDP in September 2020.[4] Although companies' ability to ramp up their borrowing has been crucial in softening the macroeconomic fallout from lockdowns and reduced consumer spending, many companies' cashflow and balance sheet problems are yet to be resolved.

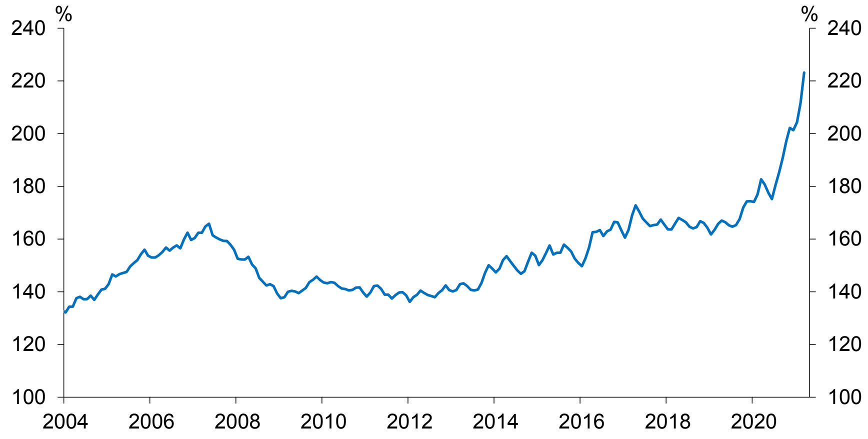
Whether these turn out to be material for the global economy, with potential spillovers to New Zealand through trade and funding channels, depends on how well the nascent global economic recovery can be sustained.

The sustainability of asset prices is a key financial stability concern for New Zealand.

The levels of many global asset prices, and the pace of their recent ascent, have called the sustainability of valuations into question. Low compensation for risk indicates that market participants may not be fully internalising risks. Prices of risky assets are therefore vulnerable to either a rise in perceived risks or an increase in risk aversion. More broadly, asset valuations are vulnerable to a rise in discount rates reflected in long-term yields, which have already crept up but could do so more sharply if inflationary expectations rise further. A disorderly unwinding of current monetary stimulus or backstops could see abrupt adjustments in asset prices, posing a particular risk to those who have purchased at the current elevated levels.

Domestically, supply constraints – including land-use restrictions and barriers to the provision of infrastructure – have seen increased demand for housing translate into higher housing rents. Against this backdrop, the global downward trend in long-term interest rates has been reflected over time in declining domestic mortgage rates. The steadily growing stream of rental income that New Zealand houses produce, combined with declining financing costs, has resulted in a bidding up of house prices in New Zealand over many years. This long-term trend in house prices has been amplified over the past year, as global monetary policy easing has seen further declines in domestic interest rates. In contrast, a market with responsive supply conditions would have seen declining finance costs translate into more houses being built leading to stable or declining rents.

Figure 2.3
20 percent deposit on median house price
(share of median annual household disposable income)

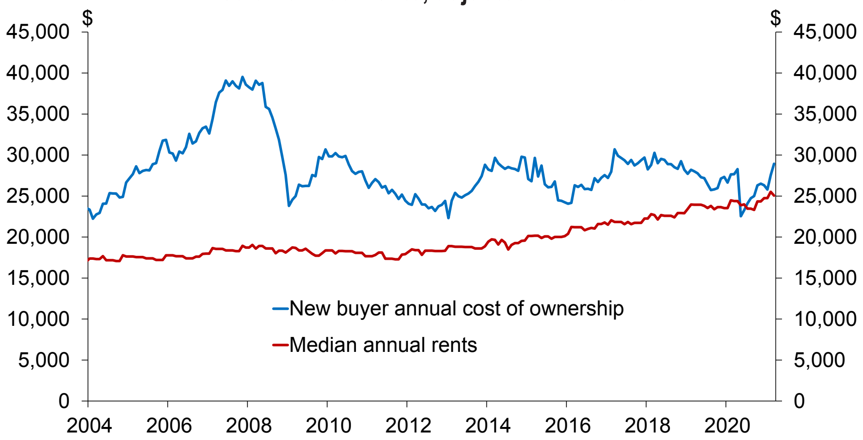


Source: REINZ, Stats NZ, Reserve Bank estimates.

Nationwide house prices rose by 24 percent in the year to March 2021, significantly outpacing house price rises in other advanced economies. New Zealand house prices appear stretched by several metrics, such as house price-to-income ratios and the affordability of entering the market (figure 2.3).

The question of house price sustainability has two parts. Firstly, are prices deviating from levels implied by their drivers, including both cyclical supply and demand factors and longer-term fundamentals (such as land-use restrictions, tax policy, and global neutral interest rates)? If so, this could signal that houses may be mispriced. Secondly, are underlying house price drivers themselves on sustainable paths, and how might they be expected to change?

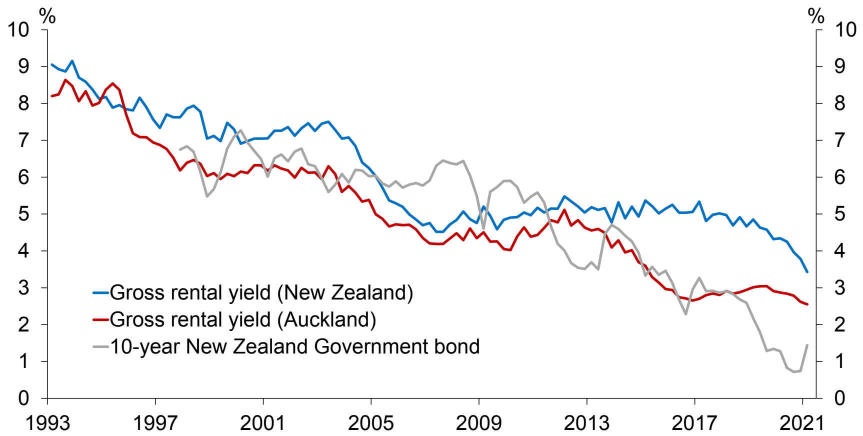
Figure 2.4
Estimated cost of home ownership for new buyers and median annual rents, adjusted for inflation



Source: Interest.co.nz, REINZ, MBIE, Stats NZ, Reserve Bank estimates.

Note: Annual cost of ownership is estimated for a house with the median sale price during the relevant month, and comprises the interest servicing cost of an 80 percent LVR loan at a two-year fixed rate, plus maintenance, rates and insurance costs equal to 1.5 percent of the house value. Annual rental costs are based on the median new weekly rent during the relevant month from Ministry of Business, Innovation and Employment (MBIE) bond data. Figures are adjusted to 2020 prices using the Consumer Price Index.

Figure 2.5
Estimated gross rental yields and risk-free rates



Source: QV, MBIE, Haver Analytics, Reserve Bank estimates.
Note: Gross rental yields are annual gross rents on a three-bedroom house, relative to the lower quartile sales price, less assumed annual maintenance, rates and insurance costs equal to 1.5 percent of the house value.

Resilient household incomes, bolstered by wage subsidies, strong migration flows prior to the border restrictions, and low domestic interest rates have all contributed to the recent surge in demand. The cost of servicing a new mortgage compared to renting remains relatively low, and the rental returns based on concurrent house prices have declined to a lesser extent than long-term risk-free rates in recent years (figures 2.4 and 2.5). These factors point to a degree of sustainability in the current level of prices.

However, current demand and supply conditions may prove temporary and are subject to uncertainty. For example, the future path of mortgage interest rates depends on the evolution of inflationary pressure and adjustments of the monetary policy stance at home and abroad relative to neutral rates, as well as credit risk in the housing market. Estimates of trend interest rates are higher than current levels, as shown in the Reserve Bank's February *Monetary Policy Statement*. More recently, the Government's extension to the bright-line property tax and the phased removal of interest expense deductibility will over time reduce the returns on investment property, particularly at high levels of leverage. Taken together, the various downside risks to house prices mean that the likelihood of a significant correction has increased.

A key longer-run determinant of the house price level is inelastic housing supply. If land development and construction could respond effectively to price signals then any change in demand would have only a short-lived effect on house prices. Ultimately, for the housing affordability problem to be resolved, policy constraints on supply need to be addressed.[5]

5 This position is consistent with statements by the Productivity Commission, Treasury, and the International Monetary Fund (IMF). For example, the IMF's Staff Concluding Statement of the 2021 Article IV Discussions for New Zealand states that "achieving long-term housing affordability depends critically on freeing up land supply, improving planning and zoning, and fostering infrastructure investments to enable fast-track housing developments".

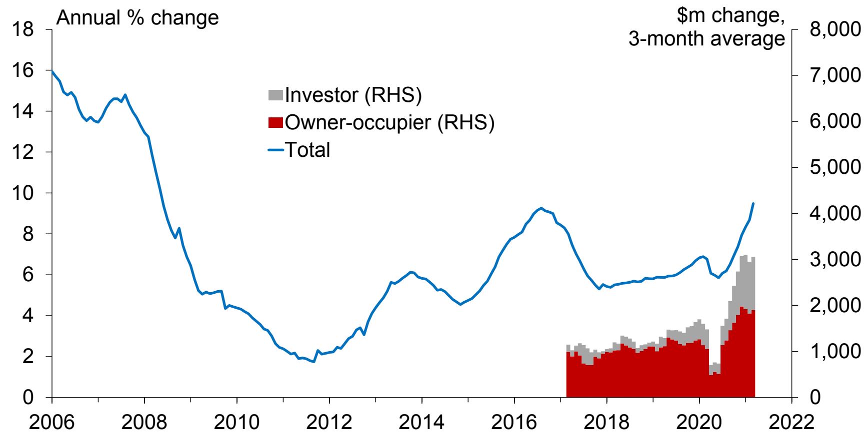
Household balance sheets

Households face significant risks in the medium term, including the potential for higher debt-servicing costs and a significant decline in house prices, which could amplify an economic downturn. Furthermore, the financial system can suffer large losses if many households default on their mortgages: household credit represents 60 percent of bank lending to the private sector, and residential mortgages account for 97 percent of household credit.

Household balance sheets appear strong owing partly to the housing market boom.

In aggregate, despite the steep recession in the first half of 2020, the household sector's balance sheet is currently healthy, supported by government policy initiatives, resilient labour market conditions, and low interest rates. The unemployment rate remained low at 4.9 percent in the December quarter, while mortgage rates have fallen to record lows. Higher house prices have boosted homeowners' housing equity, which represents approximately half of household net wealth. Reflecting the relative strength of the labour market, less than 0.1 percent of mortgage loan values remain on principal and interest payment deferrals, from a peak of 8 percent in June 2020, and the non-performing loan ratio for mortgages remains low, at 0.2 percent.

Figure 2.6
Composition of housing loan growth



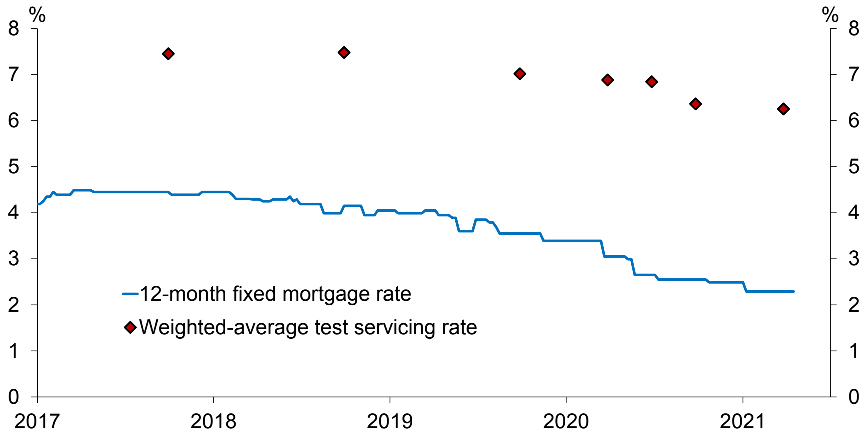
Source: RBNZ *Bank Balance Sheet survey, Standard statistical return.*

However, risky mortgage lending has grown as standards have weakened…

Strong housing demand has driven household debts higher, with outstanding residential mortgage lending by banks growing 10 percent in the year to March 2021 (figure 2.6). In addition, the resurgence in mortgage lending growth has occurred alongside an easing in origination standards. The serviceability test rate levels that banks use to assess new borrowers have generally declined over the past year (figure 2.7).

New mortgages taken out for house purchases in the past two years represent approximately 30 percent of the current stock of mortgage lending. Newer borrowers will generally be more vulnerable than earlier borrowers, as they have repaid less principal, generally experienced smaller equity gains, and may have had their serviceability assessed at lower interest rates.

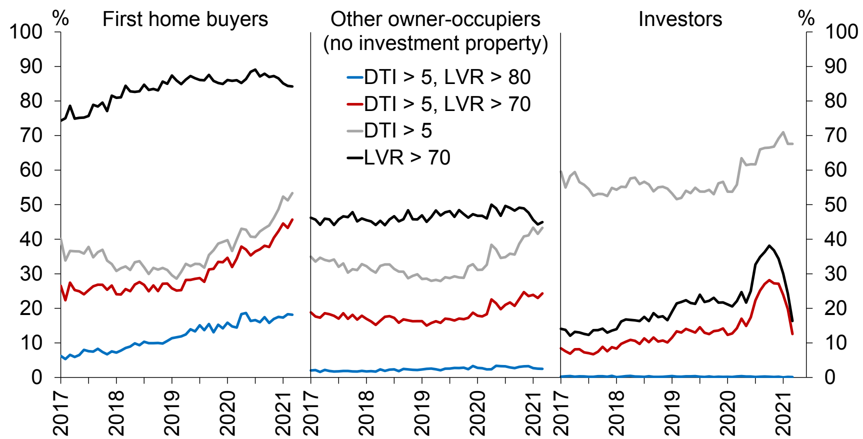
Figure 2.7
Mortgage serviceability test rates



Sources: RBNZ *Credit conditions survey*, interest.co.nz.

