

Highlights from the Reserve Bank's October 2004 Financial Stability Report

The economic and financial environment

The macroeconomy – domestically and internationally – has been in an expansion phase. Strong growth is supporting asset values and debt servicing capabilities.

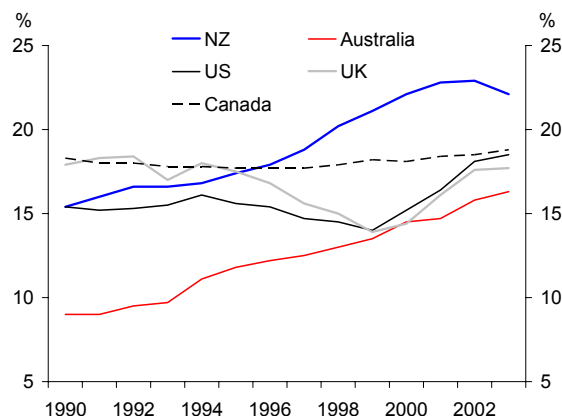
In recent years, households in several countries, including New Zealand, have significantly increased their leverage. However, debt servicing burdens have not increased to the same extent, due to lower interest rates. But households may be more vulnerable than usual to an unanticipated increase in interest rates or a slowdown in income growth.

Business sector income is reasonably solid, reflecting the strong performance of the economy in recent years. The appreciation of the New Zealand dollar has kept exporters' incomes contained, although there has been a positive offset from higher world commodity prices.

New Zealand's net international obligations are among the highest in the developed world. The banking system has raised a significant share of the foreign capital required to fund the current account deficit.

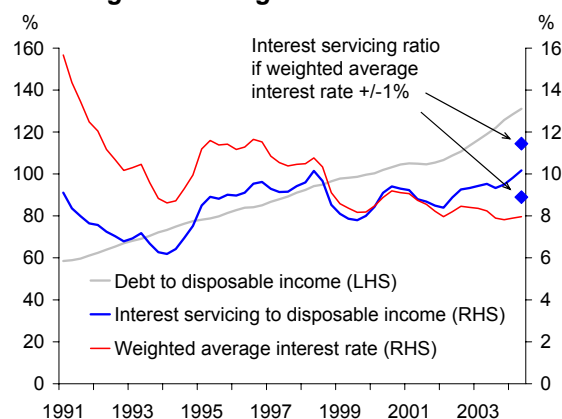
The stability of this external position depends on maintaining an ongoing capacity to service the obligations incurred. Strong bank balance sheets indicate a good capacity in this regard, although New Zealand's small size and relative lack of economic diversification mean that it could be quite exposed to unexpected events.

Household debt-to-asset ratios



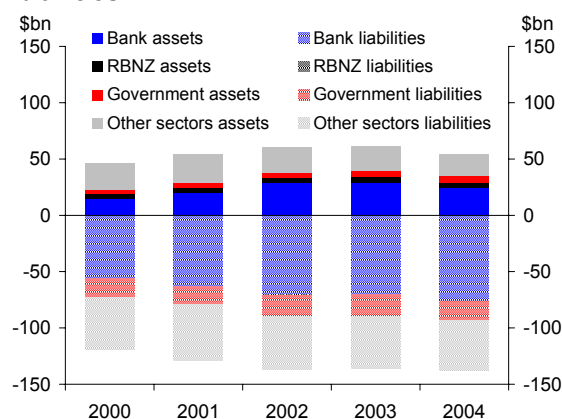
Source: RBNZ, RBA, BIS, UK Office for National Statistics, Bank of Canada.

Total household debt-to-income, interest servicing and average interest rate



Source: RBNZ, Statistics New Zealand.

New Zealand's external assets and liabilities



Source: Statistics New Zealand.

New Zealand's financial institutions

Currently the banking system is assessed as sound, on the basis of strong underlying profitability, high quality and generally well-diversified asset portfolios, and strong parent banks.

