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# Financial Stability Report

## *Highlights*

May 2007

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### Summary

The Reserve Bank today released its *Financial Stability Report*, a twice-yearly report that assesses the health of the New Zealand financial system. The report covers developments in financial institutions, foreign exchange and debt markets, and payments systems. It also comments on recent financial policy developments.

New Zealand's financial system has continued to be stable. Financial markets are performing well and the banks continue to be well capitalised and strongly profitable. However, there are significant economic imbalances which present risks for the financial system. The ongoing housing boom and large savings deficit in the household sector are being funded by international borrowing via the domestic banking system. While global markets are currently very liquid, this will not always be the case; the longer imbalances run, the more likely we are to see a sharp correction.

The banking system is highly competitive, but while competition is to be encouraged, the low level of lending margins has contributed to ever increasing levels of household debt and upward pressure on house prices. Financial indicators suggest that banks are managing the risks associated with their individual portfolios adequately. However, it is not clear that banks are taking appropriate account of the systemic risks associated with the rapid growth in their aggregate lending.

This possibility raises the question of whether a regulatory response is needed to better manage the risks to a sound and efficient financial system. The increased focus on risk sensitivity in Basel II will introduce a better alignment of risk and regulatory capital – for instance, loans on higher loan-to-value ratios will command higher regulatory capital holdings. The Bank has also been considering whether the current framework should be modified in this direction ahead of the introduction of Basel II.

The best contribution to continued financial stability would be a moderation and gradual adjustment in the housing market. Banks should be mindful of this and be careful not to exacerbate the risks inherent in already-stretched household balance sheets.

The material in this report was finalised on 4 May 2007

# The economic and financial environment

## International

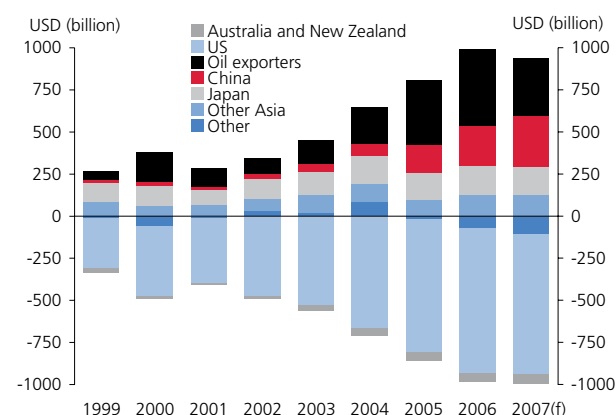
- International conditions have generally been favourable for financial stability. Global growth is expected to soften, but remain relatively robust. Financial markets have been performing strongly: asset prices are high, and credit spreads are low.
- However, global imbalances remain a feature of the international environment (figure 1). As noted in the last *Report*, large and persistent saving and investment imbalances raise the possibility of a disorderly correction in foreign exchange and capital markets.
- Late February/early March saw downward moves in most major equity markets, scaling back of carry trades, and increased levels of risk aversion. These developments proved temporary, and were sparked by a sell-off in the Shanghai share market and concerns about the sub-prime mortgage market in the US.

## Domestic

- Household debt increased by 10 percent in real terms over the year to December 2006, and now stands at approximately 160 percent of household disposable income. In nominal terms, household debt is over \$150 billion.
- Household assets have been boosted by appreciation in house prices. Over the year to December 2006, total household assets (approximately two thirds of which are housing) increased by around seven percent, in real terms.
- To put house prices increases into perspective we look at historical house price developments in New Zealand and in other countries. The largest inflation-adjusted fall in New Zealand house prices occurred in the 1970s, when inflation-adjusted house prices fell by nearly 40 percent (figure 2).
- High levels of debt also reside in the agricultural sector. Agricultural balance sheets are heavily dependent on land prices, that have recently been buoyed by strong dairy returns.
- Business leverage remains lower than in the later half of the 1990s, however, there has been some upward drift in debt-to-profit, and debt-to-net capital stock ratios (figure 3).