Note: Mortgage test servicing rates are weighted by banks' share of new mortgage lending commitments.

Figure 2.8
Share of high DTI and LVR new mortgages by buyer types, before policy exemptions



Sources: RBNZ *LVR New commitments survey, DTI New commitments survey.*

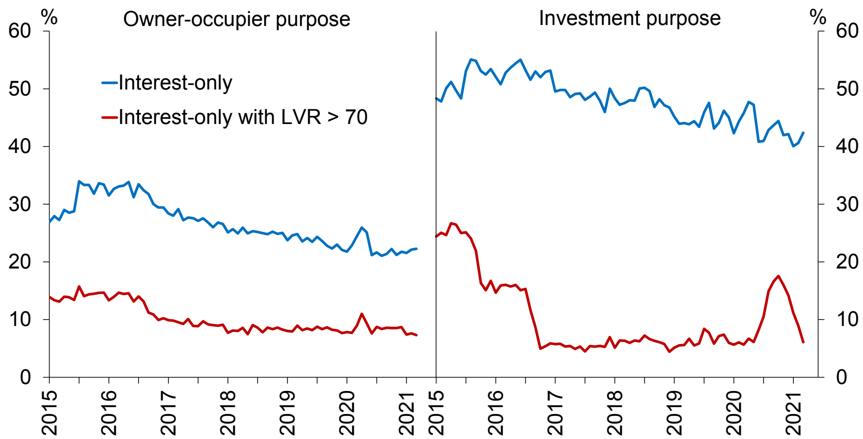
...exposing households and the economy to potential interest rate increases.

The size of new mortgages has increased relative to borrowers' incomes, reflecting rising house prices and low interest rates. The share of new investor lending with a debt-to-income (DTI) ratio above 5 rose to 69 percent in the three months to March 2021 from 55 percent a year earlier, driven by loans with a loan-to-value ratio (LVR) above 70 (figure 2.8). The share of new owner-occupier lending with DTIs above 5 has also increased, albeit from a lower level than investors, led by loans with relatively high LVRs. High-DTI households are likely to have less of a buffer to absorb future increases in interest rates or falls in income.

The share of new lending on interest-only payment terms has trended down for several years (figure 2.9). Interest-only lending can carry additional risks, such as uncertainty about borrowers' capacity to meet the additional servicing burden when the loans revert to principal and interest terms. Banks tend to manage these risks by including principal repayments in their initial serviceability assessments, and applying tighter LVR limits on interest-only lending in general.

An interest rate rise from a low level represents a greater proportional increase in debt-servicing costs, and the impact on borrower serviceability is magnified by a high DTI ratio. Reserve Bank estimates suggest that, for a typical recent owner-occupier borrower, an increase in the one-year mortgage rate to 5 percent would increase their debt-servicing ratio (DSR) to above 40 percent from around 30 percent currently (figure 2.10). Investors are expected to show a larger DSR increase for a given magnitude of interest-rate rise, although on average they have higher incomes to deal with the shock and may seek to raise rents to an extent. Large increases in debt serviceability burdens can produce negative feedback effects on the economy, as highly indebted households reduce their consumption spending and distressed borrowers default on their loans.

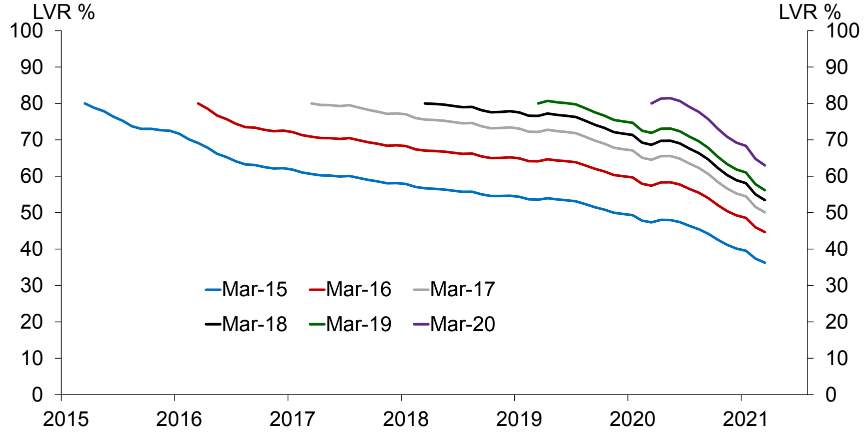
Figure 2.9
Interest-only share of new mortgage commitments, by loan purpose



Source: RBNZ *LVR New commitments survey.*

Note: Interest-only includes revolving credit loans with a non-reducing limit.

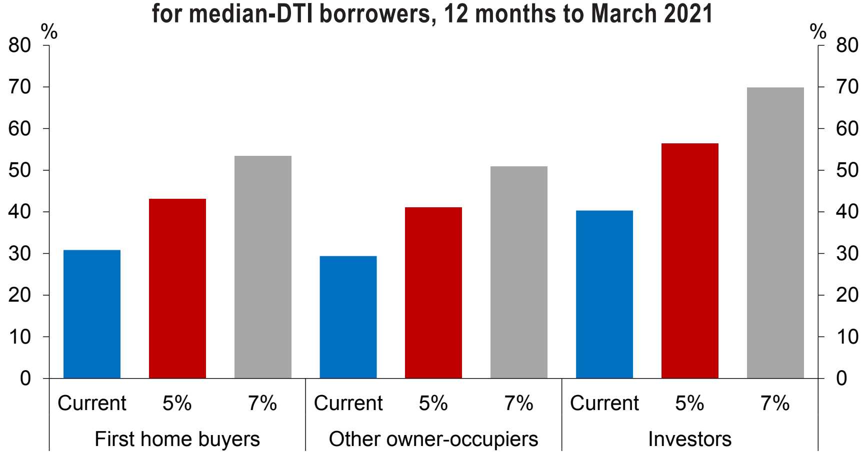
Figure 2.11
Estimated equity position of 80 percent LVR buyers, by year of house purchase



Sources: REINZ, interest.co.nz, Reserve Bank estimates.

Note: Estimates assume borrowers have an 80 percent initial LVR loan with 30-year term, pay the best available one-year fixed rate, adjust their remaining loan term to keep repayments constant over time, and that the property value tracks the REINZ national house price index.

Figure 2.10
Estimated debt-servicing ratios at different mortgage rates for median-DTI borrowers, 12 months to March 2021



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

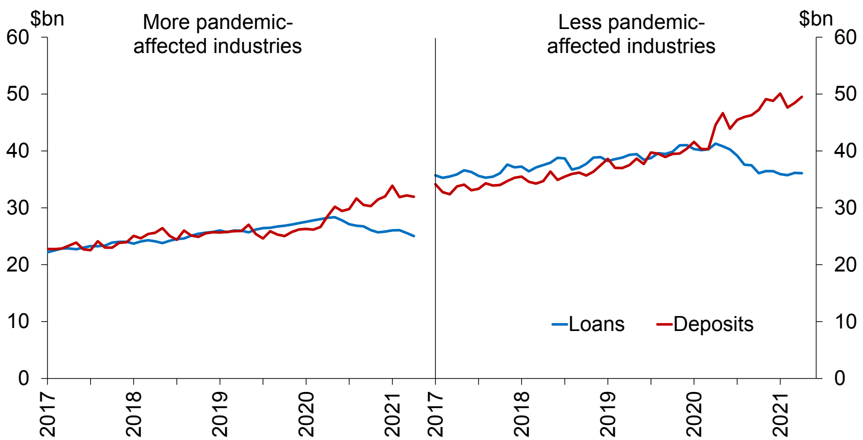
Note: Borrowers are assumed in this modelling exercise to have 30-year mortgages, pay the best available major bank 12-month fixed interest rate, and have no other debts or social security contributions. Methodology assumes linear statistical distribution in the Reserve Bank's DTI and gross income data buckets.

Recent borrowers are vulnerable to a house price fall, although banks are less at risk.

Underscoring concerns around house price sustainability, borrowers and the economy are vulnerable to a severe decline in house prices. A sharp contraction in households' housing wealth would dampen consumption spending, with adverse flow-on effects on the business sector and banks' business lending portfolios. The Reserve Bank has reinstated LVR restrictions to reduce the risk that large declines in house prices amplify a wider economic downturn. By limiting borrowers' leverage, LVR restrictions lean against high-risk lending during an upswing, and reduce the negative feedback effects of falling housing wealth on household spending during a downswing. The LVR policy has been reinstated at a more restrictive calibration for investors, reflecting the greater potential for investors to amplify the housing market cycle.

A decline in house prices in the absence of an economic downturn would be unlikely to impair the soundness of the banking system, owing partly to the resilience benefits conferred by the LVR policy over the past seven years. Homeowners who purchased in the past few years have seen strong growth in house prices, and a steady decline in mortgage rates, providing a large equity cushion (figure 2.11). The prospect of negative equity for most recent buyers is limited, unless a house price decline is very severe.

Figure 2.12
Banking system loans to and deposits from non-financial industries
(excludes commercial real estate and agriculture)



Source: RBNZ *Bank Balance Sheet survey.*

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

Business sector vulnerabilities

The business sector is experiencing a mixed recovery.

Lending to businesses accounts for around 35 percent of the banking system's total loans, and is made up of 14 percent to general businesses, 8 percent to commercial property operators, and 13 percent to agricultural producers. The financial health of the business sector is critical to the health of the financial system, through this direct lending and through the labour incomes that enable households to service their debts. Reflecting the shape of the economic recovery over the second half of 2020, business revenue has improved strongly in sectors linked to household durable goods consumption and construction. However, ongoing border restrictions and periodic ramp-ups in Alert Levels domestically have continued to weigh on transport, tourism, and leisure-related industries.

Businesses are focussing on de-risking their balance sheets…

While activity has partially recovered, business investment intentions remain low given the overall uncertainty about the resolution of the pandemic and the strength of the economic recovery. Firms are using current positive cashflows to deleverage and reduce risk on their balance sheets, reflected in growing deposits and declining loan balances (figure 2.12). Temporary support measures that banks provided to their business customers have also largely ended. Firms that temporarily switched to interest-only terms have largely returned to principal and interest payments.

Government-supported lending schemes are also providing additional and lower-cost financing options to small and medium-sized enterprises. By early April, total approved limits for the Business Finance Guarantee Scheme were $2 billion, and a further $1.7 billion has been advanced directly by the Government under the Small Business Cashflow (Loan) Scheme.

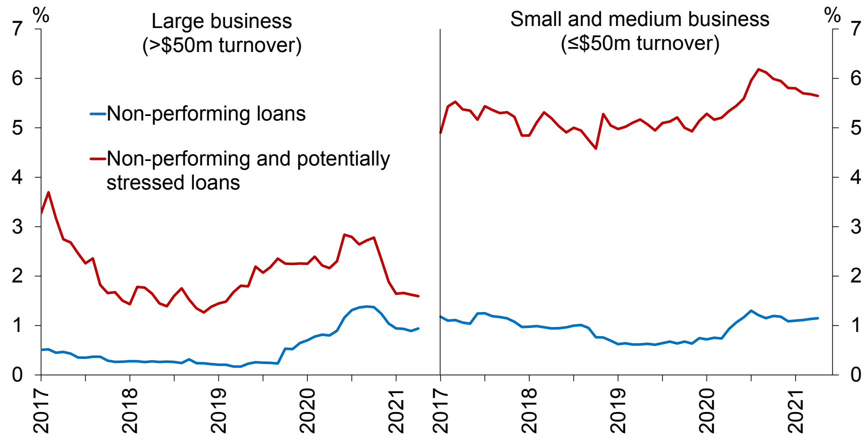
...with the full economic effects of the pandemic yet to flow through.

With economic activity having rebounded in most sectors, asset quality metrics for banks' business lending improved over the latter half of 2020 (figure 2.13). Ongoing COVID-19 uncertainty and border restrictions, coupled with the tapering of government support schemes, mean the strength of the recovery may prove short-lived, and trading conditions may deteriorate. Supply chain disruptions continue to affect some sectors, creating cashflow pressures and limiting business expansion. The full effects of the pandemic on banks' asset quality have yet to flow through.

Credit conditions remain stable, with low demand reflecting low investment.

Banks have been generally supportive of their business customers, with credit availability only tightening to sectors particularly hard hit by the pandemic and ongoing border restrictions. In aggregate, bank credit limits for small and medium-sized enterprises have grown over the past year, with reduced borrowing mostly reflecting subdued demand and low investment (figure 2.14). While total bank lending to businesses has fallen, some banks have grown their market share over the past year through loan syndications and refinancing, indicating the market remains competitive.

