

---

# Financial Stability Report

## *Highlights*

May 2006

---

### Summary

New Zealand's financial system is well placed to weather the slowdown in the economy. With few exceptions, financial institutions are well capitalised and profitable. Foreign exchange markets have facilitated an orderly, albeit sharp, depreciation in the New Zealand dollar.

This Report highlights that there is a wide degree of variation in financial exposure among households and financial institutions, however.

Household indebtedness has reached a record high, raising households' vulnerability to higher interest rates, unemployment, and a downturn in house prices. Vulnerabilities may be concentrated in those households that have recently invested in residential rental property.

New Zealand's banking sector is profitable, well capitalised, and able to bear increases in impaired assets as economic conditions become more challenging. In this environment, credit risk management needs to be monitored closely, especially in light of the implementation of Basel II, the new regime for bank capital requirements.

A combination of rapid growth and comparatively young institutions, which have limited experience in managing a downturn, makes a significant part of the finance company sector particularly vulnerable to a more challenging economic environment. Isolated and individual failures among these institutions are unlikely to threaten overall financial stability, however.

In conclusion, some of the risks facing the financial system have crystallised since our last Report. Others have increased. Maintaining financial stability will require that risks continue to be adequately identified, priced and allocated to those best able to manage them.

The material in this report was finalised on 12 May 2006

# The economic and financial environment

## International

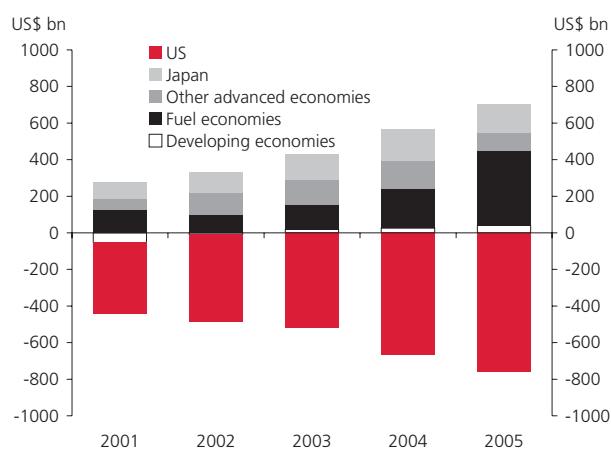
- More optimistic economic growth outlooks in Japan and Europe, coupled with a lower US exchange rate and some increase in long-term US interest rates are signs that rebalancing of the global economy may be underway. However, the potential for a disruptive correction in global imbalances remains.
- In large part, the counterparts to the US current account deficit are surpluses in East Asia (figure 1). The build up of currency reserves in surplus countries has underpinned low levels of US long-term interest rates. Petrodollars are also adding to global liquidity.

## Domestic

- Abundant global liquidity has in turn led to a 'search for yield'. As a high yielding country, capital flows into New Zealand have been buoyed by the 'search for yield'. These inflows have helped to finance the current account deficit, which is at record levels and expected to widen further.
- Persistently large current account deficits - and concomitant increases in external liabilities and household debt (figure 2) - aggravate the potential economic costs of a period of financial stress or crisis. With debt at unprecedented levels, households have raised their vulnerability to interest rate changes, unemployment, and a downturn in house prices.
- Despite the increase in aggregate household borrowing, mortgage data for owner-occupied dwellings suggests that higher income households have more substantial mortgage debts relative to the capital valuation of their property, than lower income households (figure 3).
- Those who have recently invested in residential rental property may have taken on higher levels of debt than in the past, and could find a period of softening house prices and lower economic growth relatively more difficult to manage.

