Excerpt from: A prosperous but vulnerable nation

An address to the New Zealand Society of Actuaries in Napier by Adrian Orr, Deputy Governor, Reserve Bank of New Zealand

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When we talk about the risks of indebtedness, it is important to remember that New Zealand is a reasonably prosperous nation. We can take on a certain amount of debt with comfort, and in some cases it is sensible to do so. The growth in borrowing in the last decade has not, in itself, raised the odds of a major financial crisis. But if things do go wrong, the losses from such a crisis could be severe – and more so now than they would have been, say, 10 years ago.

The Reserve Bank's interest in this area stems mainly from two features of borrowing behaviour in New Zealand. First, New Zealand relies heavily on funds borrowed from offshore, and a large and increasing share of these funds is channelled through the banking system. This channel has become more industry and geographically concentrated: just four Australian banks now own 85 per cent of New Zealand's banking system assets, and they also perform some of the key functions of their New Zealand operations. In a banking sector crisis, an interruption to these intermediation services would create disruptions across the whole economy.

Second, a great deal of the funds raised offshore end up as household debt. In normal times, households are quite capable of managing their own balance sheets, and their decisions about spending, saving and investment may well be rational. But there is always a risk, albeit small, of a major economic shock that could leave many households without any income to service their debts.

Ideally, households would have used the recent run of strong economic growth to build up a buffer against such an event; instead, they have tended to leverage up further and invest more heavily in a few domestic asset classes, especially housing. The result is that a major shock could result in more defaults and heavier losses for banks and other lenders.

For policymakers, the stakes are higher now than they have been in the past. In response, we have taken a fresh look at our approach to banking regulation and supervision. In particular, we are developing our capacity to respond to banking crises in ways that serve the interests of New Zealand. This includes policies that aim to ensure that foreign-owned systemically important banks can be run legally and operationally from New Zealand on a stand-alone basis if and when needed. We are also working to ensure that there is as much coordination and cooperation as is possible between regulatory authorities both here and abroad during times of financial stress.

We also have a brief to monitor the wider financial system for emerging signs of stress. The publication of our first regular *Financial Stability Report* is another step in raising awareness and debate around financial stability issues.

Banking policy should be part of a safeguard against rare, but costly, financial crises. We can think of it as a form of insurance: if the potential loss from an unforeseen event rises, it is appropriate to add a little more insurance cover. We believe that recent policy developments provide this extra cover, in ways that are consistent with our duty to promote the soundness and efficiency of the financial system.