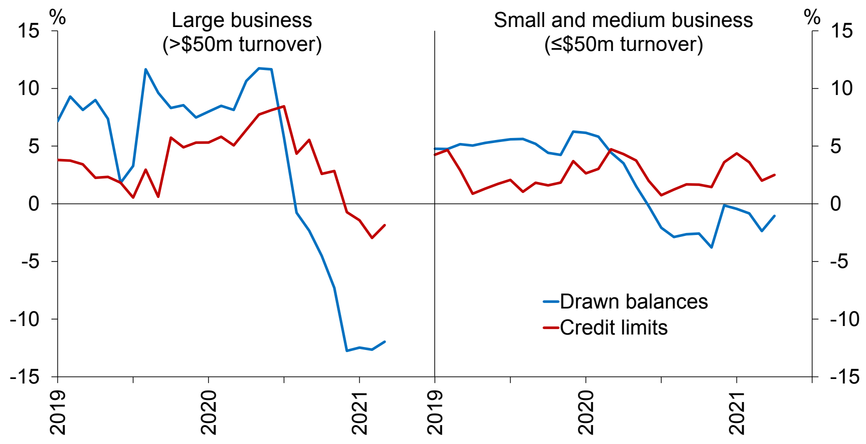
Figure 2.13
Non-performing and potentially stressed business lending, by firm size



Source: RBNZ *Bank Balance Sheet survey.*

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

Figure 2.14
Business lending balances and credit limits, annual percentage change



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

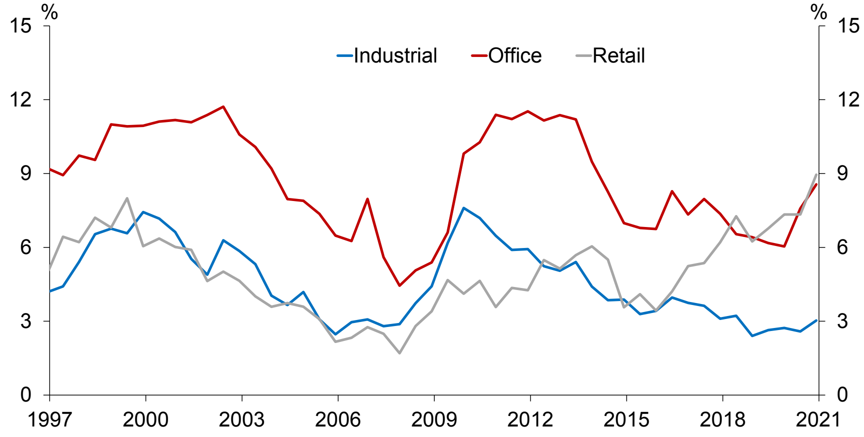
COVID-19 is having different outcomes across commercial property segments…

Around 8 percent of the banking system's lending is to commercial property investors and developers, and some smaller non-bank lenders are more exposed to the sector. Losses on commercial property lending have historically led to institutional failures both in New Zealand and abroad.

Strong demand and low levels of new supply have underpinned industrial property values, with vacancy rates remaining near historical lows of around 3 percent. Large developable sites that are well connected to transport infrastructure have only gradually become available in the major cities over the past decade. These stable supply conditions, and demand growth for distribution and logistics space in particular, have led to steady rental growth. Consumer shifts to e-commerce that have accelerated during the pandemic are likely to see these favourable conditions continue.

On the other hand, the outlook for office space is uncertain, as the normalisation of working-from-home arrangements causes tenants to reassess their long-term floor space needs. A relatively limited amount of high-grade office space has come to the Auckland market over the past decade, while capacity in the Wellington market is slowly recovering from the loss of stock after the 2016 Kaikōura earthquake. While supply limitations are likely to continue to support occupancy levels for prime offices in the major cities, lower-quality or peripherally-located office buildings are at risk of increasing vacancies. Across the three main centres, office vacancy rates reached 9 percent at the end of 2020, approaching levels seen after the global financial crisis, and rents have begun to soften (figure 2.15).

Figure 2.15
Commercial property vacancy rates



Source: JLL.

Retail space is similarly facing headwinds as a result of the pandemic, including the ongoing border restrictions. While retail sales were stronger than anticipated over the second half of 2020, this may not persist as the lack of overseas visitors weighs on demand. Vacancy rates are elevated across the three main centres at 9 percent, with the Auckland market having absorbed three large mall developments recently, placing further pressure on existing retail sites. Overall retail rents have softened, leading to a 17 percent decline in capital values in the year to December 2020. In the long term, retail properties continue to face competition from online e-commerce platforms, and this trend has been reinforced by the pandemic.

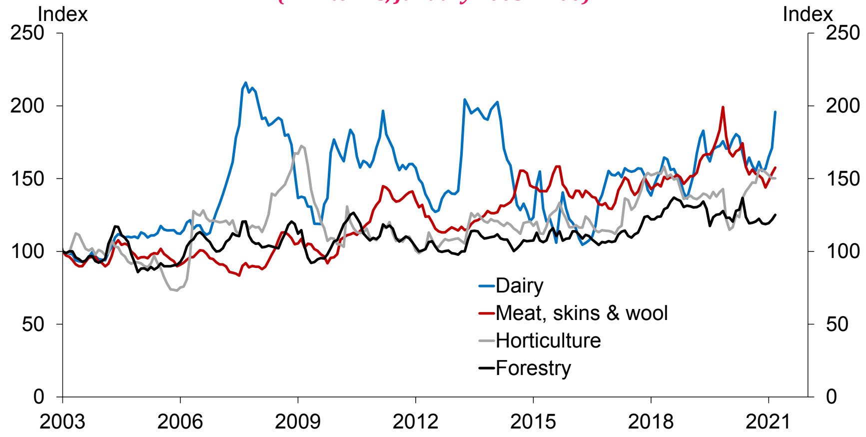
...but banks' exposures to the sector have continued to perform well so far.

Banks maintained relatively tight lending standards in the years prior to COVID-19, including by limiting their exposure to development lending to around 15 percent of their portfolios. To date, banks' non-performing loans to the commercial property sector remain near their pre-COVID levels at 0.2 percent, but they have made loan loss provisions to accommodate a rise in impaired loans to around five times this low level. As office and retail tenants' leases come up for renewal, vacancy rates may further increase, and valuations for less attractive sites may further decline. Banks have reported a tightening in their appetite for further lending to these sectors, in view of the negative outlook.

Strong commodity prices are supporting ongoing debt consolidation and risk deleveraging in the dairy industry.

Demand for agricultural commodities has remained robust throughout COVID-19, with New Zealand milk prices now higher than their pre-pandemic levels. China's rapid recovery from the pandemic has supported continued demand for New Zealand's key agricultural commodities. While demand for dairy has been the driving factor, stronger prices have recently also been recorded for meat and forestry products (figure 2.16).

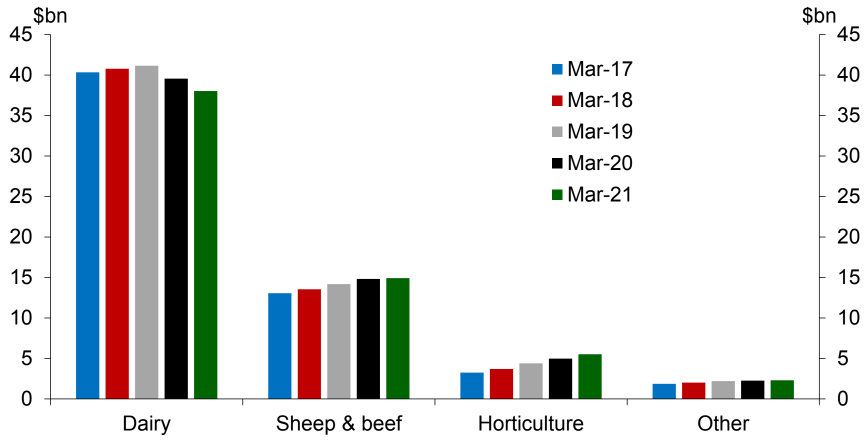
Figure 2.16
New Zealand commodity prices
(NZD terms, January 2003 = 100)



Source: ANZ Commodity Price Index.

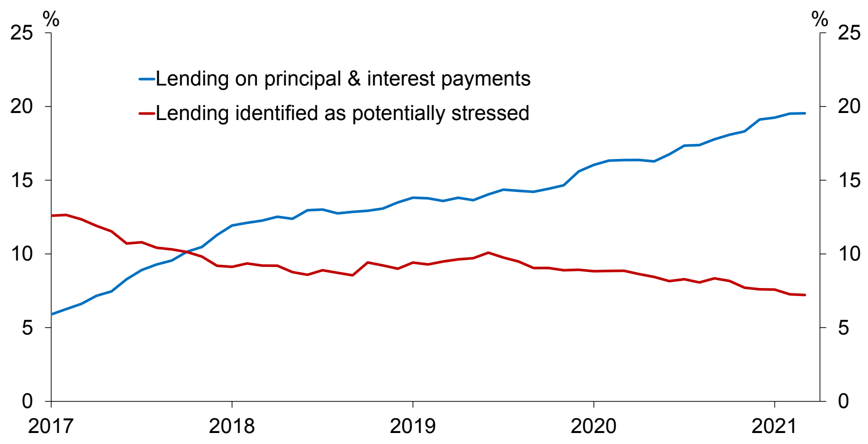
Banks have continued to diversify their loan portfolios away from dairy in favour of sheep and beef farming and horticulture, lessening the financial system's exposure to sector-specific risks (figure 2.17). While dairy's share of banks' agricultural sector lending remains considerable, it has declined from 69 to 63 percent in recent years. Banks are encouraging farmers to take advantage of the current milk prices and low interest rates to pay down existing debt. In addition, the number of dairy farmers identified by banks as being stressed has continued to decline (figure 2.18). These trends are helping to build resilience in the dairy sector.

Figure 2.17
Bank agricultural lending, by subsector



Source: RBNZ *Bank Balance Sheet survey.*

Figure 2.18
Dairy lending stress indicators



Source: RBNZ *Bank Balance Sheet survey.*
Note: Potentially stressed loans includes loans that banks have assigned internal credit rating grades equivalent to B (S&P/Fitch) or B2 (Moody's) or lower, but are not non-performing.

However, vulnerabilities remain for the agriculture sector.

While still relatively small, banks' lending to horticulture producers has maintained a solid growth rate, increasing 11 percent in the year to March. Banks should continue to monitor potential risks associated with this growth, including the sector's vulnerability to labour shortages and severe weather events.

The agriculture sector as a whole also faces several longer-term headwinds, including increased variability in climatic conditions as climate change intensifies. The expected full entry of the sector to the Emissions Trading Scheme from 2025 will likely raise compliance costs and weigh on profitability. Further potential risks such as surplus overseas milk production, the growth of milk alternatives, bovine and crop disease outbreaks, heavily concentrated export markets, and geopolitical trade tensions have the potential to undermine commodity prices and sector prosperity.

Bank funding and liquidity

New Zealand banks have reduced their reliance on wholesale funding…

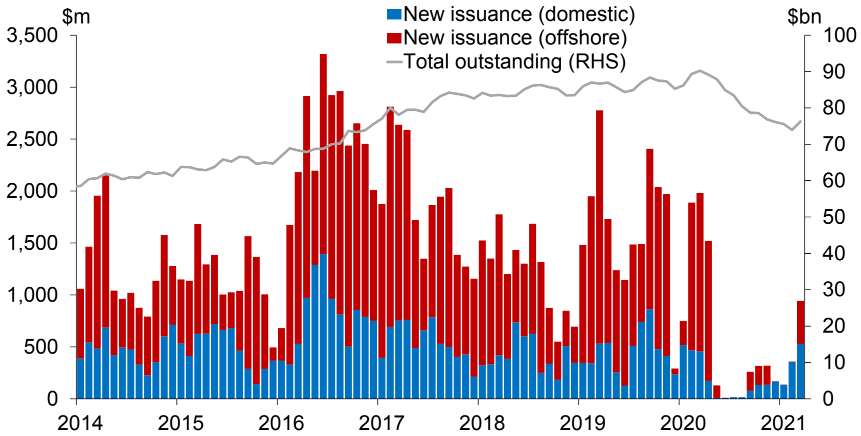
New Zealand banks entered the COVID-19 crisis with much more resilient funding and liquidity positions than they had during the global financial crisis. As a result, when wholesale markets temporarily seized up at the onset of the pandemic, New Zealand banks did not have any immediate need to roll over market funding. Once the turmoil subsided, wholesale funding market participation resumed albeit at a much slower pace of issuance (figure 2.19). Since March 2020, New Zealand banks' outstanding long-term wholesale funding, including from domestic and offshore sources, has declined by $14 billion.

…as deposit funding has soared on the back of fiscal and monetary stimulus.

Over the past year domestic fiscal and monetary policy responses have led to a strong surge in deposit creation (figure 2.20). At the same time, sluggish overall lending growth has reduced new funding requirements. Both factors have allowed New Zealand banks to meet their core funding needs with domestic deposits.

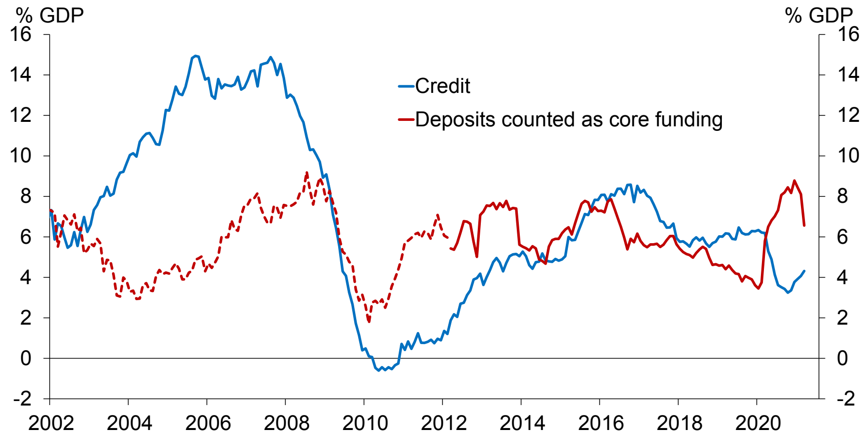
The tapering of government deficit spending has seen a slowdown in deposit growth in the past six months, particularly among households. To maintain their core funding positions at their current rates of credit growth, major banks are likely to re-enter wholesale funding markets over the coming months at longer tenors. This would be to complement the shorter-term funding facilities available from the Reserve Bank, such as the Funding for Lending Programme.

Figure 2.19
Long-term wholesale funding of locally-incorporated banks



Source: RBNZ *Liquidity survey.*
Notes: Three-month moving average issuance of wholesale funding with initial maturity greater than two years.

Figure 2.20
Annual growth in bank credit and deposit funding



Source: RBNZ *Standard statistical return, Liquidity survey, Bank Balance Sheet survey,* Stats NZ, Reserve Bank estimates.