Figure 1

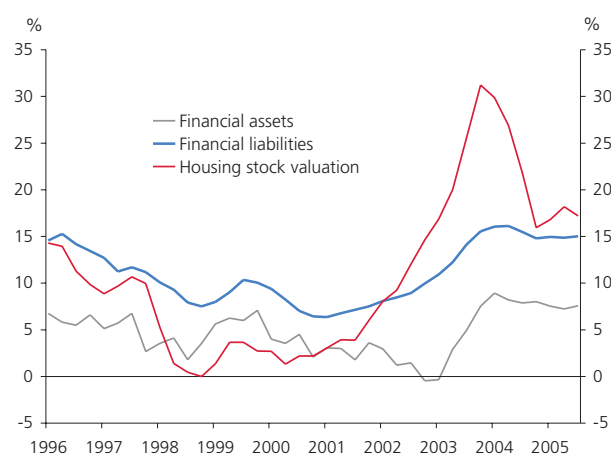
Global current account balances



Source: IMF, OECD

Figure 2

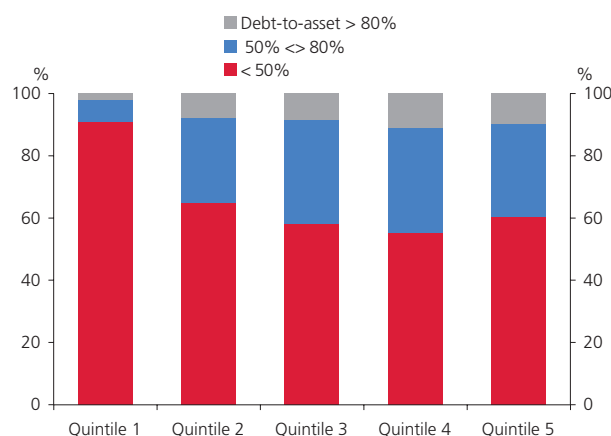
Growth of household assets and liabilities



Source: RBNZ, Quotable Value Ltd.

Figure 3

Debt-to-asset ratios for owner-occupied dwellings



Source: RBNZ calculations, Statistics New Zealand

# New Zealand's financial markets

## The foreign exchange market

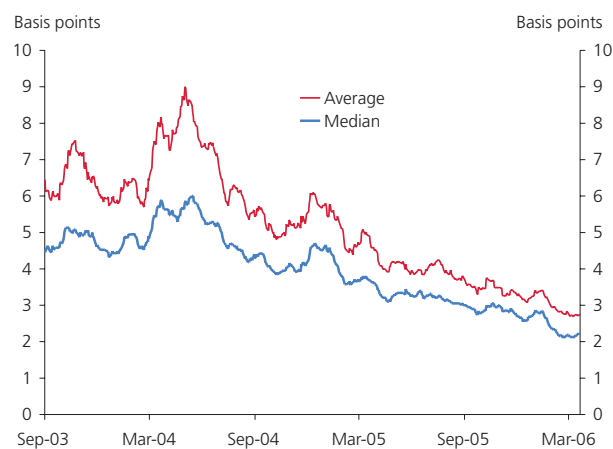
- Foreign exchange markets have facilitated an orderly cyclical adjustment in the exchange rate to better reflect the underlying fundamentals of the economy. The March quarter decline in the New Zealand dollar (NZD) of 10.3 per cent was one of the largest since the NZD was floated.
- The depreciation of the NZD from its previous exceptional and unjustifiable level, represents a significant reduction in risk to the financial system.
- Bid offer spreads (figure 4) indicate that the market remained liquid. In addition, short term volatility in the NZD/USD rate remained below the historical average (figure 5).

## The fixed income markets

- Signs of excess demand pressure in the money markets emerged for a period, and threatened to place pressure on the payments system. For example, overnight borrowing rates in the FX swaps market to levels significantly above the OCR plus 25 bp (figure 6).
- The Bank responded by making liquidity more widely available as a short-term measure, and is undertaking a wider review of liquidity management.