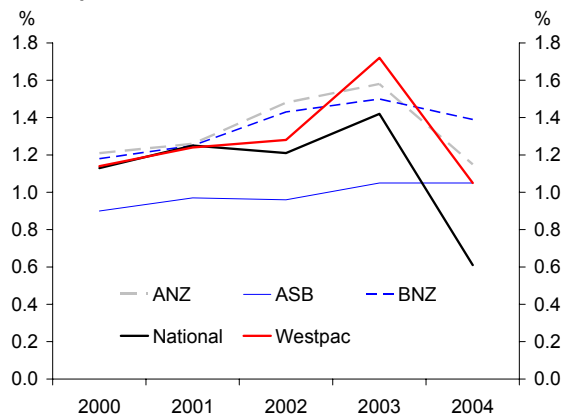
For the year to March 2004, the return on average assets for the major banks – after adjusting for one-off factors that lowered some banks' results – is estimated to have remained close to previous years' levels of up to around 1.2 per cent. This is somewhat above both the international standard of 'good' performance of 1 per cent, and the returns earned by their parent banks.

Banks' problem loans are at very low levels, which reflects the generally low-risk nature of their lending and the buoyant economy.

Banks have placed greater focus on housing loans, including financing rental investments. We assess the extent of any increase in risk in their residential loan portfolios to be modest. Banks' terms and conditions and security arrangements for this lending provide them with a generally high level of protection against loss.

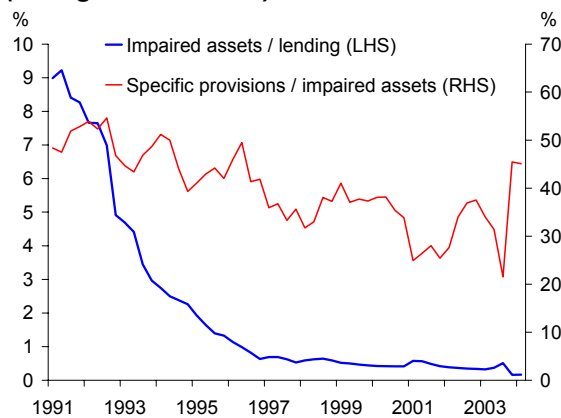
Non-bank financial institutions, particularly property financiers, have increased their lending substantially since 1998. A slow-down in the property market could result in some difficulties for institutions that have achieved rapid growth by taking on more speculative business. However, the small size of these institutions suggests that financial distress or failure within the group poses a relatively small risk to the stability of the financial system.

Net profit after tax as a percentage of average assets (systemically important banks)



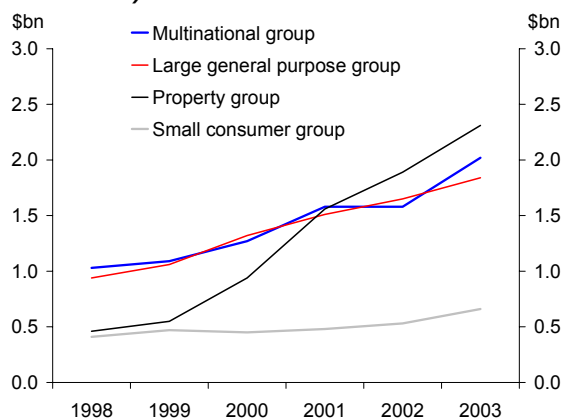
Source: Registered banks' disclosure statements.

Impaired assets and specific provisioning (all registered banks)



Source: Registered banks' disclosure statements.

Non-bank loans to non-household borrowers (by category of lending institution)



Source: RBNZ.