Chapter 3

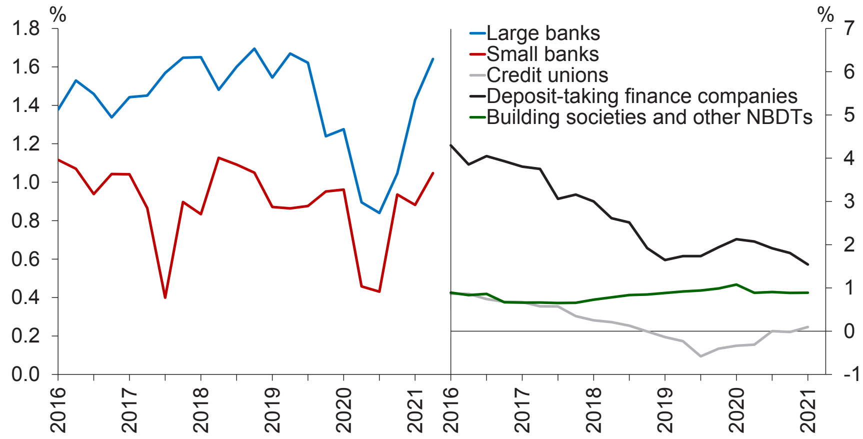
Financial sector dynamics and institutional resilience

The soundness and efficiency of the financial system is fundamental to the overall resilience of the New Zealand economy. This includes recognising the role of the financial system in providing access to capital to different segments of society (Box B). During periods of economic weakness, it is important that financial institutions are able to continue to provide their services to viable customers in order to support the economy. Banks should be strong enough to maintain credit availability for businesses and households, who use their borrowings to support demand in the economy. Insurance also provides certainty to these households and businesses, mitigating some risks for decisions on consumption and investment.

The banking sector has benefited from an improvement in economic conditions over the past six months, which has supported asset quality and seen profits stabilise (figure 3.1). Overall, this has improved capital positions and institutional resilience. However, the underlying resilience of some households and businesses remains weaker than prior to COVID-19, and stresses on bank loans may still materialise over the next year.

Non-bank deposit takers (NBDTs) have also benefited from the strong policy response and better-than-expected conditions. The sector, credit unions in particular, has seen profitability stabilise after a period of weakness. However, some smaller institutions still face pressure due to high underlying costs, and deposit-taking finance companies could see elevated volumes of non-performing loans.

Figure 3.1
Return on assets
(pre-tax, annualised)



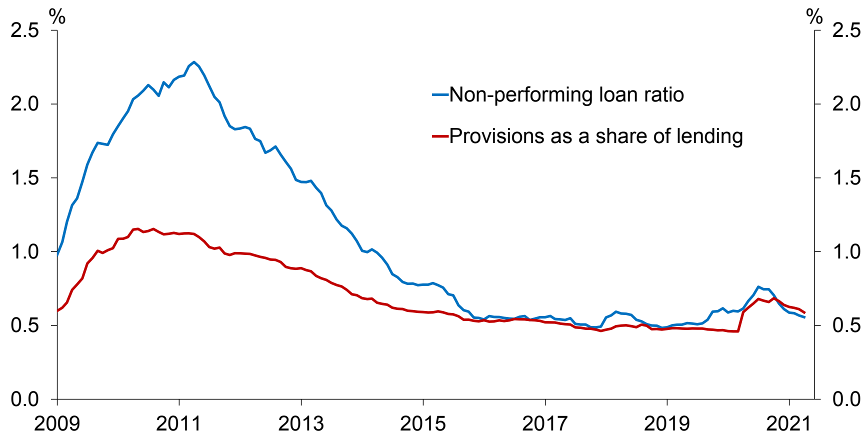
Source: RBNZ *Income statement survey, Bank Balance Sheet survey, Non-bank deposit takers survey.*

Banks

Substantial monetary and fiscal policy responses have buttressed bank positions…

Economic conditions are considerably stronger than initially feared at the start of the pandemic, largely due to the strong and effective economic and public health responses. As a result, banks have not faced a severe stress event. Non-performing loans (NPLs) have remained at relatively low levels, peaking at 0.76 percent in June. This is well below the levels seen during the global financial crisis, reflecting the effectiveness of policy responses in softening the initial economic impacts of the pandemic (figure 3.2).

Figure 3.2
Non-performing loan ratios and loan provisions
(locally-incorporated banks)



Source: RBNZ *Bank Balance Sheet survey*, private reporting, and General Disclosure Statements.

…but underlying weaknesses could still see stresses materialise.

The outlook remains weak compared to pre-pandemic, and the underlying resilience of some households and businesses is still being challenged as relief initiatives have rolled off. The broader impacts of the weak economic conditions may result in an increase in the number of loan defaults over the coming quarters.

There are also elevated risks associated with mortgages previously on deferred payments. While banks have transitioned the majority of deferral customers back to regular payments, some of these customers may continue to face stress and struggle to continue making regular payments.

Banks have already taken into account the potential for further loan losses through large provisioning expenses in 2020. By the end of 2020, provisions remained around $850 million higher than at the end of 2019, representing a 40 percent increase. Modest increases in NPL ratios are therefore unlikely to have a significant impact on bank profitability or pose a threat to financial stability.

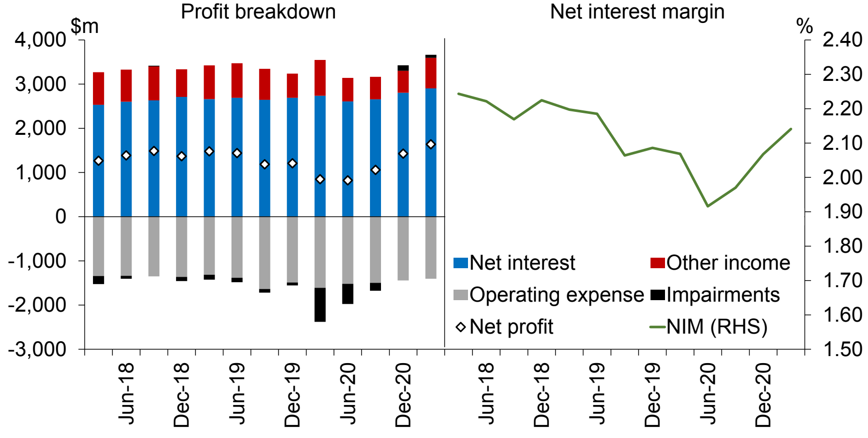
Bank profits have recovered.

Bank profits have picked up on the back of better economic conditions and low default rates. Quarterly profits have now recovered to pre-COVID levels, and banks have been able to write back some of their initial provisioning expenses. The system average net interest margin (NIM) was also strong, with provisional data showing it reaching 2.14 percent on an annualised basis in the first quarter of 2021 (figure 3.3).

With ample deposits in the system, and access to the Funding for Lending Programme (FLP) as a backstop, banks' reliance on term deposits has declined. Interest rates on term deposits have declined to historical lows. This has prompted some term depositors to move their savings into on-call accounts, as they perceive the benefit of having readily accessible funds to outweigh the modest interest earned on term deposits (figure 3.4). Accordingly, as banks pay lower interest on call accounts than on term deposits, the shift to call deposits combined with lower term deposit rates has seen funding costs decline considerably. Banks have also broadly passed on these funding cost reductions to interest rates on lending (figure 3.5).

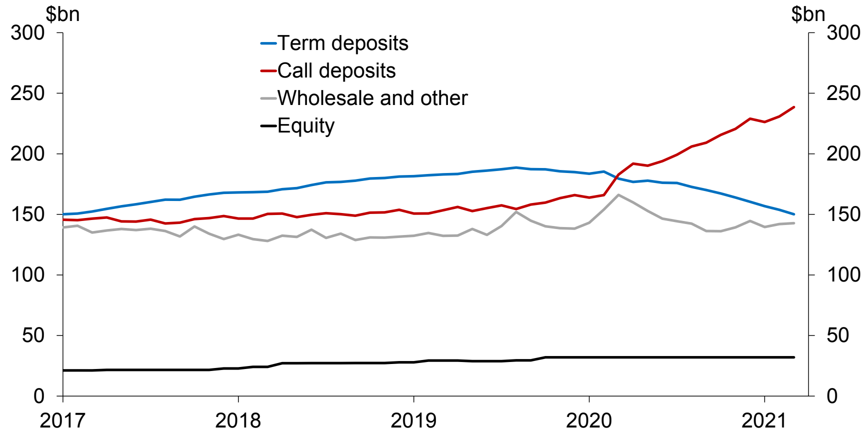
However, interest-expenses are unlikely to decline further as call deposit rates are already close to zero, and a significant share of term deposits has already been repriced to lower rates. At the same time, banks may see their interest incomes start to decline as more existing mortgages, which tend to have longer fixed-rate periods than deposits, begin to reprice at lower rates.

Figure 3.3
Profitability of locally-incorporated banks



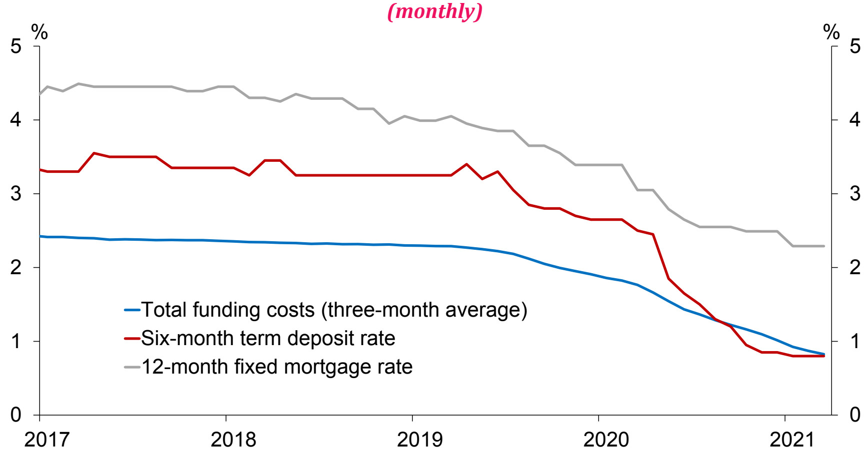
Source: RBNZ *Income statement survey, Bank Balance Sheet survey.*
Note: Net interest margin is the annualised quarterly value.

Figure 3.4
Funding sources for banks



Source: RBNZ *Bank Balance Sheet survey.*

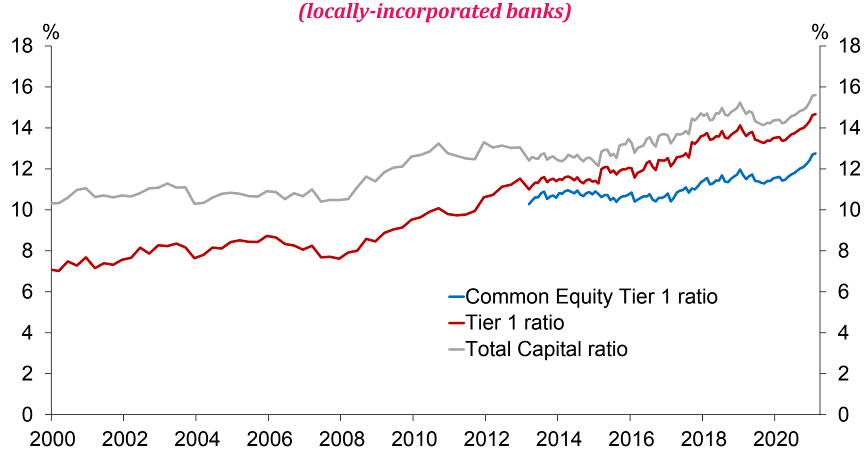
Figure 3.5
Interest rates and cost of funds
(monthly)



Source: RBNZ *Income Statement survey*, RBNZ *Bank Balance Sheet survey*, interest.co.nz, Reserve Bank estimates.

Note: Average cost of funding is the interest expenses for the past three months divided by the average interest-earning assets over that period.

Figure 3.6
Capital ratios
(locally-incorporated banks)



Source: RBNZ *Capital adequacy survey*, General Disclosure Statements.

As the gap between credit and deposit growth widens, banks could face funding pressures and may need to source funding from more expensive sources, such as term deposits and wholesale funding. Conversely, an ongoing higher share of call deposit funding would mean that banks need to maintain higher levels of liquid assets to meet their prudential liquidity requirements. As the interest earned on liquid assets is generally very low, this would weigh on overall profitability.

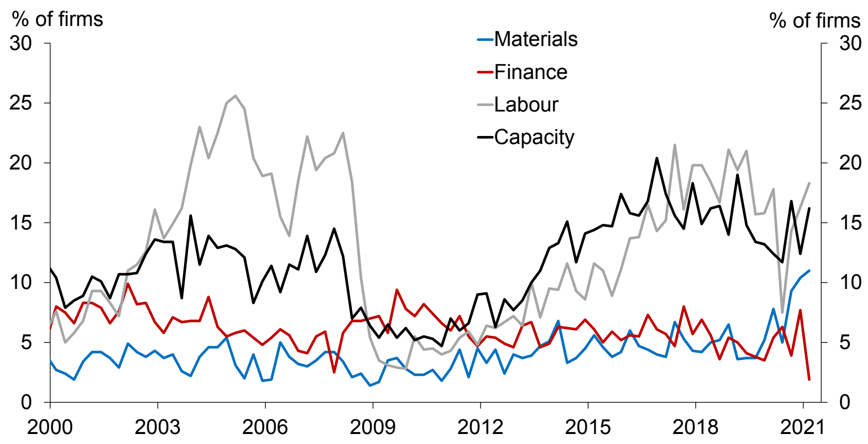
Banks are in a strong position to support their customers.

The banking sector entered the downturn with strong liquidity and capital buffers. These buffers have improved further over the past 12 months on the back of resilient underlying profits and dividend restrictions (figure 3.6). This means that the banking sector is in a stronger position to weather potential deteriorations in conditions and support an efficient financial system by maintaining credit flows to viable households and businesses.

While there was limited new bank lending in the first half of 2020 due to the soft demand caused by COVID-19, new lending has since recovered. This has been most prominent in the housing sector, where mortgage lending has seen a strong resurgence in activity.

