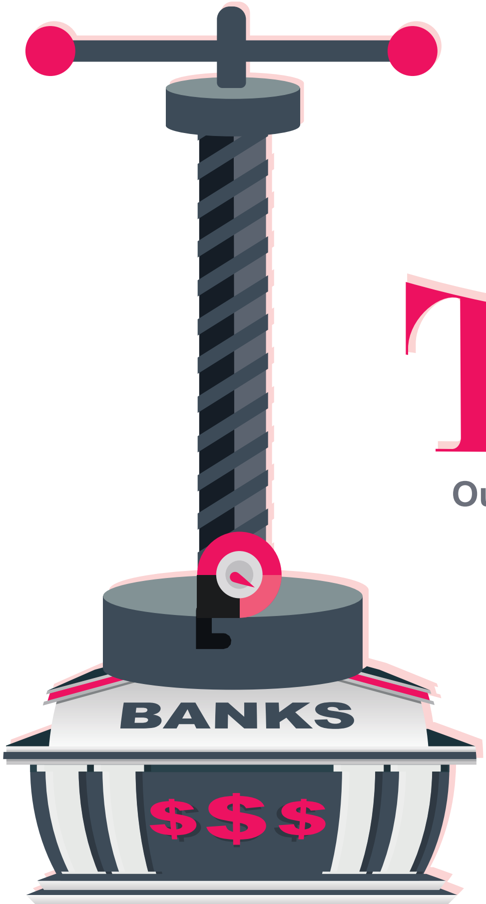


Stress TEST

Outcomes from a COVID-19 stress test of New Zealand banks

Stress testing is one of our best tools to provide a forward looking view of risks to the financial system. It involves modelling the effect of a hypothetical, severe but plausible shock on financial institutions. The Reserve Bank launched a stress test in March to determine the resilience of banks and the financial system to the risks posed by COVID-19.

The objective of stress tests is to improve our understanding of risks to financial stability, and assess the resilience of the banking system to a plausible but severe worsening in the economic outlook. The scenarios in this stress test were developed in late March and early April. At that time, the global pandemic and economic outlook were deteriorating rapidly around the world.

The COVID-19 stress test was conducted in two parts.

1

First, a desktop stress test of New Zealand's largest banks[1], that hold 92 percent of loans, in which the Reserve Bank modelled the impact on the banks capital of two severe but plausible scenarios involving unprecedented falls in economic activity, increasing unemployment and falling property prices.

2

Secondly, the Reserve Bank coordinated a process in which the five largest banks used their own models to estimate the impacts on their capital based on the same two scenarios as the desktop exercise.

The scenarios

The scenarios were set at different levels of severity taking elements of the scenarios developed by Treasury in April combined with different degrees of global economic stress. It is important to note that these scenarios, although plausible, are hypothetical and are considerably more severe than the Reserve Bank's central scenario.

1 in 50 to 1 in 75
year event

Pessimistic baseline scenario

The pessimistic baseline scenario (PBS) can be characterised as a 1 in 50 to 1 in 75 year event with the unemployment rate rising to 13.4 percent and a peak-to-trough fall in house prices of 37 percent.

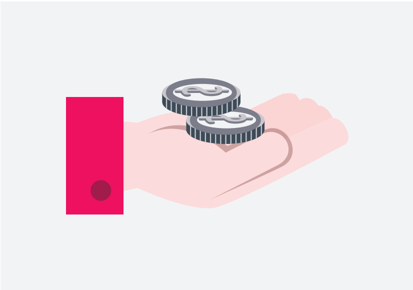
1 in 200
year event

Severe scenario

The severe scenario is close to a 1 in 200 year event with the unemployment rate rising to 17.7 percent and a peak-to-trough fall in property prices of 50 percent.

1. ANZ Bank New Zealand, Bank of New Zealand, ASB Bank, Westpac New Zealand, Kiwibank, TSB Bank, Southland Building Society, Heartland Bank and The Co-operative Bank.

Reserve Bank modelled results



Pessimistic baseline scenario

The aggregate Common Equity Tier 1 ratio declined from 11.4 percent to a trough of 7.7 percent after two years. Despite the large fall in capital, all banks remained above regulatory minimums even while continuing to meet the demand for credit. This provides reassurance that banks will remain resilient even under pessimistic scenarios.

Severe scenario

The aggregate Tier 1 and aggregate Total Capital ratio fell below the regulatory minimums. The shortfall in total capital reached $7 billion. Banks would require significant mitigating actions, including capital injections, to remain above the regulatory minimum. This shows that there are limits to bank resilience to severe but plausible scenarios.

Capital buffers are designed to be built up during the good times, so that they can be drawn upon when economic conditions sour. These stress tests show that banks can withstand a broad range of economic scenarios while retaining sufficient capital to keep on lending. It is important that banks use their buffers to continue supporting their customers as this will support economic recovery, and reduce the chance of a very severe economic downturn.

In December 2019, the Reserve Bank finalised decisions in its review of the capital adequacy framework, known as the ‘Capital Review’, for locally incorporated banks, including confirming the proposed increase in regulatory capital requirements from current settings. The current events underscore the importance of banks building strong capital buffers. Banks would be in a stronger position to withstand worsening economic conditions if they had been implemented prior to this downturn. The onset of the pandemic has made clear to banks and regulators the importance of considering more severe ‘black swan’ events in stress test scenarios. The implementation of the capital review has been delayed until at least 1 July 2021, and the Reserve Bank will be considering over the coming months whether further delays are warranted.