Recent developments in banking regulation and supervision

The Reserve Bank is responsible for supervising registered banks for the purposes of (a) promoting a sound and efficient financial system and (b) avoiding significant damage to the financial system that could result from the failure of a registered bank. Recently the Reserve Bank, in addition to conducting its regular supervision, has been placing an increased focus on the second of these two elements. Specific developments include:

- **Local incorporation policy:** The Reserve Bank requires systemically important banks to be incorporated in New Zealand. The failure of a locally-incorporated bank would be more manageable than in the case of a branch of an overseas bank, because there would be more legally certain and rapid access to the assets and liabilities of the New Zealand bank. Currently, three of the four systemically important banks are locally incorporated, and we are working with the other bank (Westpac) to determine how it can meet our requirements.
- **Outsourcing policy:** The Reserve Bank is implementing a policy to manage outsourcing risk. Outsourcing of key functions can create risks for a bank, particularly if the outsource provider is unable to provide the contracted services. This would be a serious issue in a crisis situation if the board or statutory manager of a systemically important bank needed to manage the bank on a stand-alone basis.
- **Crisis management preparedness:** The Reserve Bank is developing a range of options for managing a bank crisis, including having the capacity to sell, re-capitalise, or if needed, to liquidate a bank in serious distress.

Trans-Tasman banking supervision has also been a focus. Two developments under this heading have been:

- **Enhanced 'home-host' supervision:** Following on from trans-Tasman officials' discussions earlier this year, we are working on an enhanced 'home-host' model of banking supervision that will seek to harmonise regulatory rules where appropriate, and to strengthen arrangements for information sharing and coordination with the Australian authorities, including in crisis situations.
- **A review of major financial institutions:** The Reserve Bank, The Treasury and MED have formed a working group to review the regulation of New Zealand's major financial institutions. The review will consider whether different institutional arrangements – both domestically and trans-Tasman – could improve the contribution of financial institutions to economic growth, while maintaining financial stability. The group is scheduled to report to the Minister of Finance in early 2005.

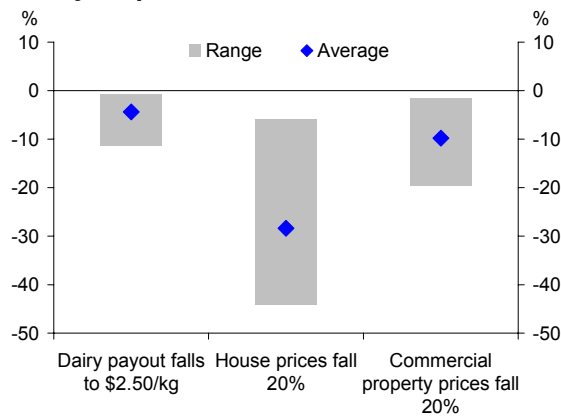
Stress testing the New Zealand banking system

As part of the IMF's Financial Sector Assessment Programme (FSAP) review in 2003, the Reserve Bank conducted a stress testing exercise with the five major banks at the time.

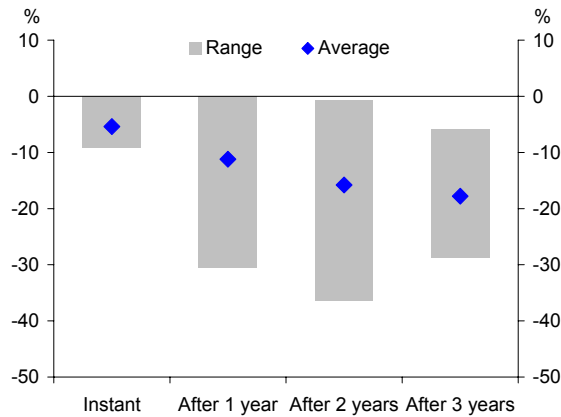
The shock scenarios included large movements in interest rates and exchange rates, economic shocks that reduce the credit quality of three key sectors of the economy, and two more complex scenarios, one resulting from a foot-and-mouth disease outbreak and the other, an increase in the cost of overseas borrowing resulting from a sharp deterioration in New Zealand's access to international capital.

