RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

COVID-19, financial stability and transparency

A speech delivered to the One Stop Update for the Accountant in the Public Sector in Wellington

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"It is better to light a candle than curse the darkness." **- Chinese proverb**

Executive summary

Whether they're financial or business decisions, clear, concise and up-to-date information is crucial to making informed decisions. As well as helping banks to keep focussed on their customers during the initial response to COVID-19, we've been working with others across Government and the financial sector to shore up confidence and cash-flow in the system. Transparency and communication about these actions, decisions and consequences is key to further understanding about our work. While the messages can sometimes be tough – it's important everyone has access to the right information at the right time. We're committed to further developing tools and approaches that enhance this transparency – including improvements to the Dashboard.

Introduction

Thank you for the opportunity to speak to you today.

Today I would like to talk about the Reserve Bank's response to the COVID-19 pandemic, with a focus on market disclosure and transparency. I will also discuss what we have done with other government agencies and our regulated institutions to shore up confidence and cash-flow in our financial system. A key support to this response has been the transparency of both the Reserve Bank and industry, through broad disclosure of actions and policies.

Market discipline is one of the three pillars in the Reserve Bank's regulatory framework. Market discipline relies on transparency through good disclosure and reporting from regulated institutions and clear communication from us as the steward of the financial system.

We want information about an institution's financial health in the public arena so people can make informed assessments and decisions. Market discipline refers to the way in which market participants influence a financial institution's behaviour through monitoring its risk profile and financial position. Market participants can exercise market discipline through the price they charge financial institutions for supplying funds, or simply by withdrawing their funds.

Importantly, if people know that they have all the important information they need, it is good for confidence as it reduces uncertainty and volatility.

COVID-19 pandemic and our response

Since the enormous economic challenges posed by COVID-19 first became clear, the Reserve Bank has worked closely with other parts of Government and industry to keep our financial system stable. The full range of initiatives can be found on our website[1], and I will focus more specifically on our financial stability initiatives and our regulatory actions.

Early on in the pandemic, we could see that the economic effect of the lockdown would be extremely severe and there could be significant impacts to the financial system. Many businesses and households were facing losses of income as a direct result of the pandemic and maintaining access to credit was crucial to ensure they could continue to meet their financial obligations. The Reserve Bank worked alongside the Government and the banking industry, to facilitate support of, and the supply of credit to, New Zealanders and their businesses.

To enable this, the Reserve Bank acted swiftly across a number of fronts. Many of these were types of regulatory relief: reducing the immediate impost of actual or planned regulatory requirements.

We relaxed or waived two rules that we did not want banks to be constrained by:

We reduced the minimum "Core Funding Ratio" requirement from 75% to 50%. The Core Funding Ratio (CFR) requires banks to meet a minimum share of their funding needs from retail deposits, long-term wholesale funding and/or capital. It was introduced after the global financial crisis because it provides a funding buffer that banks could use in the heat of a crisis. We always envisaged it could be reduced during times such as these.

We also delayed implementing the outcomes of our recent Capital Review[2] by 12 months – to 1 July 2021. This gives the banking sector significant capital headroom, providing scope for banks to supply up to around $47b more lending than otherwise would have been the case.

As explained by Deputy Governor Geoff Bascand in a speech last week, banks also played a key role in supporting customers during the initial COVID-19 response period. Having consulted closely with the Reserve Bank and Government, banks announced a mortgage deferral scheme at the end of March. The scheme allowed a six month principal and interest payment deferral for mortgage holders and small to medium enterprise (SME) customers whose incomes have been affected by COVID-19.

We provided guidance on the capital treatment of deferred mortgages – allowing them to be treated as performing loans. Ordinarily, loans that have been granted a repayment deferral or have past due payments are treated as non-performing, and banks need to have more capital to reflect the higher risk associated with these loans. This would in turn, limit a bank's

[1] https://www.rbnz.govt.nz/Mahi-Tahi-COVID-19-response

[2] The Capital Review began in May 2017 and looked at our framework for bank capital. A decision was made in December 2019 to increase the level of capital required by banks, with implementation beginning 1 July 2020. For more detail see https://www.rbnz.govt.nz/regulation-and-supervision/banks/consultations-and-policy-initiatives/active-policy-development/review-of-the-capital-adequacy-framework-registered-banks

ability to make additional loans to other customers and therefore reduce the availability of credit. A key point of difference under the scheme is that the deferrals have been actively offered by the lender.