As the economic outlook has improved, business demand for working capital has started to return and the financial system has been accommodative in providing this credit. Banks reported no significant tightening in lending standards to businesses in most areas in the recent RBNZ Credit Conditions Survey. Similarly, the NZIER Quarterly Survey of Business Opinion suggests that accessing credit is not the key constraint on most firms' activity (figure 3.7). The past six months have also seen some banks growing their business lending portfolios despite the overall decline in business loans, a sign that there are still competitive dynamics in the market for these customers.

Figure 3.7
Firms' views on the key factor limiting expansion



Source: NZIER *Quarterly Survey of Business Opinion.*

Prudential regulations will begin to normalise and build up resilience in the system.

As economic conditions begin to improve, it is important that prudential regulations begin to normalise so that the financial system is resilient to future shocks (see Chapter 4). The pathway to normalising regulations also considers the need to build up buffers gradually, so that banks can improve their resilience while also being able to support their customers.

On 31 March this year, the Reserve Bank announced that banks will be able to pay dividends of up to 50 percent of their earnings. This easing of dividend restrictions reflects the relative improvement in economic conditions. However, in the context of ongoing uncertainty, it is important that banks remain prudent and consider the implications of dividend payments on their ability to support their customers. The decision to ease the dividend restrictions is also part of the broader policy normalisation process.

As part of this process, the pathway to higher capital requirements under the Capital Review will begin in 2022 after a two-year delay. It is important that the banking sector can weather large shocks and continue lending to households and businesses. While the economic impacts of COVID-19 have been significant, the government support and policy responses have helped the banking sector to avoid severe stress. The Capital Review reforms will progressively increase capital requirements for banks, ensuring that the sector is resilient to all but the most severe shocks.
In addition, the Reserve Bank intends to increase the minimum core funding ratio requirement to its previous level of 75 percent on 1 January 2022, subject to no significant worsening in economic conditions.

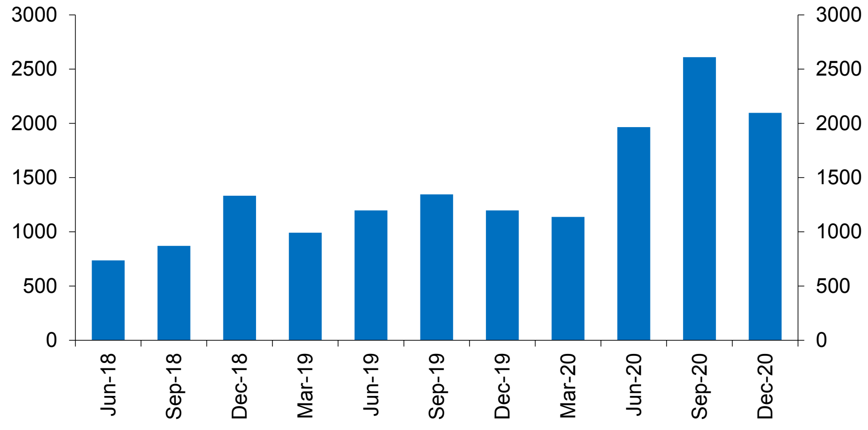
Operational risks have been elevated.

The global pandemic has presented a number of operational challenges for the financial system and elevated the risk of losses due to process or system failure. Operational risks have materialised in a number of high-profile cyber incidents over the past year, including a recent illegal breach of a third-party file-sharing software application used by the Reserve Bank. These events highlight the importance of remaining vigilant and ensuring operational risks are appropriately managed.

Over the past 12 months, the banking sector has faced a number of broader challenges to how banks operate their businesses. The direct impacts of lockdowns and social distancing have required banks to adjust their processes for managing face-to-face interactions with customers. There have also been periods when the number of mortgage applications have reached capacity limits, which can stress processes and systems. Banks have also had to adapt and prepare their systems for negative interest rates, should they be required.

Permanent changes in operating models through increased working from home and the broader digitalisation of systems may increase banks' exposure to cyber risk. According to CERT NZ, the number of reported cyber incidents increased 65 percent in 2020 (Figure 3.8). By comparison, for organisations providing financial services, the increase was about 6 percent. Nonetheless, it is still important that financial institutions are vigilant in an environment with heightened cyber risks. The Reserve Bank has recently published the finalised guidance on cyber resilience, which will support the financial sector to further develop appropriate policies to mitigate cyber risks (see Chapter 4).

Figure 3.8
Number of reported cyber incidents in New Zealand
(quarterly)



Source: CERT NZ quarterly reports.

Innovation through digital platforms promotes efficiency.

The digitalisation of the financial system also provides a platform for innovation and supports a more efficient financial system. Over recent years, the New Zealand financial system has seen some of this innovation through the emergence of 'buy now, pay later' schemes and online investment platforms. Open banking – that is, a standardised and secure framework for sharing bank customer data with trusted financial service providers – also has the opportunity to promote greater competition in the banking sector. While the risks to consumers from these new platforms and digitalisation are still being understood, innovations like these also promote efficiency by providing more access to financial services and promoting competition.

Table 3.1

Key metrics for New Zealand's banking system

Metric	Value (%) March 2021	Value (%) 1 year ago	Regulatory minimum (%)	Comment
Tier 1 capital ratio[1]	14.7	13.6	8.5*	Banks' Tier 1 capital ratios have increased over the past 12 months, driven by strong underlying earnings and retention of profits.
Mismatch ratio (one month)[2]	5.6	5.9	0	Banks' mismatch ratios have remained elevated, reflecting the role of large-scale asset purchases (LSAP) and other interventions in supporting liquidity in the market.
Core funding ratio	86.8	88.3	50	Banks' core funding ratios are well above regulatory minimums. Banks should also be able to meet the regulatory requirements when they normalise in January 2022. As deposit growth slows, banks will rely more on wholesale markets to obtain core funding to support credit growth.
Annual return on assets (after tax)	0.8+	0.9		Nominal profits have stabilised after a brief decline in 2020. Return on assets has largely recovered to pre-COVID levels.
Net interest margin (monthly, annualised)	2.03+	1.98		Banks have, for the most part, been able to reduce both funding costs and lending rates to maintain their margins.
Non-performing loan ratio	0.57	0.62		Non-performing loans have been relatively low for a period of economic weakness, reflecting the strong policy response and regulatory initiatives.
Cost-to-income ratio	44.6+	44.5		Costs have fluctuated over the past 12 months. Operating expenses increased in the first months of the pandemic; however, they have since tapered.

Source: RBNZ *Capital adequacy survey, Liquidity survey, Income statement survey, Bank Balance Sheet survey.*

1 Tier 1 capital ratios are for February months.

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

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

\+ Provisional data.

Non-bank deposit takers

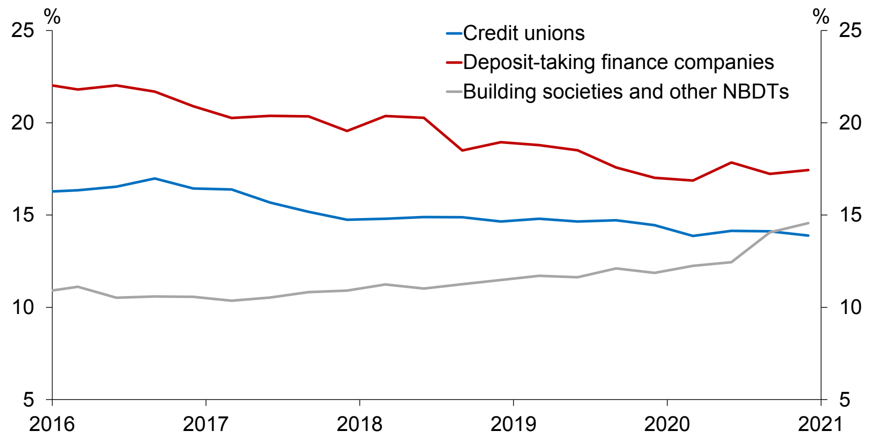
There are 19 financial institutions – with a diverse range of corporate structures and business models – that make up the non-bank deposit taker (NBDT) sector. Together they have a total lending amount of $1.8 billion, less than 0.5 percent of total lending. Although NBDTs are small compared with the banking sector, they provide services to those who otherwise may not be able to access finance and banking services and contribute towards a more competitive financial system.

CUBS have stabilised or improved their capital positions.

Credit unions and building societies (CUBS) are mutually owned. As such, their primary purpose is often to provide low-cost financial services to their members rather than to maximise earnings. Nonetheless, it is important that these entities have sufficient earnings to maintain sound capital positions and remain resilient.

Credit unions have been challenged in recent years, with high costs supressing earnings. This has seen a number of credit unions consolidate into larger entities. Over the past 12 months, lower deposit rates across the financial system have supported earnings for credit unions, with interest expenses declining more than interest income. Alongside the better-than-feared economic conditions, this has contributed to a stabilisation of capital positions. While this is a positive step for resilience, credit unions remain vulnerable to a deterioration in conditions, particularly smaller entities that do not benefit from economies of scale. As such, further consolidation may be necessary to capitalise on economies of scale and boost the resilience of the sector.

Figure 3.9
Capital ratios of NBDTs, by subsector



Source: RBNZ *Non-bank deposit takers survey.*

Note: Excludes FE Investments Limited.

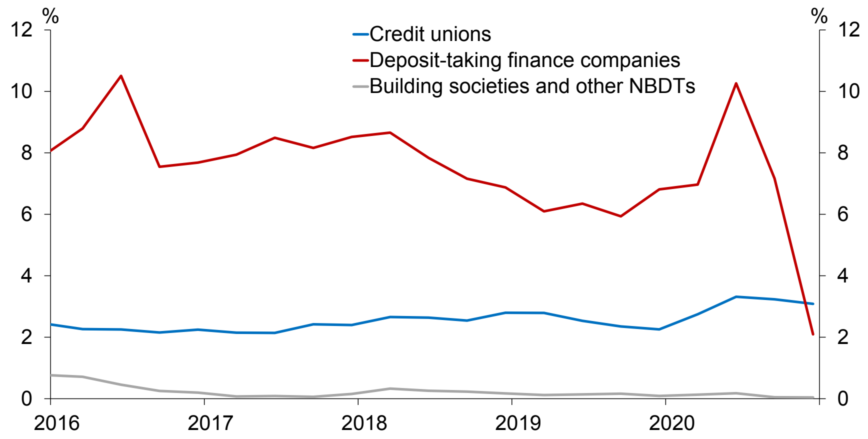
Building societies have remained profitable throughout the pandemic, which has allowed them to build up their capital positions (figure 3.9). The subsector has also maintained a very low NPL ratio. This reflects building societies' focus on mortgage lending and correspondingly lower risk profile.

Deposit-taking finance companies could see an increase in non-performing loans.

Deposit-taking finance companies are a small part of the financial system. They have historically maintained high capital ratios, and these have remained relatively stable over the past 12 months following a downward trend over the previous few years. For deposit-taking finance companies, the low interest rate environment has placed some pressure on earnings as interest incomes have declined further than interest expenses.

Deposit-taking finance companies tend to target higher-risk forms of lending, leading to higher NPL ratios than those in other sectors. Over 2020, NPL ratios peaked in June at over 10 percent, but then quickly fell to 2 percent by December (figure 3.10). This decline reflected a mix of loan write-offs and impaired customers being able to return to regular payments or paying off their debt. While NPL ratios are currently low, weak economic conditions could weigh further on asset quality and there is a risk that the number of non-performing loans may increase over the next year.

Figure 3.10
Non-performing loan ratios for NBDTs, by subsector



Source: RBNZ *Non-bank deposit takers survey.*

Note: Excludes FE Investment Limited.

Table 3.2
Key metrics for New Zealand's NBDT sector

Metric	December 2020			December 2019		
	Credit unions	Building societies and other[1]	Finance companies[2]	Credit unions	Building societies and other	Finance companies
Number of licensed institutions	8	4	7	9	4	7
Total assets	$1,144m	$1,375m	$252m	$1,140m	$1,267m	$300m
Capital ratio (%)	13.9	14.6	17.4	14.5	11.9	17.0
Non-performing loan ratio (%)	3.1	0.0	2.1	2.3	0.1	6.8
Annual return on assets, before tax (%)	0.1	0.9	1.5	-0.3	1.1	2.1

Source: RBNZ *Non-bank deposit takers survey.*

1 Includes Christian Savings Limited.

2 Finance companies' financial data for December 2020 exclude FE Investments Limited, which entered receivership in March 2020. However, FE Investments Limited is still included in the "Number of licensed institutions".

Insurance

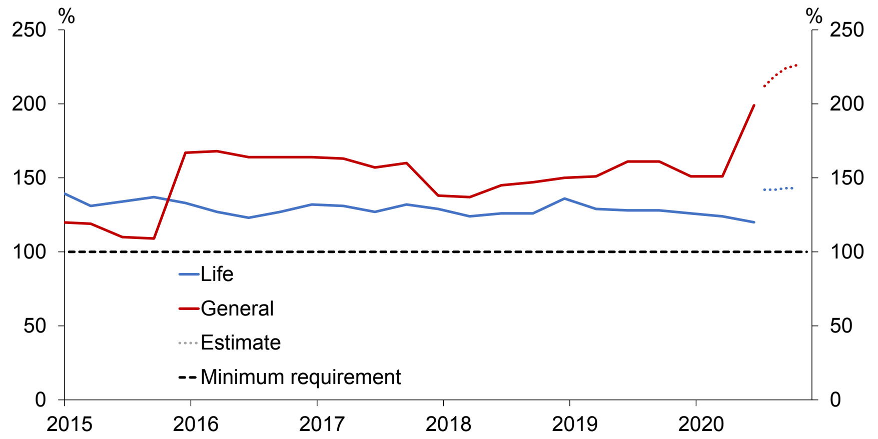
Insurers have an important role in the financial system as they allow businesses and households to manage risks. General insurers account for the largest part of the New Zealand insurance sector, with around 59 percent of total gross premium revenue. Life insurers account for around 29 percent of premium revenue, while health insurers account for around 12 percent of premium revenue.