The exercise suggested that the major New Zealand banks could withstand a range of substantial shocks without becoming distressed. However, the results, while comforting, should be treated with some caution. Stress tests are artificial in nature, particularly in that the shocks are assumed to be temporary. That will not always be so apparent in a real world situation.

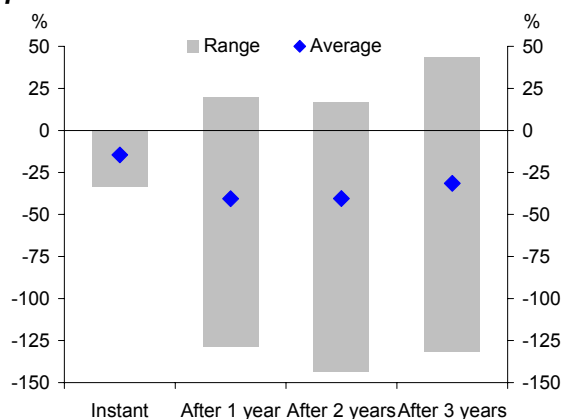
Credit shocks: cumulative change in banks' profits (after 3 years) as a percentage of base-year profits



Foot-and-mouth outbreak: change in banks' profits as a percentage of base-year profits



Offshore borrowing shock: change in banks' profits as a percentage of base-year profits



New Zealand's foreign exchange and government bond markets

Preliminary results for the April 2004 BIS survey of foreign exchange markets show that average daily turnover in New Zealand was US\$7.5 billion, compared to US\$4.2 billion in the 2001 survey. The increase since 2001 arose mainly from the rise in the New Zealand dollar against the US dollar, but about a quarter of the increase was due to growth in transaction volume.

The liquidity of the New Zealand foreign exchange market appears to be in line with the size of the New Zealand economy. Day-to-day volatility has been higher in recent months, but this has been mainly US dollar-sourced.

The New Zealand dollar is scheduled to be added to CLS Bank arrangements in November 2004. CLS Bank is a cooperative venture amongst the major international banks, which will enable both 'legs' of a foreign exchange transaction to be settled simultaneously, thereby eliminating foreign exchange settlement risk. All of the major New Zealand banks that deal in foreign exchange will be participating in CLS.

The Government has run operating surpluses in recent years, and government debt on issue has not kept pace with the growth of the New Zealand economy. At some stage this could result in less liquidity in the government debt market, although the government is expected to maintain net debt issuance in the future, and illiquidity in the market is not an immediate issue.

Foreign exchange turnover in New Zealand by market

Market	Average daily turnover (US\$m)	% of total
Spot	1554	21
Forward	547	7
Swap	5226	70
Derivatives	126	2
Total	7453	100

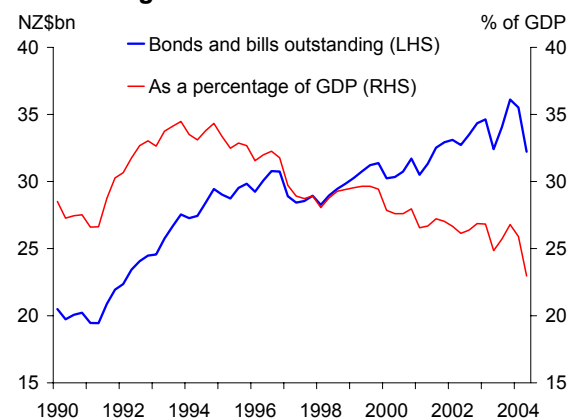
Source: RBNZ data for BIS 2004 survey.

Foreign exchange turnover in New Zealand by currency

Currency	Average daily turnover (US\$m)	% of total
NZD/USD	4304	58
USD/AUD	1741	23
USD/EUR	543	7
USD/JPY	176	2
USD/GBP	203	3
Other	486	7
Total	7453	100

Source: RBNZ data for BIS 2004 survey.

Domestic government debt on issue



Source: RBNZ, Statistics New Zealand.