Such treatment cannot be open-ended. We have not yet made a decision on whether we will extend or modify this guidance; or revert to the pre-COVID position. We are mindful of the importance of accurate and transparent disclosure and of not letting the real risk associated with a loan deviate markedly from the reported risk – in as much as it is possible to estimate such a thing in these highly volatile and uncertain times.

The other restriction that we completely removed for at least 12 months was our Loan to Value Ratio (LVR) policy. This limited the proportion of new loans that banks could advance at high LVRs. We wanted banks to show flexibility to their customers (including providing deferrals that would lead to rising loan balances). Our action removed the risk of that flexibility being impeded by the LVR rules.

These initiatives, along with accommodative monetary policy settings and the provision of central bank liquidity, are intended to support the banks to continue to supply credit to businesses and households. The Reserve Bank, along with the other Council of Financial Regulators[3] (CoFR) agencies agreed to delay a number of regulatory initiatives to free up time for institutions to focus on their businesses and customers.

We of course would not have been able to design or implement any of these initiatives without the close working relationships with industry and the whole of Government. It was particularly important that we worked very closely with Treasury on many of these initiatives: we needed to be fully joined up and our deep expertise on the different parts of the financial system was crucial. Regular meetings and briefings were held with Treasury and industry to ensure we had the most up-to-date information. We would like to go on record to thank the industry for their open dialogue during this time and the numerous supervisory meetings held virtually throughout the lockdown.

Working with CoFR, the Financial Markets Authority (FMA) announced in March an extension to the deadline for filing audited financial statements for FMC reporting entities from four months to six months. This now applies for balance dates up to 31 July 2020. This was to recognise that entities required time to assess the impact of COVID-19 on their business and how that information should be reflected in their financial statements, as well as the difficulties with the financial reporting and auditing processes due to the lockdown. Our regulated institutions are FMC reporting entities, and were therefore eligible for this extension. However, the Reserve Bank has additional reporting requirements, such as

[3] The Council of Financial Regulators is a forum for agencies with responsibility for financial sector regulation. CoFR is comprised of the Reserve Bank, Financial Markets Authority, the Treasury, Ministry of Business, Innovation and Employment, and the Commerce Commission

disclosure statements for banks and solvency information for insurers. So in co-ordination with the FMA, we extended the deadline for our financial reporting. We did note however that most institutions were able to file their financial reporting within the ordinary deadlines, showing that their reporting and auditing processes were robust. Accordingly, both the Reserve Bank and the FMA announced last week that we have removed the extension for financial reporting deadlines for balance dates after 1 August 2020.

The Financial System

At the end of May we released our six monthly *Financial Stability Report (FSR)* which assesses the health of the financial system. This assessment presents particular challenges during more volatile and uncertain times; we want to report openly and fully about the state of financial stability and the risks that we see, but we have to be mindful of the risk of exacerbating the situation, and further undermining confidence.

We used stress tests to inform ourselves and our audience about banks' and insurers' resilience. We developed two scenarios to test the banking system, which had similar economic projections to the Treasury's COVID-19 scenarios[4]. Results from our modelling indicated banks would be able to maintain capital above their minimum capital requirements under a scenario where unemployment increased to over 13 percent and house prices fell by a third. However, a second more severe scenario showed the limits of bank resilience. Under this scenario with unemployment of over 18 percent and house prices falling by half, banks would likely fall below minimum capital requirements without significant mitigating actions. General and health insurers are likely to be resilient to all but the most catastrophic of scenarios, and while life insurers are currently meeting capital requirements, some are operating close to their regulatory minimum. Life insurers with higher risk investment portfolios are exposed to further declines in equity prices, as well as some being adversely affected by falling interest rates.