Insurers have retained capital during the period of economic uncertainty.

In November 2020 the Reserve Bank relaxed its guidance to insurers that they should not pay dividends until the economic picture and financial impacts of COVID-19 became clearer. Even though the worst-case economic scenarios envisaged earlier in the pandemic have not materialised in New Zealand, the Reserve Bank expects that insurers will consider, when making decisions about dividends, how they would respond to significant stresses on their businesses and protect the interests of policyholders.

Overall, the solvency capital ratio of the general insurance sector has increased. The solvency ratio for the life insurance sector dipped slightly in June 2020, but is estimated to have increased to 143 percent as at October 2020 (figure 3.11). The solvency ratio for the health insurance sector remains above 300 percent.

Figure 3.11
Solvency ratios for the general and life insurance sectors



Source: RBNZ *Insurer Solvency Return*.

Note: Monthly estimates from July 2020 onward are prepared by insurers on a best-endeavours basis. For example, these do not include year-end accounting adjustments that can have material impacts on the balance sheet and solvency ratio. The Reserve Bank ceased collecting monthly estimate data from insurers in October 2020, on the basis that the risks to the solvency and financial health of the insurance sector were no longer as elevated as earlier in the year.

The cost of business interruption claims remains low…

In many overseas jurisdictions, insurers initially denied COVID-related business interruption (BI) claims from their customers, as they believed cover for infectious diseases was excluded from the policies they offered. Multiple court rulings (in particular in the United Kingdom and Australia, which are the closest jurisdictional analogues to New Zealand) have now determined that many of those policy exclusions are not robust enough to deny cover for losses sustained from COVID-19 lockdowns. The Insurance Council of Australia estimates that the cost to the insurance industry in Australia alone may be AU$10 billion, and many insurers there have raised additional capital or increased provisions to cover an expected influx of claims. There is a risk that as the size of overseas claim costs becomes clearer, overseas parent insurers may look to reduce financial support for their New Zealand businesses or seek higher dividends to shore up their financial positions.

To date, no class action or legal challenges like those seen overseas have been initiated in New Zealand. Insurers believe the definition and interpretation issues assessed by courts overseas are not applicable for most New Zealand BI policies. The Reserve Bank is obtaining information from insurers to assess the size and scope of BI policies that could be affected if similar court rulings applied in New Zealand.

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

New Zealand's economic downturn has been less severe than those in other countries. Insurers offering credit protection, loan repayment and redundancy insurance products may be exposed to greater claim costs if the New Zealand economy remains weak, but claims on those products to date appear to be at normal levels.

There remains a risk that further outbreaks could lead to significantly greater mortality rates and higher levels of claims on life insurance policies. There is also emerging evidence that COVID-19 can have recurring or long-lasting negative health effects on individuals who recover from the virus, and this may lead to elevated levels of disability and trauma claims over the long term.

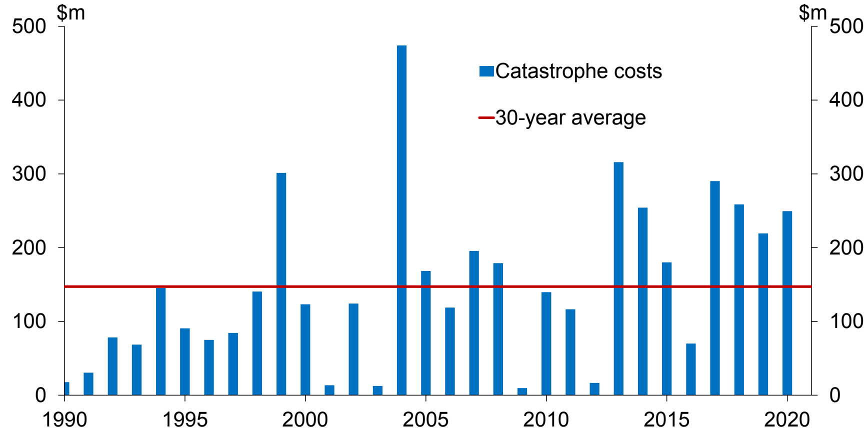
While international travel volumes remain low, there is little demand for travel insurance products and the gross premium revenue of travel insurers is greatly reduced. For most insurers, travel insurance products are only one business line in a suite of products offered, so the impacts on their solvency and financial health are limited.

The Reserve Bank is placing a greater focus on how insurers respond to climate change risks.

In recent years, the cost of weather-related catastrophes in New Zealand has been consistently higher than long-term averages (figure 3.12). General insurers typically rely on years with benign weather conditions to offset elevated claim costs from years with more extreme events, without needing to make significant adjustments to premiums for insured businesses and individuals. With climate change, extreme weather events are becoming more commonplace and the frequency of years with benign weather will be greatly reduced.

The Reserve Bank expects that insurers will respond to these changes by continuing to develop their granular, risk-based pricing models. This may lead to greater variations in the level of premiums charged to customers, with higher premiums or reduced coverage in locations with high risks, such as those prone to flooding. These changes in pricing and coverage will come on top of changes already being introduced for updated assessments of earthquake risks. As a result, this will allow households and businesses to appropriately internalise the risks associated with climate change in their decision making.

Figure 3.12
Cost of catastrophes
(excludes earthquakes and man-made)



Source: ICNZ, CoreLogic, Reserve Bank estimates.

Note: The cost of catastrophes is adjusted by the CoreLogic total value of housing stock, which is used as a proxy to represent the growth in built-up areas and the total value of property protected by insurance.

Table 3.3

Key metrics for New Zealand's insurance sector

Metric	Value (%) Current[1]	1 year ago[1]	Regulatory minimum (%)	Comment
General insurers				
Solvency ratio	199	161	100	Solvency ratios increased significantly in early 2020 when general insurers ceased paying dividends and retained capital.
Profit margin	10.3	13.2		General insurer profit margins have dipped back towards more normal levels after two relatively high profit years.
Expense ratio	13.5	13.0		Expense ratios have remained steady since 2017.
Life insurers				
Solvency ratio	120	128	100	Some life insurers are operating with small margins over their minimum solvency requirements, and the Reserve Bank is monitoring those insurers closely.
Profit margin	11.9	16.1		Profit margins have decreased over the year. Bancassurers* and mature traditional businesses tend to have higher profits than insurers that distribute through advisors.
Expense ratio	22.8	22.2		Expense ratios for life insurers that distribute their products through brokers and advisors are higher than for bancassurers*.
Health insurers				
Solvency ratio	313	332	100	Health insurers generally have stronger capital buffers than general insurers, reflecting the fact that many are mutual companies with restricted access to capital.
Profit margin	3.3	4.0		Profit margins are low for health insurers, again reflecting the fact that many are mutual companies that lack profit-motivated parent-firms or shareholders.
Expense ratio	12.2	11.3		Health insurer expense ratios have trended slightly upward in recent years.

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

1 Profit and expense figures are from the *Quarterly Insurer Survey* to September 2020 for current, and to September 2019 for one year ago. These cover just under 90 percent of the insurance sector by premium. Profit margin is profit after tax divided by gross premium revenue; note that this measure overstates profitability for mature traditional life insurers with large balance sheets and low levels of premium. Expense ratio is non-commission expenses divided by gross premium (expressed as a percentage). Solvency figures are from the *Insurer Solvency Return* to June 2020 for current, and to June 2019 for one year ago.

* Bancassurers are insurers that distribute products largely through banks.

Financial market infrastructures

Financial market infrastructures have continued to perform satisfactorily despite the uncertainty of the COVID-19 environment...

Financial market infrastructures (FMIs) have continued to show resilience through the changing environment caused by the pandemic. FMI operators have adapted to the different Alert Levels effectively, instigating business continuity plans and moving to split onsite-offsite team operations as required. There has been no repeat of the prolonged and elevated volumes of transactions experienced at the time of the Alert Level 4 lockdown in March and April last year.

...however, there have been operational problems.

The new versions of the Reserve Bank operated systems – 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) – have generally performed well in their first year of operation. However, they have each experienced some issues in recent months.

ESAS experienced a significant outage on 30 November 2020, when issues associated with the implementation of some software changes prevented the system opening. As a result, no transactions could be processed, including NZClear transactions with a cash settlement component. The issue was corrected around midday, with the backlog of unsettled payments cleared within an hour.

The Reserve Bank issued a number of communications during the outage to ensure that ESAS participants and other interested parties were kept well informed. Although this was a major outage that impacted the entire New Zealand financial system, the Reserve Bank believes that the incident response was timely and effective. Nevertheless, the Reserve Bank has subsequently reviewed its system monitoring and incident-response procedures to identify areas for improvement.

On 2 December 2020, the NZClear system experienced an extended delay to the completion of start-of-day processing, mostly as a result of high transaction volumes causing system slowness. This delay meant that transactions could not be processed for over two hours. The Reserve Bank has since introduced measures to mitigate future incidents caused by high-transaction volumes, while also working with the provider of the system software to find a permanent solution to the underlying issue. NZClear experienced a further outage on 12 March 2021 as a result of a processing issue, with the system unavailable most of the morning. The Reserve Bank has now taken additional actions to mitigate and manage potential outage events in the future. It is a key priority of the Reserve Bank for ESAS and NZClear to operate safely and efficiently. The immediate response to operational incidents, and subsequent actions to review and improve processes are the responsibility of the Reserve Bank's Payment Services Department. In addition, the Reserve Bank's Supervision Department and the Financial Markets Authority (FMA) will continue to monitor the effectiveness of countermeasures put in place since the incidents.

FMA has released its NZX IT review, encompassing the NZCDC settlement system.

On 28 January 2021, the FMA released a review of New Zealand Exchange's (NZX) technology that covered both the trading-volume-related system issues and outages experienced in April 2020 as well as the distributed denial-of-service (DDoS) cyber-attacks in late August and early September. Although this review was initiated by FMA to determine whether NZX was meeting its obligations as a licensed market operator, the findings were also applicable to NZX's clearing and settlement system (NZCDC), which is jointly supervised by FMA and the Reserve Bank. The review found that NZX failed to meet its licensed market operator obligations due to insufficient technology resources. NZX is working on developing a formal action plan to address the issues raised by FMA. The Reserve Bank will continue to engage with FMA and NZX, as NZX acts to address the issues raised by the review to the extent that those actions relate to the settlement system.

The payments industry continues with significant projects.

The Reserve Bank and the payments industry are continuing to work closely to progress two major projects, both of which will require system changes by the Reserve Bank and industry participants. ISO 20022 messaging will allow richer information to be included with payment instructions and SBI 365 will enable daily payment settlement to occur over weekends. As ISO 20022 is a critical international project, the Reserve Bank will be not only ensuring its own systems are upgraded appropriately but also closely monitoring the work being done by industry participants.

Meanwhile, Payments NZ has released a high-level discussion document, the *Payments Modernisation Plan*, which looks at what capabilities are required to modernise New Zealand's payments ecosystem. The Reserve Bank views the Plan as a positive initial step toward improving the efficiency of the New Zealand payments system, and believes it is important that the initiatives contemplated by the Plan are progressed. The Reserve Bank will therefore closely monitor and engage with Payments NZ on the *Payments Modernisation Plan's* further development and operationalisation.

Box B

Kimihia te mea ngaro – Māori access to capital

The Māori economy is an integral part of the New Zealand economy, encompassing around $69 billion in assets as of 2018. It comprises businesses across a vast array of industries, including key commercial sectors such as farming, fishing and forestry. Māori also represent an increasing proportion of New Zealand's population, and a growing part of the workforce.

In recognition of the role of Māori in the New Zealand economy, and as part of its Te Ao Māori strategy, the Reserve Bank recently released *Te Ōhanga Māori – Māori Economy Report 2018* in partnership with Business and Economic Research Limited (BERL, 2021). This report identified several challenges faced by the Māori economy, with access to capital highlighted as one of the primary concerns.[6]

Māori customers and entities seeking to develop their economic or business positions tend to self-report lower rates of capital accessibility than non-Māori. This impacts their ability to realise their full economic potential and also inhibits the growth and productivity of New Zealand's economy. These issues are interrelated with the financial system's role of allocating capital in the economy. The Reserve Bank, through its mandate to promote a sound and efficient financial system, has an interest in better understanding the potential underinvestment of capital in Māori assets.

The Reserve Bank has therefore launched a work programme to better understand Māori access to capital in the New Zealand economy, with a focus on bank lending to Māori small and medium-sized enterprises. Bank lending to Māori households and individuals may also be considered as part of this work. Initial research designed to capture a snapshot of the issues landscape has already been completed. It highlights a dearth of quantitative data, while qualitative interviews suggest the Reserve Bank should dive deeper into this issue to understand its implications more clearly.

The next step in this research will be to further develop the quantitative assessment of Māori access to capital. It will also assess whether any issues arising in capital access either constitute a potential market failure or highlight gaps in the New Zealand lending market. This assessment will guide policy and regulatory interventions, if and where necessary.

This work aims to use the Te Ao Māori strategy to incorporate a long-term, intergenerational view of wellbeing into the Reserve Bank's core functions. It will also inform the Reserve Bank's financial inclusion work and the allocative efficiency elements of its monetary policy and financial stability mandates. The Reserve Bank is treating this work as a high priority within its strategic work programme.

The intention is for this work to be a cross-agency effort, involving both the public and private sectors.

6 Research recently undertaken by **BDO (2020)** and the **Productivity Commission (2021)** also reported similar findings.

Box C

The Reserve Bank 2021 Stress Testing Programme

Stress testing is used by the Reserve Bank to assess the resilience of institutions and the financial system to hypothetical severe but plausible scenarios. It complements historical indicators of financial stress by providing a forward-looking view of high-impact, low-probability events.

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

A review of the Reserve Bank's stress testing conducted last year identified a number of initiatives to increase the value derived from stress testing and to improve the capability across the industry. These include:

- moving to annual industry stress tests for banks;
- testing a wide range of risks, including the traditional economic downturn, liquidity shocks, cyber and other operational risk events, and climate change;
- introducing industry stress tests for insurance;
- developing the Reserve Bank's internal bank stress-test modelling; and
- increasing resourcing to support these developments.