Figure 4

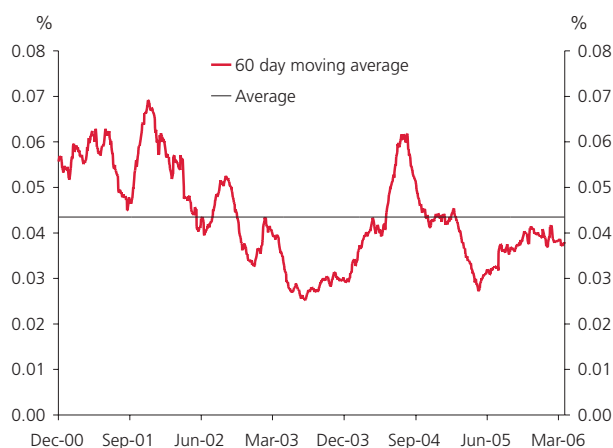
Bid-offer spreads in the NZD spot market



Source: RBNZ, Reuters

Figure 5

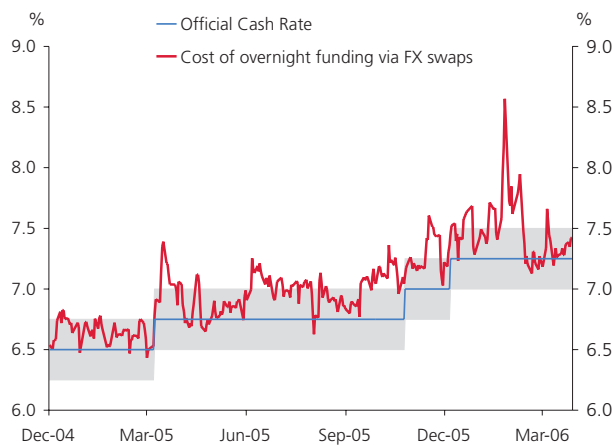
Daily movement in NZD/USD per NZD 1 million traded



Source: RBNZ, Reuters.

Figure 6

Overnight FX swap rate and the OCR



Source: RBNZ.

# New Zealand's financial institutions

## Banks

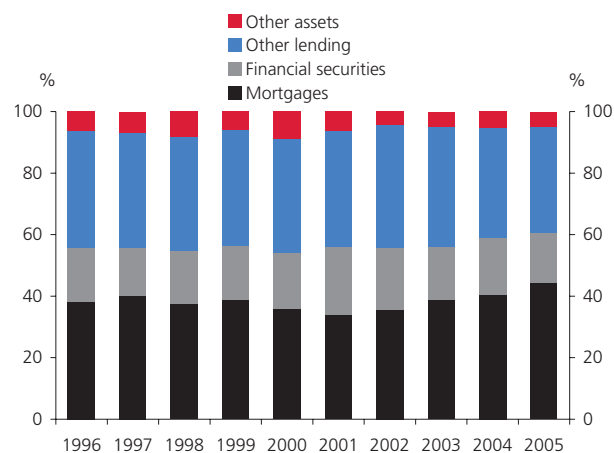
- Banks are profitable, well capitalised and able to bear an expected increase in impaired assets.
- Lending growth remains strong despite a slower pace of economic growth, with bank assets remaining concentrated in household lending. The proportion of bank lending to households has increased from 34 per cent to 44 per cent between 2001 and 2005, increasing alongside the cyclical pickup in house prices (figure 7).
- However it is possible for risks associated with residential mortgage lending to be under-estimated during periods of strong growth in residential house prices.
- Further, given households' vulnerability to higher interest rates and a weakening economic environment, some deterioration in asset quality is inevitable.
- Also, profits are under pressure from competition for market share, which is reducing margins on lending, and there is little scope for expense reduction.

## Non-bank financial institutions

- Non-bank financial institutions are a diverse group. A number of these institutions have grown extremely rapidly in the last five years, and are vulnerable to a more challenging economic climate, particularly those with lending portfolios concentrated in property and consumer finance.
- Significantly higher loan losses have recently been reported by some companies which have experienced faster growth, one of which was recently put into receivership.
- However, individual and isolated failures are unlikely to pose significant risk to the stability of the financial system.