I should note that bank capital buffers have increased significantly in the past decade, in response to actual and forthcoming increases in regulatory requirements; therefore the banks entered the Covid-19 pandemic in a sound position. Additionally, since early April the Reserve Bank has prohibited banks from paying dividends to their shareholders, which further supported the capital positions of New Zealand banks. This gives banks headroom to continue to supply credit, which will play a large role in supporting the economic recovery.

The Dashboard

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[4] Economic projections similar to Treasury's Covid-19 scenarios 2 and 5 were used. See Box A of the May 2020 *Financial Stability Report*.

Disclosure will remain an important part of our supervisory philosophy. During business-as-usual times, transparent disclosure of banks' financial information gives teeth to market discipline. One of the Reserve Bank's key initiatives for disclosure is the Bank Financial Strength Dashboard (the Dashboard). The Dashboard website was launched in May 2018 and went on to receive the Central Banking Publications global 'Initiative of the Year' award in 2019. The Dashboard is an interactive website all about the financial health of registered banks in New Zealand. The Dashboard helps enhance market discipline in two key ways: it makes it easier to compare the relative risks and financial position of different banks, which in turn should influence the decisions of depositors and investors; the other is that the Dashboard is more timely than disclosure statements. Consequently, it helps depositors and investors make decisions based on more up to date (and hence relevant) information.

Not surprisingly, there is increased interest in financial disclosures during times of economic stress. Through first few months of the COVID-19 pandemic, we saw a nearly fivefold increase in visitors to the Dashboard website. The media made use of the Dashboard for their reporting and their reference to the Dashboard in articles drove further traffic to the website.

We communicated closely with banks for the production of Dashboard data. One of our aims was to keep to the original timing for publication of the Dashboard (produced on a quarterly basis, 40 working days after the quarter end), as we wanted to ensure timely disclosure for users. We also had discussions with the banks on how to present some of the information as some of the relief packages - such as mortgage deferrals - resulting in us creating different categories to the existing reporting classifications that banks have been reporting on. It is crucially important that Dashboard information is of high quality and treated consistently across the banks. Thanks to everyone's hard work and close communication between ourselves and the banks, the Dashboard for the quarter ended March 2020 was produced on time.

The Dashboard is working well and we want to make sure that it continues to meet users' needs. As promised two years ago, we will be reviewing the Dashboard starting later this year, partly to ensure it maintains a relevant picture of new emerging risks such as cyber and climate related risks. The review will also refresh some of the existing content, including adding or changing metrics, adding some new interactive features, and reviewing the publication process. The user community will be encouraged to provide their input on how we can make the Dashboard better. We will hold a public consultation to collect this feedback, most likely in the first quarter of 2021, and would aim to refresh the Dashboard in late 2021.

Along with the refresh, we are exploring a prudential disclosure Dashboard for the insurance and Non-Bank Deposit Taker (NBDT) sectors. While this will take longer, we intend to begin consultation with insurers and NBDTs in the last quarter of this year. A number of sector participants have been wanting data that is comparable across the industry. The insurance Dashboard will be linked with the Insurance (Prudential Supervision) Act review and the review of insurer solvency standards, both of which are being relaunched in the fourth quarter of this year following a delay due to COVID-19.

Some major disclosure projects ahead

Looking ahead now, while the public health outcomes from COVID-19 in New Zealand thankfully seem encouraging at this stage, the impact on the economy and the banking sector will play out over a much longer period. A number of the relief packages announced at the beginning of the COVID-19 pandemic had a limited timeframe – in particular the wage subsidy, which was originally for 12 weeks, and has had an extension until 1 September for businesses especially effected by the pandemic, and the mortgage deferrals, which were for six months. So at the end of this period, some of the support and key relief packages are set to come to an end.

