

Highlights of the May 2005 *Financial Stability Report*

The economic and financial environment

The world economy may be past the peak of the growth cycle, but global financial conditions remain stable. In the major economies, firms have benefited from low interest rates, and corporate balance sheets have generally strengthened. In contrast, households in many countries have increased their borrowing to previously unseen levels.

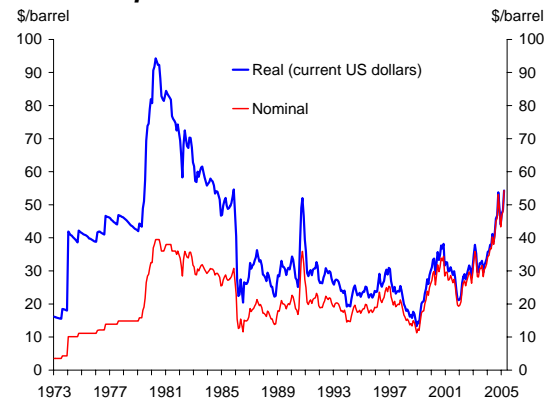
Perceptions of risk in global financial markets are low, reflecting the current point in the economic cycle. But confidence could be shaken by inflation pressures, such as a sustained rise in oil prices, that could require higher interest rates; or by a disorderly downward adjustment in the US dollar.

The New Zealand economy is expected to slow to more sustainable rates of growth. Possible risks to what have been benign financial conditions include further appreciation of the New Zealand dollar, a fall in agricultural export prices, or a sharper-than-expected slowdown in the domestic economy.

The corporate sector is generally well-placed to deal with a period of slower growth, although recent performance has been mixed. Export industries face uncertainty about the direction of the New Zealand dollar, with past exchange rate hedges rolling off. Rapid growth in borrowing has left agriculture sector returns more sensitive to changes in global demand and exchange rates.

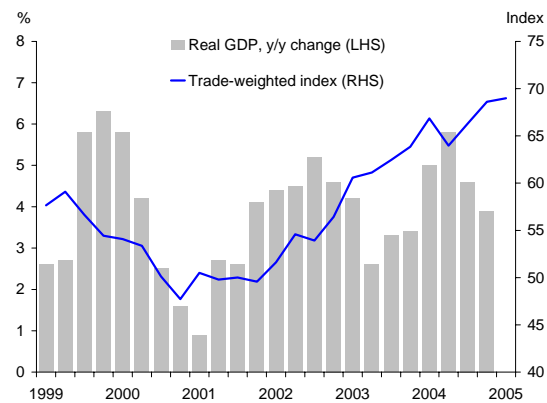
Household debt has risen to levels that are unprecedented in New Zealand. Higher interest rates may have a greater impact on households than in the past, and the most highly-indebted households could face some financial strains. The household sector as a whole may also cut back on discretionary spending, contributing to slower economic growth and a weaker lending environment in general for financial institutions.

Crude oil prices



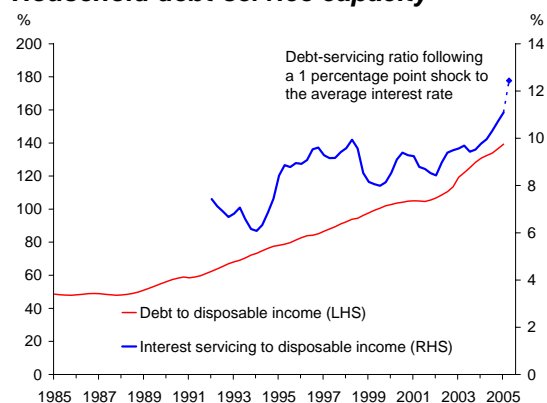
Source: US Federal Reserve, US Department of Labor.

New Zealand's macroeconomic environment



Source: RBNZ, Statistics New Zealand.

Household debt-service capacity



Source: RBNZ, Statistics New Zealand.

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New Zealand's financial institutions

The four major banks are well-placed to weather less favourable conditions, with strong balance sheets, solid earnings, high credit ratings, and strong owners. The return on assets for these banks over 2004 was 1.1 per cent, slightly better than the international standard of 'good' performance of 1 per cent. On the whole, the other banks have also achieved stronger performance in 2004 than in 2003.

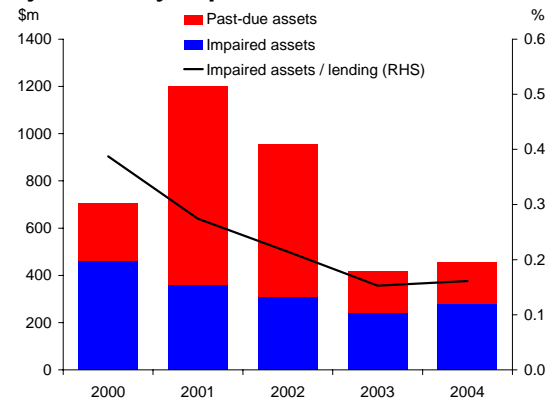
A slowdown in lending and earnings growth is possible if the economy slows, given competitive pressures on interest margins. The scope to bolster earnings by reducing operating costs is less now than it has been in recent years.