Figure 7

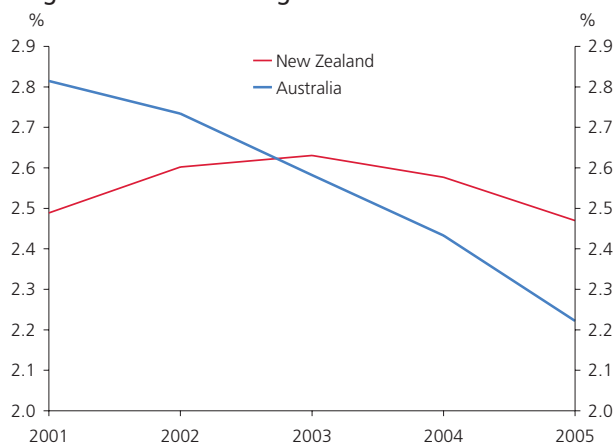
### Composition of bank assets



Source: Registered banks' GDS, as at 30 September.

Figure 8

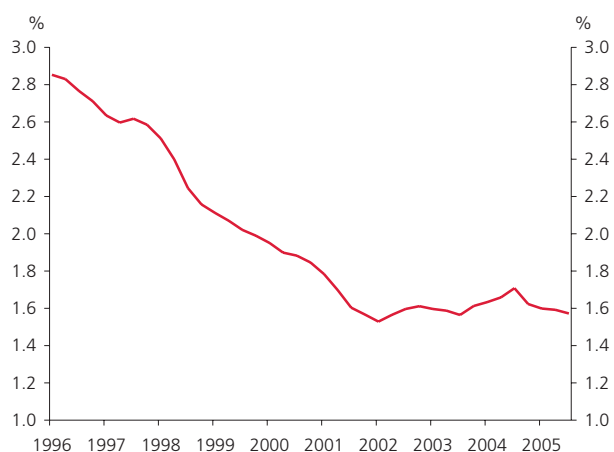
### Large bank interest margin



Source: Registered banks' GDS, as at 30 September.

Figure 9

### Bank wide operating expenses to average assets



Source: Registered banks' GDS, as at 30 September.

Note: Operating expenses excludes interest costs.

# The New Zealand payment system

- Significant risks have been all but eliminated from New Zealand's high value payment and settlement systems.
- A sound and efficient retail payment system is a key part of the financial infrastructure in New Zealand. The New Zealand Banker's Association (NZBA) is leading two projects in this area: the Failure to Settle Project and the Access & Governance Project.
- The Failure to Settle Project has resulted in better identification of risk in the retail payment system and some risk reduction. The focus is now on further risk reduction. The Bank believes that significant risk reduction can be achieved by having more frequent interbank settlement and by removing high value transactions from the retail payment system or by more actively managing the risk posed by high value transactions.
- Reducing risk and considering risk management mechanisms in the context of the Failure to Settle Project should also make it easier to address access issues in the Access and Governance Project.

## Recent developments in financial regulation

### Basel II

- Under Basel II banks may be able to use their own internal statistical models and processes to calculate minimum capital requirements. Banks will need to submit their applications to the Reserve Bank by July this year.
- A key focus for the Reserve Bank in assessing accreditation applications will be on how a bank's proposed 'internal ratings based' approach addresses the bank's exposure to losses on housing loans. New Zealand banks are, through the extension of housing loans, potentially vulnerable to fluctuations in household income, interest rates, and the level of household debt.
- The Government expects to release a public consultation paper on the reform options in July/August 2006. It is expected that policy proposals will be taken to Cabinet at the end of 2006, with any resulting legislation being implemented in 2008.

### Anti Money-Laundering and Combating the Financing of Terrorism

- The Government is working to improve compliance with the IMF's Financial Assessment Task Force recommendations on anti-money laundering, and combating the financing of terrorism.

### Review of financial products and providers

- The Government has decided in principle that a single agency should prudentially regulate and supervise the financial sector, and that that agency should be the Reserve Bank, though the details of the proposed institutional arrangements are still to be worked through.

---

## Towards a framework for promoting financial stability

---

- A stable financial system is one that has the resilience to continue to efficiently provide financial services in a plausible range of circumstances.
- The preconditions for financial system stability exist when all financial system risks are adequately identified, priced, allocated, and managed.
- Each of the preconditions is important to ensure that the financial system is resilient to a wide range of economic and financial shocks, and able to absorb losses from financial crises with least disruption.
- The preconditions for financial stability also best ensure that the financial system is efficient in its delivery of financial services, and in allocating resources throughout the economy.