The Reserve Bank's resourcing and revised framework are now more closely aligned to the Basel Committee on Banking Supervision's stress-testing principles and the practices of overseas regulators (table C.1).

The 2021 programme has been designed around these initiatives and includes four components:

1. Bank industry stress test

The 2021 bank stress test consists of one scenario designed to test banks' capital adequacy, and two other scenarios with different degrees of severity to test banks' resilience to a liquidity shock.

The capital adequacy scenario describes a global economic downturn precipitated by an extension to the COVID-19 outbreak combined with a drought event that tests the physical risks from climate change on bank agricultural exposures. Accordingly, the Reserve Bank will provide banks with a series of indicators, including a decline in national output, rising unemployment, significant property price falls, and drought-related shocks to dairy production and working expenses. Banks will use their own models to estimate the impacts of the scenario on their profitability, balance sheet, and capital.

The two liquidity shock scenarios involve a bank-specific event – such as a cyber-attack, IT system disruption or fraud – leading to reputational damage and an outflow of deposits. Banks will model the impacts of the scenario on their net cash position over a six-month timeframe to determine whether they have sufficient liquidity to fund the deposit outflow while continuing to lend. Banks will then identify strategic actions they could take to mitigate the outcomes.

Figure C.1

Stress-testing annual cycle

Dec-20 | Jan | Feb | Mar | Apr | May | June | July | Aug | Sep | Oct | Nov

Identify key risks to banks and financial system

Design stress scenarios, templates and instructions

Consult banks

Finalise instructions and template

Banks carry out modelling impact of scenarios

Reserve Bank runs a parallel process with own models

Reserve Bank analyses submissions

Q&A banks

Develop insights

Communication of results to the market

Provide individual bank feedback

Review of process

This year's stress test marks the move from a one-off project-based approach to an annual repeatable cycle (figure C.1). The forward guidance is designed to allow banks to prepare for these exercises well in advance. The Reserve Bank recognises stress tests are resource intensive and plans to work with industry to optimise the efficiency of the process whilst delivering valuable insights.

2. General insurance industry stress test

This is the first stress test conducted by the Reserve Bank for the insurance sector. It consists of four scenarios to test the resilience of the five largest general insurers to impacts from: an economic downturn; a series of severe weather events involving three large storms; and stress on the insurers' reinsurance arrangements. Insurers will use their own models to estimate the impacts on profits, balance sheets, and solvency.

3. Reserve Bank stress-test capability improvement

In 2020, the Reserve Bank developed a high-level bank stress-test model to estimate the impacts of the COVID-19 stress-test scenarios on individual banks. The Reserve Bank has a continuous improvement plan to build on this foundation, with the focus this year on improving the credit-risk modelling, which is the key driver of stress-test results for capital outcomes.

The 2021 stress-test plan begins our stress-test journey of climate change, with the inclusion of drought conditions in the bank stress-test scenario and the severe weather events in the insurance stress test.

4. Dairy industry stress test

Whilst stress testing has generally been used on financial institutions, similar principles apply to other industries. The Reserve Bank has recently completed a desktop stress test of dairy farms in partnership with the Ministry for Primary Industries. The process simulated a five-year path of a sample of dairy farms' cashflows and balance sheets under various conditions, especially around milk prices and land prices.

The draft results indicate that while the sector overall has been gradually deleveraging, dairy debt is highly concentrated and pockets of vulnerability to a milk price downturn or drought remain. Simulations suggest that in a scenario with the milk price reduced to $5.50 per kgMS for five years, almost one-third of dairy farms would have negative cashflows and over half of these would require some form of debt restructuring.

Table C.1

Bank stress-testing practices across regulators

Bank stress tests	Reserve Bank of New Zealand	Federal Reserve Board	Bank of England	European Central Bank	Australian Prudential Regulation Authority
How often are industry stress tests conducted?	Annually	Annually	Annually	Annually	Every 2-3 years moving to annual
What types of stress scenarios are used?	Economic downturn, liquidity shock, operational risk	Economic downturn	Economic downturn, operational risk	Economic downturn, liquidity shock, operational risk	Economic downturn, liquidity shock, operational risk
Any plans for an industry climate-change stress test?	2021 explores risks of drought to the agricultural sector	Under consideration	2021 climate-change stress test	No identified plans	2021 vulnerability assessment
How many banks participate in the stress test?	10 banks with over 95 percent market share	19 large banks	8 banks with 75 percent market share	50 banks with 70 percent European Union market share	8 largest banks with over 80 percent market share
Do published results rely on regulator or bank modelling?	Mix of bank and Reserve Bank modelling	Federal Reserve modelling	Mix of bank and Bank of England modelling	Bank modelling	Mix of bank and APRA modelling
Are individual banks' capital results disclosed?	Under consideration – currently publish anonymised results	Yes	Yes	Yes	No, only system results and a range of outcomes
Are bank actions incorporated into the scenario?	2021 allows for feedback effect from bank actions	No	No	No	No
What are the main uses of results?	Assurance of financial system resilience and inform risks to participating banks	To approve banks' capital plans including dividends and buybacks	To assess the level of banks' capital	Assurance of financial system resilience and inform risks to participating banks	Assurance of financial system resilience and inform risks to participating banks
Is it a pass or fail exercise?	No	Yes	Yes	No	No
Do you run stress tests with other regulators?	Yes with APRA, most recently in 2017	No	No	Yes, across European jurisdictions	Yes with RBNZ, most recently in 2017

Chapter 4
Regulatory initiatives

Recognising the impacts of COVID-19 on the economy and financial institutions, the Reserve Bank took a number of steps last year to support the provision of credit to the economy and promote financial stability (table 4.1). These included relaxing a range of regulatory requirements, restricting dividend payments, and delaying the Capital Review implementation.

While the New Zealand economy has done better than feared at the outset of the pandemic, there remain vulnerabilities in the financial system and some continue to increase. Accordingly, subject to the orderly recovery of economic conditions, the Reserve Bank intends to reinstate, and in some instances further enhance, regulatory measures to support financial system resilience over the medium term. In addition, the comprehensive review of the Reserve Bank Act is ongoing, and seeks to ensure that the legislation is fit for purpose, flexible, and enduring.

Update on COVID-related regulatory actions to support financial stability

Loan-to-value ratio (LVR) restrictions were removed in April 2020 to remove a potential barrier to credit flow and to ensure that banks were not deterred from offering mortgage deferrals to their customers. However, a stronger-than-anticipated housing market, partially fuelled by high-risk mortgage lending, led to concerns over the risk to the economy and the financial system. As a result, the Reserve Bank reinstated LVR restrictions from 1 March 2021. A further tightening of the restrictions on investors took effect on 1 May.

Currently, a maximum of 5 percent of new lending to investors can be at LVRs above 60 percent. Additionally, a maximum of 20 percent of new lending to owner-occupiers can be at LVRs above 80 percent. With these restrictions in place, new lending to investors at high LVRs is slowing.

The Reserve Bank will continue to monitor high-LVR lending and other indicators of risk to financial stability and may adjust the calibration of the LVR restrictions in the future.

Another step towards the normalisation of regulatory settings regards the easing of dividend restrictions placed on locally-incorporated banks in April 2020. The easing allows banks to distribute up to 50 percent of their earnings as dividends to their shareholders.

The 50 percent dividend restriction will remain in place until 1 July 2022, at which point the Reserve Bank intends to normalise the dividend settings by removing the restrictions entirely subject to no significant worsening in economic conditions.

Table 4.1

Regulatory actions for banks in response to COVID-19

Action	Description	Current status	More information
Payment deferrals	Concessionary capital treatment for loans on payment deferral from 27 March 2020.	Programme ended on 31 March 2021.	**Reserve Bank Extending Mortgage Deferral Scheme (17 August 2020)**. **Loan deferrals guidance extension letter to banks.**
Loan-to-value ratio restrictions	Removed on all residential mortgage lending from 30 April 2020.	Since 1 May 2021, a maximum of 5 percent of new lending to investors can be at LVRs above 60 percent. Additionally, a maximum of 20 percent of new lending to owner-occupiers can be at LVRs above 80 percent.	**Loan-to-value ratio restrictions.**
Dividend restrictions	No dividend payments permitted from 2 April 2020.	Banks are now allowed to pay up to a maximum of 50 percent of their earnings as dividends to their shareholders until 1 July 2022, at which point the Reserve Bank intends to normalise the dividend settings by removing the restrictions entirely.	**Explanatory note regarding dividend restrictions**. **Letter to banks regarding dividend restrictions and Capital Review implementation.**
Core funding ratio requirement	Minimum reduced from 75 to 50 percent from 2 April 2020.	The Reserve Bank intends to increase the CFR minimum requirement to 75 percent on 1 January 2022, subject to no significant worsening in economic conditions.	**See next section for further information on CFR normalisation.**
Capital Review	Implementation delayed to begin on 1 October 2021, with higher capital requirements starting from 1 July 2022.	Submissions on consultation closed on 31 March 2021. Final documents due to be published in June.	**Review of the capital adequacy framework for registered banks.**
Outsourcing policy transition	On 18 March 2020, the Reserve Bank announced that it would extend the transition period for its revised outsourcing policy by 12 months.	Extended the end of the transition period by one year from 30 September 2022 to 30 September 2023.	**Letter on Proposed Conditions of Registration Updates.**

Core funding ratio normalisation

As New Zealand moved into its first lockdown, the Reserve Bank was concerned that banks' core funding ratios (CFRs) – which ensure that banks fund a minimum proportion of their lending with stable long-term sources – could begin to decline, and therefore cause banks to reduce lending to the economy. In response, the Reserve Bank lowered the CFR minimum requirement from 75 percent to 50 percent in April 2020.

In November 2020, the Reserve Bank committed to keeping the CFR minimum requirement at 50 percent until at least 31 March 2021 (later extended to May 2021), and indicated the minimum requirement would only return to 75 percent once three conditions were met (table 4.2).

The Reserve Bank now assesses that the normalisation conditions have been satisfied. As a result, the Reserve Bank intends to increase the CFR minimum requirement to 75 percent on 1 January 2022. This transition path is subject to no significant worsening in economic conditions, in which case the transition could be extended.

Table 4.2

Core funding ratio normalisation criteria

Normalisation condition	Assessment
1. Wholesale funding markets are functioning similarly to prior to COVID-19 and are expected to remain so; or, in the absence of this condition, banks are able to source stable long-term funding through Reserve Bank facilities, which can be included as core funding for CFR purposes (subject to certain requirements).	Wholesale funding markets appear to be functioning similarly to before COVID-19. Banks have informed the Reserve Bank that wholesale funding markets are available to them if needed. In addition, the Reserve Bank has observed a strong appetite from investors for wholesale funding market issuances.
2. The Reserve Bank is satisfied that there is sufficient credit availability for creditworthy borrowers.	The Reserve Bank believes that there is sufficient credit availability for creditworthy borrowers (see Chapter 2).
3. The Reserve Bank is comfortable that any increase to the CFR minimum requirement will not adversely affect credit availability.	Affected banks have indicated to the Reserve Bank that they would choose to raise core funding rather than decrease lending to meet the minimum requirement, as long as the transition period was sufficiently long to do so.

Capital Review update

In December 2019 the Reserve Bank announced final decisions on the comprehensive review of the capital adequacy framework for locally-incorporated banks (the Capital Review). To support the stability of the financial system during the period of economic uncertainty resulting from COVID-19, the Reserve Bank delayed the implementation of the Capital Review, with different parts of the framework phasing in from the second half of 2021.

The Exposure Draft consultation for the Capital Review implementation closed on 31 March 2021. Feedback was received across a range of topics and the Reserve Bank intends to publish the final Banking Prudential Requirement (BPR) documents, which implement Capital Review decisions, in early June.

Some of the feedback received in the submissions asked for changes to the Capital Review implementation timetable. The Reserve Bank has made the following decisions:

- The formal start date for implementing the BPRs will be extended from 1 July 2021 to 1 October 2021. This will provide banks more time after the final BPRs are published to adjust their systems and internal processes to accommodate the changes.
- Before the 1 October date, the Reserve Bank intends to recognise Tier 2 capital instruments issued in accordance with the new BPRs. The Reserve Bank will communicate with industry on how this will work when the BPRs are published in June.
- The start date for the derecognition of existing non-compliant capital instruments will be extended to 1 January 2022. This is an extension of six months and helps provide more time for banks to prepare for issuing new instruments.
- All other implementation dates will remain the same as previously communicated, including the 1 January 2022 introduction of an output floor set at 85 percent of the Standardised outcome for internal ratings-based risk-weighted assets.

A detailed implementation timetable is available at **www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks**.

All other responses to the feedback will be published with final BPRs in June. The Reserve Bank will be writing to banks to inform them of these decisions and a copy of the letter will be publicly available online.

Insurance reviews

The Reserve Bank is conducting two reviews of insurance regulation. They are a review of the Insurance (Prudential Supervision) Act 2010 (IPSA) and a review of solvency standards, which are rules issued under IPSA imposing minimum capital requirements on insurers.

The IPSA review will involve several public consultations and legislative changes are not expected until after 2024. A recent public consultation on the scope of the act and treatment of overseas insurers closed in March this year. The Reserve Bank is now going over the submissions and will publish a feedback statement shortly.

Another public consultation on policyholder security will be issued in mid-2021. This will consider:

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

For the solvency standards review, the guiding principles were consulted on late last year. Following this, the Reserve Bank published a modified set of review principles at **Principles and Timeline Consultation**. Feedback from a second consultation on the structure of the standards and some core conceptual issues is now being considered and a feedback statement will be published shortly.

The next steps in the solvency standards review are to issue a draft interim standard in mid-2021 and then explore the rules for the amount of capital insurers should hold against different risks. The Reserve Bank expects to issue final solvency standards toward the end of 2023.

