

Financial Stability Report

Highlights

November 2005

Summary

The New Zealand financial system, overall, is well placed to weather a possible slowdown in the economy. The economic expansion of recent years has been reflected in strong financial sector balance sheets, and levels of trading in financial markets that have given them depth and liquidity.

However, these same developments have also sown the seeds for a more testing time ahead. Household indebtedness has continued to climb, relative to household incomes, and house prices have become more inflated. Farm debt and farm land prices also appear stretched.

A counterpart to these developments has been a further widening of the balance of payments current account deficit, to 8 per cent of GDP. This deficit is very large by OECD standards and is not sustainable over the medium term.

Adjustment to these imbalances, if abrupt, could test the resilience of the financial system.

In financial markets, large imbalances invariably trigger changed risk assessments at some point. These can be abrupt and can result in financial market volatility.

There are also implications for borrowers, and for the lending institutions. Adjustment to imbalances will mean changes in the circumstances facing many households and firms, and possible strains on the abilities of some to service debt.

We do not see those strains as spilling over to the financial system on a scale that would undermine its overall stability – though specific stresses cannot be ruled out.

All in all, the risk conditions facing the financial system over the next six months could be more testing than during the past six months. Maintenance of ongoing financial stability will require prudent management and pricing of risk by all participants – by those who borrow, by the institutions that lend, and by those who invest in the financial markets.

The material in this report was finalised on 9 November 2005.

The economic and financial environment

Low global interest rates have been central to the favourable global economic environment over the last few years. But this has also led investors to 'search for yield', while accepting a higher level of risk for which they may not be adequately compensated. This trend is reflected across a broad range of asset classes, including New Zealand dollar-denominated bonds.

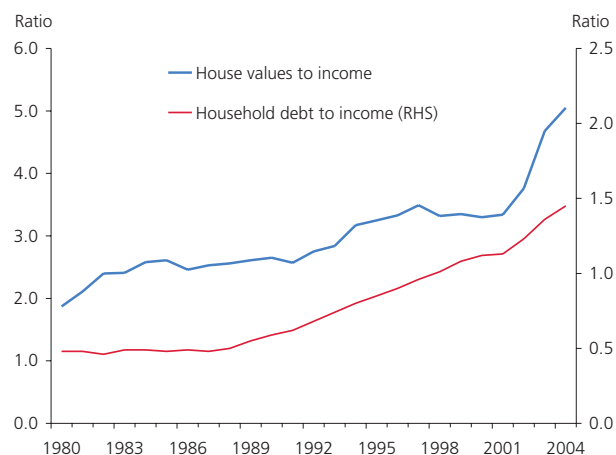
New Zealand's current account deficit reflects the strength of domestic spending, and signals the need for a rebalancing of the New Zealand economy. Adjustment, while often orderly, can be sharper than anticipated, and can place strains on those most exposed. This can be either because of the sector they are in, or because they have already stretched balance sheet and debt-servicing positions.

For the household sector, the ratio of debt to disposable income remains at an unprecedented level. Within this overall position, of the one third of households with a mortgage, one in ten is devoting 50 per cent or more of their disposable income to debt servicing.

Borrowers may have viewed mortgage interest rates as 'cheap' based on expectations of on-going capital gains. But this assessment could change quickly if interest costs – including as the result of higher future fixed rates, or higher risk premia – rise further, and if rental yields or house prices fall short of expectations.

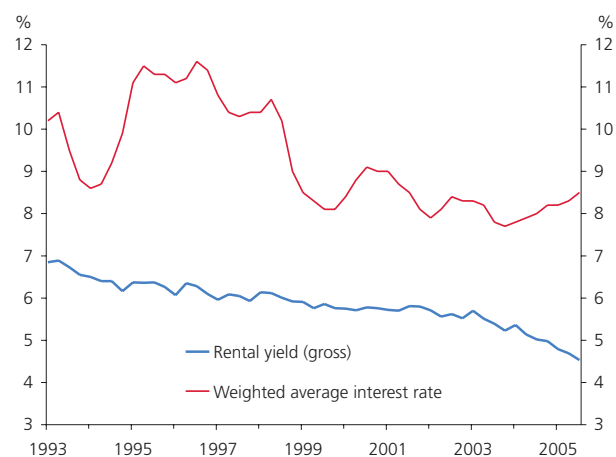
The corporate sector, overall, appears quite well placed to deal with potential economic headwinds. But the level of exposure varies both across and within sectors, with export firms facing pressure on profits owing to the strong exchange rate. In the rural sector, farm land prices and borrowing have increased rapidly. These developments increase the rural sector's exposure should the world prices of New Zealand's commodity exports fall, interest costs rise, or the exchange rate remains strong.