Figure 1

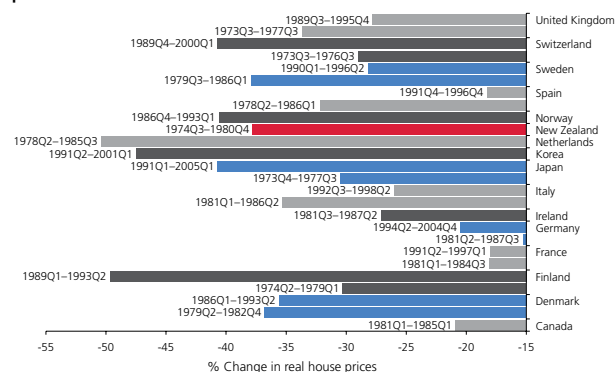
### Current account positions



Source: IMF World Economic Outlook (April 2007), RBNZ staff calculations.

Figure 2

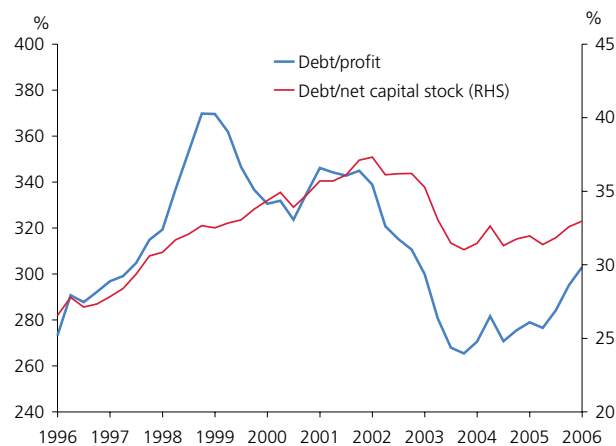
### Periods of real house price declines larger than 15 percent



Source: Girouard, Kennedy, Van den Noord and Andre (2006).

Figure 3

### Business debt ratios

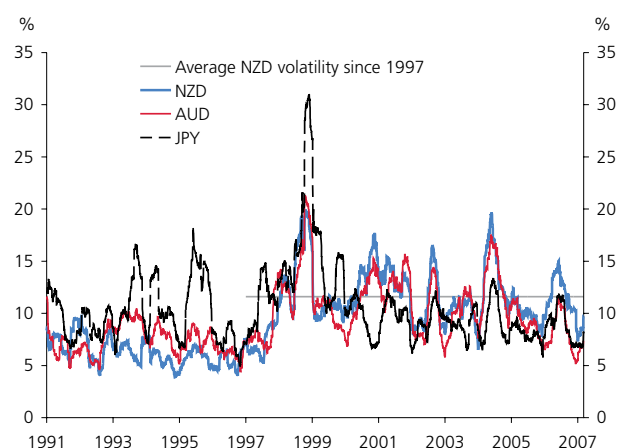


Source: Statistics New Zealand, RBNZ calculations.

# New Zealand's financial markets

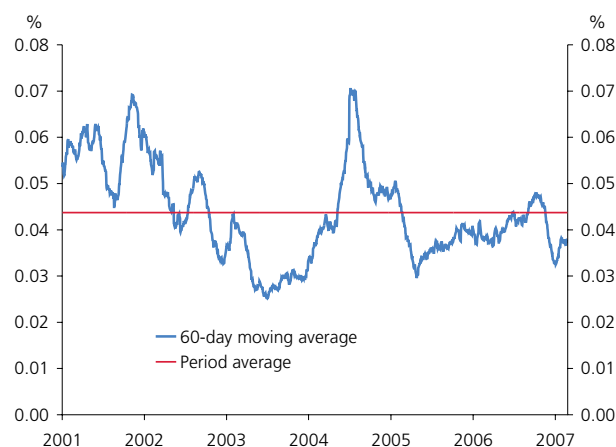
- New Zealand's relatively high interest rates continue to underpin demand for the NZD, and the currency has undergone some large movements. The currency is now at higher levels than at the time of the last Report. Overall, recent movements have seen an increase in short-term NZD exchange rate volatility, although volatility remains below the average since 1997 (figure 4).
- Liquidity in the New Zealand dollar market remains strong. While daily exchange rate movements have been large at times, these have been associated with greater-than-average traded volumes (figure 5).
- The high interest in the NZD has been supported by the interest rate differentials, and the pace of NZD-denominated bond issuance in offshore markets (Eurokiwi and Uridashi bonds), which remains strong (figure 6).
- Signs of increased risk aversion were reflected in the relatively sharp depreciation of the NZD in late February, as investors sought to unwind carry trades. However, risk appetites have recovered, and remained robust. It is expected that substantial upcoming maturities in Eurokiwi and Uridashi bonds will be met with continued offshore issuance of these bonds.