There is a risk that banks will seek to offset these pressures on earnings growth by lowering credit standards. The Reserve Bank will continue to monitor developments in this area.

While many finance companies are long-established and experienced in consumer and business lending, more than a third lend principally for property investment and development. The latter lenders, as a group, have grown the fastest amongst finance companies, and experience indicates that recent rapid growth can be a marker for greater risk. A number of domestic finance companies will face the first real test of their soundness if the economy slows.

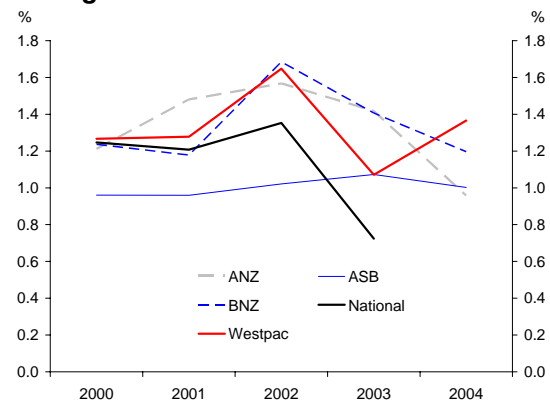
Life insurance assets in New Zealand have declined over time, as policies with a saving element have been superseded by managed funds products. Globally, in the early part of the decade, insurers faced some financial stress due to losses on investments; New Zealand life companies were exposed to this mainly through ownership linkages, rather than losses in New Zealand. The sector overall appears to have stabilised in the last two years.

Impaired and past-due assets for systemically important banks



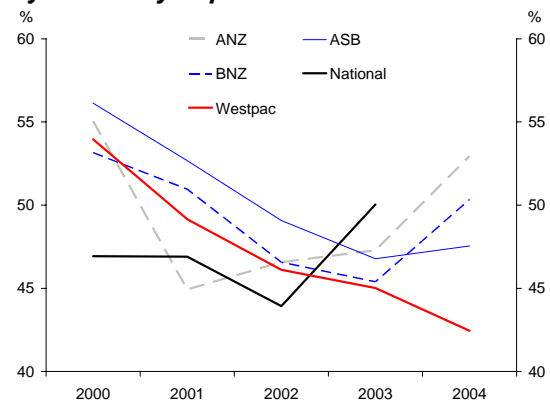
Source: Registered banks' disclosure statements.

Net profit after tax as a percentage of average total assets



ANZ data for 2004 is for the merged ANZ National Bank. Source: Registered banks' disclosure statements.

Operating costs to income for the systemically important banks



Source: Registered banks' disclosure statements.

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New Zealand financial markets

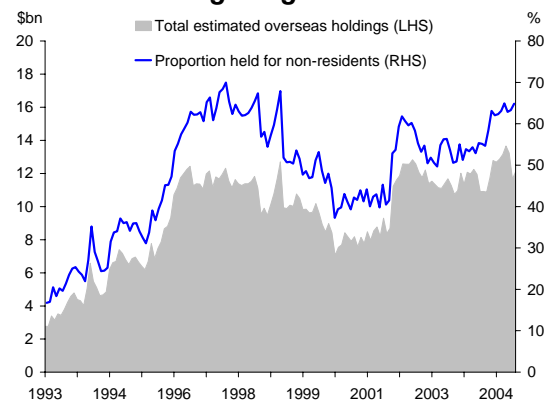
The government bond market has been functioning effectively, as demonstrated by steady price-making by the key dealing institutions and low bid-offer spreads. However, some pockets of illiquidity have emerged in recent years, as specific bonds have become difficult and/or expensive to obtain at times.

There are indications that these pockets of illiquidity may become a more recurring feature. The supply of government bonds has been limited, given the Government's fiscal surpluses. Meanwhile, there has been increased demand from banks, for prudential needs and for facilitating real-time settlement of large-value payments; and from offshore investors attracted by New Zealand's relatively high interest rates.

The Reserve Bank has increased the use of foreign exchange swaps in its daily liquidity management operations, which has the advantage of not withdrawing bonds from the market. The Bank is considering other ways that it could address market liquidity, with details expected to be provided to the market in the coming months.

With the New Zealand dollar around post-float highs, the risk of a disorderly adjustment may be greater. However, the New Zealand dollar foreign exchange market has been functioning well, and market measures of exchange rate volatility suggest that market participants are not experiencing or expecting any degree of market disorder at present.

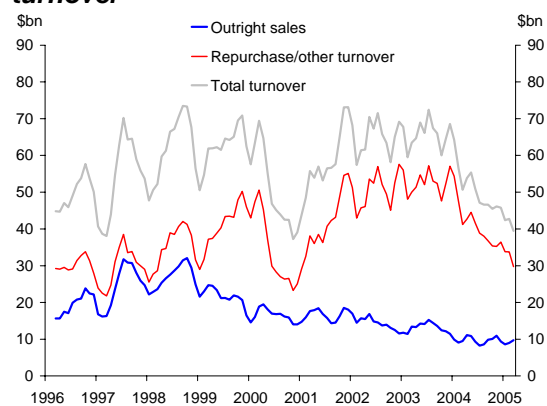
Offshore holdings of government bonds



Excludes Reserve Bank and other government sector holdings.