Review of the Reserve Bank of New Zealand Act 1989 (Phase 2) and Deposit Takers Bill

The Review of the Reserve Bank of New Zealand Act 1989 (Phase 2) is being jointly led by the Reserve Bank and the Treasury. It includes the Reserve Bank of New Zealand Bill and the forthcoming Deposit Takers Bill.

The Reserve Bank of New Zealand Bill was introduced to the house in July 2020 and had its first reading 8 December 2020. It reforms the Reserve Bank's existing governance arrangements (including by establishing a new decision-making board), and the legislative provisions underpinning the Bank's non-regulatory functions (such as currency issuance and market operations). It is currently sitting with the Finance and Expenditure Committee, which is due to report back by early June 2021.

A summary of submissions on the consultation paper for the Deposit Takers Bill has been published.[7] Cabinet made final policy decisions on a number of key design parameters for the Deposit Takers Bill on 19 April, including a commitment to double the proposed coverage of the deposit insurance scheme to $100,000 per depositor, per institution.

Drafting of the Deposit Takers Bill will commence shortly, with some final policy work happening concurrently. The Reserve Bank will be leading the passage through the parliamentary process, which is expected to begin later this year.

7 Further information on Phase 2 of the review, including consultation responses, can be found on the Treasury website **www.treasury.govt.nz/news-and-events/reviews-consultation/reviewing-reserve-bank-act**.

The Financial Markets Infrastructures Bill

The Financial Market Infrastructures Bill 2021 (the FMI Bill) is nearing enactment. The FMI Bill provides an enhanced set of regulatory powers that apply to FMIs that are identified as systemically important, or that opt in to access legal protections around settlement finality, netting, and the enforceability of their rules. The regulatory powers include oversight of rules (including a requirement for rule changes to be approved by the regulator, and the regulator having the ability to require rule changes) and crisis management powers (direction powers and a tailored statutory management regime). Powers under the FMI Bill are jointly exercised by the Reserve Bank and the Financial Markets Authority (FMA), except in relation to payment systems, where the Reserve Bank is the sole regulator.

A transitional period of around 18 months is planned to implement the new regime. Key work streams include the designation of relevant FMIs, the design and issuance of standards, and a variety of other matters relating to the implementation of the new regime. The Reserve Bank and FMA will consult stakeholders on several aspects of the new regime, such as a framework to identify systemically important FMIs and the design of standards.

Promoting cyber resilience of the financial sector

In April 2021 the Reserve Bank released its **guidance on cyber resilience**, consulted on between October 2020 and January 2021. The guidance contains a set of high-level recommendations on how to achieve both a baseline and enhanced level of cyber resilience. The guidance applies to all regulated entities, including registered banks, licensed non-bank deposit takers, licensed insurers and designated FMIs. While the guidance is not a regulatory requirement, it aims to support entities' own cyber risk management, and the supervisory oversight of cyber risks.

The Reserve Bank will also develop an information collection plan and partner with the National Cyber Security Centre (NCSC), Computer Emergency Response Team (CERT NZ), and FMA. Based on consultation, key areas for developing an information sharing and gathering plan include:

- taking a coordinated approach and avoiding duplication;
- clearly defining the benefits of information collection and future usage of the information collected;
- protecting anonymity; and
- ensuring the security and integrity of information collected.

Material breach reporting regime

In 2018 the Reserve Bank announced that it would revise its approach to the publication of banks' breaches of their regulatory requirements, including introducing a materiality threshold. Until now, banks have had to publish all breaches of Conditions of Registration in their disclosure statements, even if breaches are minor or trivial.

In 2019 the Reserve Bank discussed with banks the draft wording of the new formal requirement to report breaches and associated guidance on the materiality threshold. However, the planned start date of 1 April 2020 was delayed due to COVID-19.

In December 2020, notices were issued under Section 93 of the Reserve Bank of New Zealand Act 1989 requiring all registered banks to report breaches privately to the Reserve Bank from 1 January 2021.

During the first quarter of 2021, the Reserve Bank had changes made to the Orders in Council that impose bank disclosure requirements. The changes took effect on 31 March 2021 and mean that for disclosure statements with reporting dates from 31 March onwards, banks will only have to disclose material breaches. The Reserve Bank will publish breaches confirmed as material on its website.

LIBOR cessation

On 5 March 2021, the United Kingdom Financial Conduct Authority (FCA), the London Interbank Offered Rate (LIBOR) regulator, announced that from 31 December 2021 the majority of LIBOR settings will cease, after which representative LIBOR rates will no longer be available. This was closely followed by the International Swaps and Derivatives Association (ISDA) triggering an Index Cessation Event under the IBOR Fallbacks Protocol (the Protocol). These announcements provide market participants with greater clarity on the timing and economic impacts of the transition from LIBOR to risk-free rates.

The Reserve Bank and more than 13,000 other organisations globally have signed the Protocol as part of their collective preparation for LIBOR cessation. While the Protocol covers derivative contracts, participants should also ensure they have arrangements in place to cover all financial arrangements that reference LIBOR, such as bonds and loans.

International regulators have encouraged the use of risk-free benchmarks as a robust alternative to LIBOR. There is a strong expectation that LIBOR will not be referenced in any new contracts beyond 31 December 2021.

The New Zealand Financial Markets Association (NZFMA) has developed, and is now publishing, its own risk-free rate, the OCR Compound Index. New Zealand currently operates dual benchmarks, with the OCR Compound Index standing alongside the current Bank Bill Benchmark Rate (BKBM), which was not subject to LIBOR-related manipulation issues and continues to be published by the NZFMA.

The NZFMA has invested heavily in benchmark reform to ensure that New Zealand's benchmarks meet equivalence with European Union (EU) Benchmark Regulation and the IOSCO Principles for Benchmarks. Further, recent regulation in New Zealand creates a new licensing regime for benchmark administrators with the purpose of:

- providing additional assurance on the accuracy, integrity, reliability, and continuity of New Zealand benchmarks;
- ensuring continued acceptance of New Zealand benchmarks in EU financial markets; and
- avoiding significant costs to the New Zealand economy that would arise if our benchmarks were not able to be used in the EU.

New Zealand's interest rate derivative markets are very active. As a result, the Reserve Bank and the NZFMA are working with ISDA on the implementation of robust fallback arrangements for derivatives referencing regional benchmarks, including BKBM, by the end of 2021.

While the Reserve Bank sees no financial stability concerns, the expectation is that all regulated entities continue with their preparations so they are well placed to manage the end of LIBOR. Entities should consider risk-free benchmarks that best meet their requirements and those of their clients, if applicable.

Box D

Regulatory cooperation

The Reserve Bank works closely with other agencies in New Zealand, in Australia and across the world. This is to enable knowledge sharing, collaboration and coordination on key issues, and to support resolution in times of uncertainty. We recognise the need to constantly develop and foster new relationships and broaden our networks to achieve our objectives.

Within New Zealand, the Reserve Bank and the Financial Markets Authority jointly chair the Council of Financial Regulators (CoFR), which brings together the chief executives of key regulatory agencies to deliver effective and responsive regulation of the financial system.[8] The Reserve Bank of New Zealand Bill – currently with Parliament – will put CoFR on a statutory basis.

CoFR agencies worked closely together during COVID-19 to refocus their regulatory initiatives and allow the financial sector to concentrate on supporting its customers. CoFR agreed a joint approach to restarting initiatives in a coordinated way. CoFR is particularly aware of the need to identify key regulatory overlaps and gaps and actively manage them to create greater coherence and consistency among regulators. For example, the Reserve Bank has worked with other agencies to create a one-stop advisory service to help new financial technology (FinTech) firms navigate the New Zealand regulatory landscape.

8 The other members of CoFR are the Commerce Commission, the Treasury and the Ministry of Business, Innovation and Employment.

CoFR has recently agreed on a risk-based approach to its work, based on a series of overarching themes that impact all New Zealanders (climate change and transition risks, conduct, digital and innovation, inclusion and access, regulatory burden and barriers to entry).

CoFR is developing a new memorandum of understanding to encourage information sharing and collaboration between member agencies, building on existing good practice.

The Reserve Bank works particularly closely with its counterparts in Australia, both bilaterally and through the Trans-Tasman Council on Banking Supervision. In 2020 the Council engaged more frequently to discuss the policy and regulatory challenges arising from COVID-19 and the related response and recovery measures.

The Reserve Bank is an active member of the Executives' Meeting of East Asia-Pacific Central Banks, and currently chairs its Working Group on Payments and Market Infrastructures.

The Reserve Bank makes a positive contribution to discussions at other international bodies such as the Bank for International Settlements and the International Association of Insurance Supervisors.

The Reserve Bank works closely with other organisations on climate change and related challenges, both within New Zealand and internationally, to ensure that the financial sector contributes effectively to the management and mitigation of climate risks. The Reserve Bank is a proud member of and contributor to the Network for Greening the Financial System and the Sustainable Insurance Forum.

Our Pacific Remittance Project work continues, with support from the Ministry of Foreign Affairs and Trade. This looks at addressing challenges facing remittance services domestically and in the South Pacific region. Regionally, the key focus has been on a collective effort with South Pacific central bank governors, the International Monetary Fund and other international partner agencies to develop a regional 'Know Your Customer' facility. Domestically, we are also exploring with relevant agencies potential policy, legislative and regulatory changes around anti-money laundering and countering the financing of terrorism issues. Both work streams involve working with banks and remittance service providers.

Another example of international cooperation is our work on indigenous inclusion. We recently announced that the Reserve Bank would be chairing a new international Central Bank Network for Indigenous Inclusion, focusing on indigenous economic research and participation within the central banking community. The network to date includes the Reserve Banks of New Zealand and Australia, and the Bank of Canada, with others to join over time.

In the coming year, as set out in the Reserve Bank's *2020/21 Statement of Intent*, we will continue to focus on effective engagement and cooperation, both domestically and internationally.

Chapter 5
Regulatory enforcement and compliance

In the event of identified non-compliance, the Reserve Bank has the discretion to take enforcement action, and decide what form this might take. This discretion is exercised for the purposes of promoting the maintenance of a sound and efficient financial system. The Reserve Bank continues to review its enforcement framework to ensure it is fit for purpose and optimised to enable the Reserve Bank to effectively regulate the entities for which it is responsible.

This section of the *Report* provides information on the enforcement activities recently undertaken by the Reserve Bank to achieve its statutory purposes.

Areas of regulatory non-compliance

Over the past six months various instances of non-compliance with prudential requirements have been identified. The breaches relate to reporting requirements, notification requirements, anti-money laundering and countering the financing of terrorism (AML/CFT) obligations, liquidity policy (BS13), open bank resolution (BS17), and outsourcing requirements (BS11).

Pacific International Insurance Pty Limited

On 3 December 2020, the Reserve Bank issued formal directions under Section 143 of the Insurance (Prudential Supervision) Act 2010 (IPSA) to Pacific International Insurance Pty Limited for breaches relating to reporting, disclosure and notification requirements. The directions followed warnings issued to Pacific International in 2018 for failing to include its solvency ratio in its New Zealand branch financial statements for three consecutive years, and an independent review under Section 126 of IPSA in early 2020. The directions required Pacific International to strengthen, monitor and continuously improve its compliance systems, controls and processes, and to obtain independent verification of this improvement in a year's time.

Westpac New Zealand Limited

On 23 March 2021, the Reserve Bank issued two notices to Westpac New Zealand Limited (WNZL) under Section 95 of the Reserve Bank of New Zealand Act 1989. The notices require WNZL to supply two reports, each prepared by an independent person approved by the Reserve Bank.

The first report will assess risk governance processes and practices applied by the WNZL Board and executive management. The Reserve Bank considers this report is necessary because of ongoing compliance issues over recent years, most recently involving material failures to report liquidity correctly. In addition, the bank has continued to operate outside of its own risk settings for technology for a number of years.

The second report is on WNZL's liquidity risk controls and risk culture. This report will provide assurance that actions taken by WNZL to improve the management of liquidity risks, and the culture surrounding those risks, are effective.

On 31 March 2021, the Reserve Bank increased WNZL's required holding of liquid assets (cash or assets that can be easily converted into cash). The increased requirement will remain in place until the Reserve Bank is satisfied that WNZL's liquidity risk control remediation work is complete and effective.

Investigations

Prescribed transaction reporting (PTR) requirements under the AML/CFT Act continue to be an area of focus for the Reserve Bank. The Reserve Bank is investigating potential non-compliance with PTR requirements across three regulated entities, relating to failures to report prescribed transactions within the statutory timeframe and failures to report required information.

The Reserve Bank continues to investigate TSB Bank Limited's compliance with its obligations relating to the risk assessment and AML/CFT compliance programme.

Box E

Reserve Bank launches Enforcement Department

In March 2021, the Reserve Bank launched a new standalone Enforcement Department to promote confidence in compliance across regulated sectors. The department will investigate breaches of regulatory requirements, provide input to supervisors on compliance matters, and recommend enforcement actions where appropriate.

The Enforcement Department is operationally separate from the Reserve Bank's Supervision Department, but the two will work closely together to achieve the Reserve Bank's compliance goals of incentivising and managing prudent behaviour and credibly deterring non-compliance. The two departments operate within the Reserve Bank's Financial Stability Group.

The Enforcement Department will support the Reserve Bank's more intensive supervisory and enforcement approach, helping the Reserve Bank to promote a sound and efficient financial system built on integrity, innovation, and inclusion.

This work aligns with the Reserve Bank's Supervision and Enforcement strategic priority of ensuring compliance of financial institutions with coherent, robust legislation, and regulatory frameworks. This is to be supported and informed by sophisticated analytical and decision-making technology and tools.

The new department is developing the Reserve Bank's enforcement framework, including establishing an Enforcement Committee that will oversee enforcement actions for repeated and serious breaches of regulatory requirements. The new enforcement framework will be transparent and public.

The department will work closely with the different Supervision teams across the range of regulated entities in the banking, insurance, and AML/CFT sectors in tracking compliance breaches and applying an escalated response to ongoing failures.