Debt to income continues to climb



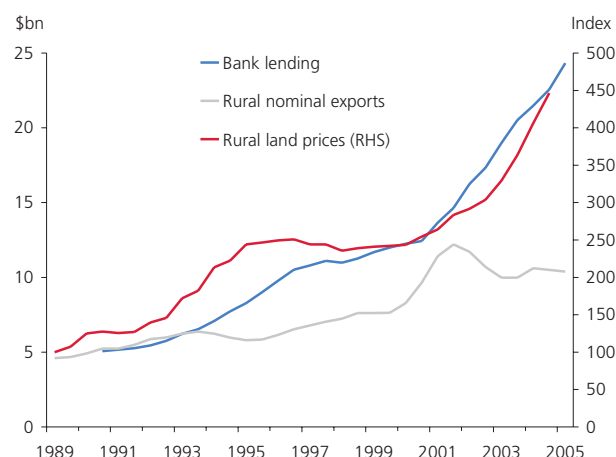
Source: RBNZ.

Rental yields and mortgage rates



Source: Real Estate Institute of New Zealand, Ministry of Housing, RBNZ.

Bank lending to the rural sector



Source: Statistics New Zealand, Quotable Value Ltd, RBNZ.

New Zealand's financial markets

Foreign exchange market

Turnover in the New Zealand dollar (NZD) has increased significantly in recent years. Much of this increase in turnover can be traced back to large-scale offshore investment flows into NZD investments, including an upsurge in NZD bond issuance in Europe and Japan (so called 'Eurokiwi' and 'Uridashi' bonds).

Standard measures of market liquidity, such as bid-offer spreads and volatility measures suggest the NZD market is functioning well at the moment. However, some, and possibly much, of the increase in liquidity in the NZD market is likely to be cyclical. When the NZ economy slows and interest rate differentials with foreign economies narrow, turnover could reduce. Also correction of the current account imbalance, if abrupt, and particularly if combined with adverse developments – like a flu pandemic – could test the liquidity of the NZD foreign exchange market.

Government bond market

Tight supply and demand conditions remain in the government bond market. In July, the Reserve Bank introduced a Bond Lending Facility (BLF). Under this facility, the Bank can lend bonds to the market that are needed to settle market contracts, but difficult to obtain in the market. The facility has been actively used and, by enabling bond transaction settlement failures to be avoided, has assisted the functioning of the market.

The Bank currently is reviewing the nature and structure of its open market operations, with a view to ensuring that those operations leave as much scope as possible for government securities to be available for trading in the market. Details of any proposed changes are expected to be released in early 2006.

Global trading in the NZD by FX instrument

Instrument	2004		2001	
	USD million	%	USD million	%
Spot	5,534	22	1,635	15
Forwards	1,755	7	846	8
FX swaps	17,478	71	8,169	77
Total	24,767	100	10,650	100

Note: For example, 1 per cent of Australian dollar trading takes place in New Zealand, while 13 per cent of New Zealand dollar trading takes place in New Zealand.

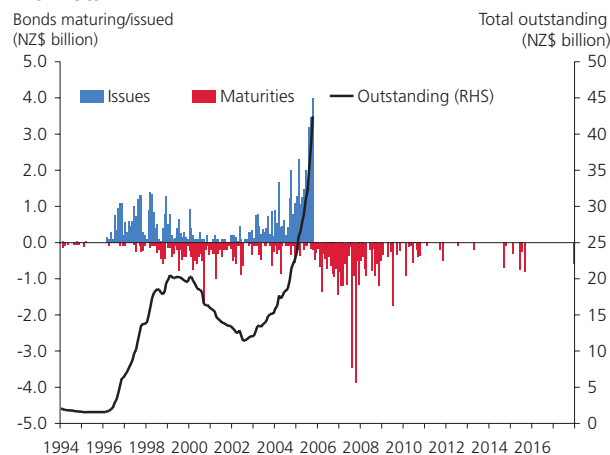
Source: BIS 2004 triennial FX turnover survey.

Bid-offer spreads in the NZ dollar spot market



Source: Reuters.

Eurokiwi and Uridashi bond issuance in offshore markets



Source: Reuters, Bloomberg.

Bond lending facility summary statistics

Proportion of days used	45%
Average daily amount (when used)	68m
Highest daily amount	357m
Average weekly amount	163m
Highest weekly amount	820m

Source: RBNZ.