**Figure 4**  
Historical volatility in the NZD, Australian dollar (AUD) and Japanese yen (JPY)



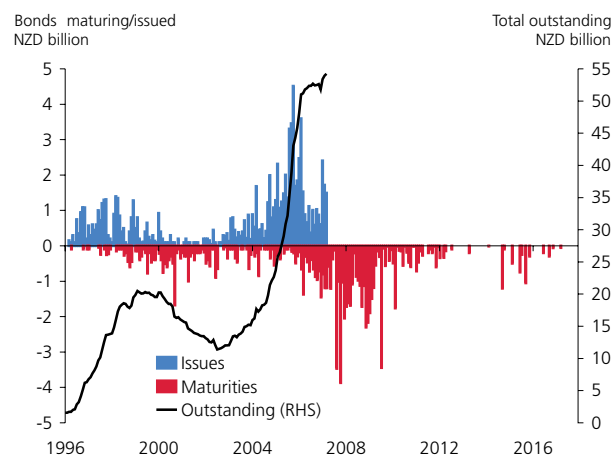
Source: RBNZ calculations, Bloomberg.

**Figure 5**  
Daily movement in NZD/USD per NZD 1 million traded



Source: RBNZ, Reuters.

**Figure 6**  
Offshore NZD-denominated bond issuance

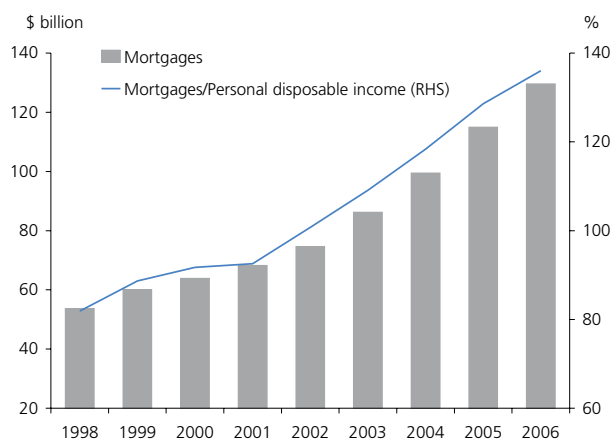


Source: RBNZ, Bloomberg, Reuters.

# New Zealand's financial institutions

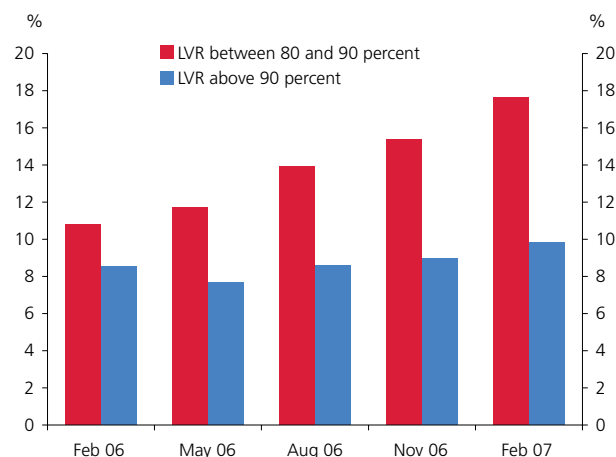
- Bank residential mortgage lending has shown a resurgence over recent months. As at the end of December 2006, bank residential mortgage lending was approximately 136 percent of personal disposable income (figure 7). At the end of February 2007, lending to this sector stood at approximately \$132 billion, which represents just over half (52 percent) of total bank claims.
- Part of the recent advance in mortgage lending has involved some banks increasingly offering new mortgages that require little or no initial borrower deposit. This is commonly referred to as high loan-to-value ratio (LVR) lending (figure 8).
- Competition among banks has also manifested itself in pressure on interest margins. The total interest margin has declined during the last year. Mortgage interest margins have also been squeezed (figure 9).
- While competition is good, we have two concerns from a prudential perspective. First, that returns adequately cover the risk. Second, that margins are sustainable in the sense of covering fixed, variable, and capital costs over the medium term.
- While risks remain in some areas of the non-bank sector, consolidation of institutions has probably been beneficial to the stability of the sector overall.