Source: RBNZ.

Monthly government bond market turnover



Three-month moving average.

Source: RBNZ.

Implied probability of a >10% move in the New Zealand dollar



Source: UBS Warburg, RBNZ calculations.

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Recent developments in financial regulation

A number of aspects of financial sector regulation in New Zealand are currently under development and review.

Earlier this year, in their annual bilateral meeting, the Minister of Finance and the Australian Treasurer agreed to establish a Trans-Tasman Council on Banking Supervision. Its main role is to enhance coordination, cooperation, and harmonisation of trans-Tasman bank regulation. While the Council will seek to facilitate the integration of the two markets to the greatest extent possible, this will not come at the expense of the safety, stability, and efficiency of either country's financial system. The existence of the Council does not lessen the existing statutory objectives, powers, and responsibilities of the respective authorities.

In addition to work in support of the Trans-Tasman Council, the Reserve Bank has been working with the Australian Prudential Regulation Authority (APRA) on how best to coordinate aspects of banking supervision operations. A milestone development has been the establishment of coordinated arrangements – a terms of engagement – for implementing new capital standards (the Basel II framework) for trans-Tasman banks, in a way that is efficient and effective for both jurisdictions.

Over the last few years the Reserve Bank has been reinvigorating aspects of its banking supervision policies. One element is the local incorporation policy, which requires all systemically important banks in New Zealand to be incorporated in New Zealand. Westpac Banking Corporation, which to date has traded as a branch in New Zealand, announced in December 2004 that it has agreed to locally incorporate. The Reserve Bank will be working with Westpac to implement this change over the coming year.

In October 2004 the Reserve Bank issued a consultation paper setting out a proposed policy on outsourcing by systemically important banks. The core of the proposed policy is that the board of directors of a bank should at all times be satisfied that they have legal and practical control of the bank's core functions. If banks outsource any systems, they should prudently manage the risks involved from not having those functions under their direct control.

A number of reviews of specific areas of non-bank financial regulation are currently under way, including:

- the Law Commission Report on the Life Insurance Act 1908;
- the Taskforce on the Regulation of Financial Intermediaries; and
- the Review of Credit Unions legislation.

These three areas of policy development will be taken forward as part of a more general review of the regulation of financial products and product providers. The Reserve Bank is participating in this review. The objective of the review is to establish a consistent regulatory framework for the regulation of insurance (life and general), other non-bank financial institutions, collective investment schemes and investment advisers. Related to this review will be consideration of the institutional arrangements for New Zealand's financial regulators.

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The payment system

The financial flows through the payment system are very large – more than \$35 billion crosses the Reserve Bank's accounts on an average day. A robust payment system is one of the core infrastructures required for financial stability. In the last 25 years the New Zealand payment system has been transformed through technological innovation, in terms of both the services provided to customers and the management of risks.

In the early 1990s the Reserve Bank began to develop a programme for risk reduction in the payment system. The objective has been to ensure that payment system risks are identified, monitored, and managed appropriately. A key outstanding element in this risk reduction programme is the establishment of robust failure-to-settle arrangements for the retail payment systems.

In 2003 a new section (Part 5B) was inserted in the Reserve Bank Act, giving the Bank formal jurisdiction over the payment system for the first time. The Bank's new powers are primarily to obtain and publish information; they give the Bank the ability to throw the spotlight on financial stability-related issues in the payment system.

Some key payment system developments

- 1979 First ATM installed.
- 1979 First credit cards issued.
- 1984 EFTPOS emerged in the New Zealand retail scene.
- 1987 Development of Kiwi Inter-bank Transfer System (KITS) for handling some high-value payments.
- 1989 RBNZ Act – no explicit reference to payment systems.
- 1990 Austraclear system introduced under licence to RBNZ.
- 1990 RBNZ raised concerns about payment system risks with the New Zealand Bankers' Association (NZBA).
- 1992 ISL became operational.
- 1992 NZBA Payment System Committee formed – RBNZ as observer.
- 1995 Banking law reform project completed – repeal of Banking Act, and amendments to cheques law.
- 1998 RTGS implemented, including on the RBNZ's Exchange Settlement Account System (ESAS).
- 1999 Netting and payments finality legislation passed.
- 1999 Consultations with payment switches initiated.
- 1999 Basel-based Committee on Payment and Settlement Systems (CPSS) Core Principles draft issued – an international standard relating to payment systems.
- Y2K Extensive contingency planning/BCP testing.
- 2000 KITS decommissioned, Same-Day Cleared Payment (SCP) system commenced.
- 2001 NZBA Failure-to-Settle project formally commenced.
- 2001 RBNZ raised access and governance issues with NZBA.
- 2003 RBNZ Amendment Act – provided for payment system oversight and designation.
- 2004 ESAS and Austraclear designated under Part 5C of the Reserve Bank Act.
- 2004 New Zealand dollar enters CLS system.