New Zealand's financial institutions

Banks continue to report strong balance sheets, with satisfactory levels of capital, strong but moderating profits, some reduction in risk concentration in their corporate loan portfolios and a very low level of impaired assets. This puts the banking system in a strong position going into a period of slower economic growth.

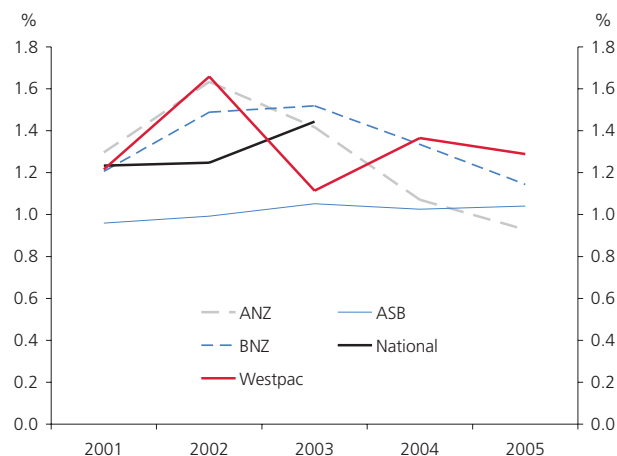
Lending growth in the banking sector has continued at a brisk pace, but interest margins are narrowing. Conditions for a slowdown in lending appear to be emerging. A potential concern is that banks seek to maintain lending growth by taking increased lending risk.

Non-bank lending institutions have continued to grow faster than banks, increasing their market share of lending institutions' assets, including banks', from under 5 percent in 2000 to nearly 7 percent at mid-2005.

Rapid expansion in lending often presents potential risks. There are some early signs that problem loan levels are past their low point in this economic cycle. Concentrations in property lending and intra-group "connected" lending, historically, have been areas of risk when credit conditions weaken.

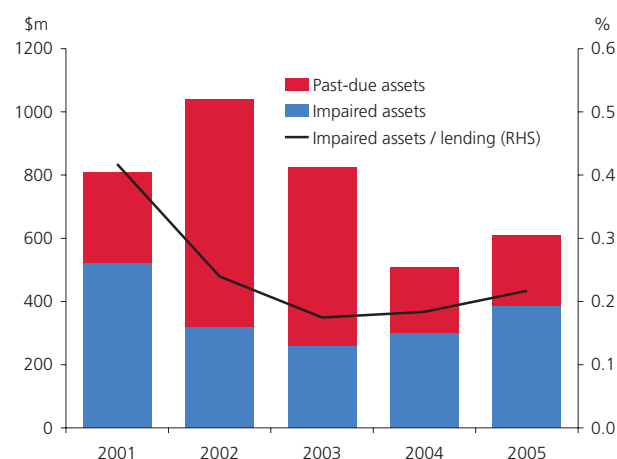
An emerging development has been the publication of ratings for a wider range of financial institutions, by a wider range of rating organisations. These can be helpful to investors. But use of ratings also requires some care. The rating organisations now rating New Zealand financial institutions differ in their experience and areas of expertise, and use different approaches and rating scales. It is important that investors understand the meaning of the ratings they use in making investment decisions.

Net profit after tax to average assets for large banks



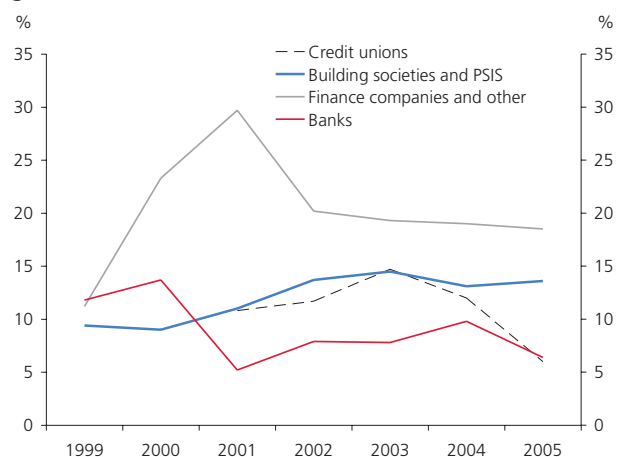
Source: Registered banks' disclosure statements.

Impaired and past due assets for large banks



Source: Registered banks' disclosure statements.

Non-bank lending institutions' annual rates of asset growth



Source: RBNZ SSR and annual NBFIs surveys, Registrar of Friendly Societies and Credit Unions, RBNZ estimates. Annual rates of growth December year, except 2005, year to June.