**Figure 7**  
Banks' exposure to residential mortgages



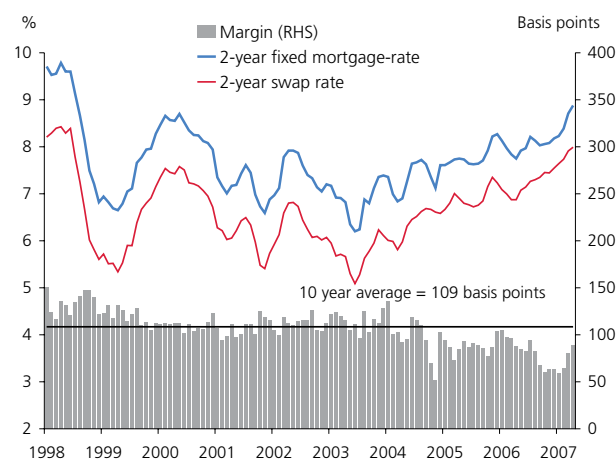
Source: Statistics New Zealand for GDP data. RBNZ – registered banks' SSR, as at 31 December 2006.

**Figure 8**  
Proportion of large banks' new mortgage lending with loan-to-value ratios above 80 percent



Source: RBNZ.

**Figure 9**  
Two-year fixed-term residential mortgage interest rate, two-year swap rate, and margin



Source: Bloomberg, RBNZ. The margin and the mortgage rate for April 2007 are RBNZ estimates.

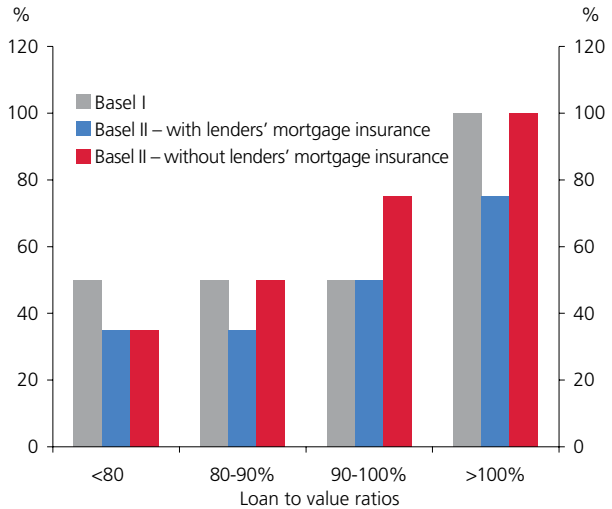
# The New Zealand payment system

- High-value payment systems have performed well since the last Report, with low levels of outages.
- Changes have been proposed to the governance arrangements of New Zealand’s high-value payment systems. Governance changes are also being considered for the retail payment system. The changes are designed to improve the effectiveness, accountability and transparency of governance arrangements, which will contribute to the overall soundness and efficiency of the payment system.

## Recent developments in financial regulation

- Residential mortgages account for a major share of New Zealand banks’ lending exposures, and it is important to ensure that the risks associated with these portfolios are adequately managed.
- Part of the way in which this is done is through banks’ holdings of capital. The Reserve Bank is working with New Zealand banks to implement the recent update of the international framework for bank capital adequacy, Basel II.
- Compared with the previous (Basel I) framework, Basel II increases the sensitivity of capital to key bank risks. For instance, higher LVR loans will require higher regulatory capital holdings. Figure 10 illustrates the risk sensitivity of capital requirements proposed for the Basel II standardised Approach, compared with the current Basel I standard. The graph shows how risk weights vary with LVR and lenders’ mortgage insurance (LMI).

**Figure 10**  
Risk weights for a residential mortgage under Basel I and Basel II standardised approach



Source: RBNZ.