The banking sector recently implemented NZ IFRS 9, which covers the treatment of financial instruments. In particular, this standard determines how to treat expected credit losses of financial assets in a way which is quite different from the standard it has replaced, NZ IAS 39. IFRS 9 takes a more forward looking view of asset impairment and whether or not there has been a significant increase in credit risk. This is of particular importance to the banking sector at a time of crisis, as it can mean that loan loss provisions increase sooner and rise higher than under NZ IAS 39, which will ultimately affect the sector's willingness to supply credit. The International Accounting Standards Board (IASB) issued some guidance which outlined that an extension of payment holidays to all borrowers in particular classes of financial instruments, such as the mortgage deferral scheme, should not automatically result in all those instruments being considered to have suffered a significant increase in credit risk. This has pushed out the timeline for the recognition of impairment of loans.

However, we have seen some banks already increase their provisioning, showing the effects of banks taking a forward-looking view. The uncertainty around how the economy will play out over the short to medium term will in turn lead to some uncertainty about how banks assess their loans. Many businesses and households have been faced with a liquidity shock arising from the COVID-19 pandemic, which is a key reason for mortgage deferral scheme, and associated guidance from the IASB on how to treat such deferrals.

Despite this guidance, our sense is that loan loss provisions could rise sooner and higher than under the previous accounting standard. We understand that auditors are having ongoing, robust discussions with banks in this area. We will continue to watch this space closely and encourage as much disclosure as possible, both quantitative and qualitative. To-date, there has been limited reasonable and supportable information to increase provisions, but the extent of this will become clearer over time. We think that qualitative disclosure will be particularly important, as the assumptions and judgements that underpin the financial statements have an increased role in a fast moving and uncertain time.

Data is critical for monitoring, assessing vulnerabilities and emerging risks. We are continuously reviewing our data needs, looking for ways to fill data gaps and adjust to changing needs. We are working with banks, insurers and other financial market businesses to capture relevant information. As COVID-19 began to directly impact New Zealand we rapidly intensified monitoring, including the setup of new detailed, high frequency data collections. For example, in late-March we started a weekly survey to better understand the impact of COVID-19 and associated policy initiatives on households, businesses and the banking sector. We are publishing the survey's results – bank customer lending metrics - because it is important to ensure transparency and inform the public about the impact of the COVID-19 lockdown measures and policy response.

Data needs remain elevated. There is no doubt that we will continue close monitoring and with that gathering of data and information. In addition to addressing data gaps we will investigate innovative ways for gathering and use of more granular data to support more flexible and timely analysis. The insights will be valuable for our assessing the health of the financial system and broader decision-making. These innovations are relevant for disclosure too. Standardised metrics are required to enable comparisons and give meaningful signals and trends. Being able to unpack a set of metrics and underlying changes over time is essential to ensuring that these metrics are credible and meaningful.

Climate change disclosure

Another area we are closely engaging with is the disclosure of climate-related financial risks. Disclosure is a critical component to our climate change strategy, which you can read more about on our website[5]. Our climate strategy at the Reserve Bank has three components: incorporating climate change into our core functions; managing our direct impact on the climate; and leading through experience and collaboration. Examples of our collaboration include being a proud member of the Network for Greening the Financial System and leading the work on climate change in the Council of Financial Regulators' new climate workstream.

[5] https://www.rbnz.govt.nz/financial-stability/climate-change

Disclosure of climate risks is a key theme of our work as it plays a key role in ensuring a smooth transition to a low carbon future. It encourages firms and markets to manage and price risks effectively and efficiently. Disclosure of climate risks will assist by incentivising risk assessment and mitigation, and ultimately, investment in emission reduction and adaptation. Disclosure can accelerate:

- Changes to firms' behaviour by directing attention to climate-related risks - 'you manage what you measure'
- Changes to investors' behaviour by reflecting the climate risks and opportunities of investment

However, survey of New Zealand insurers and banks last year found broad concern that climate change exposed the financial system to significant risk, but, little evidence that climate risk concerns are influencing daily business decisions. That is why we supported the recent New Zealand legislative proposals for mandatory disclosure regime for climate risks, especially one that is collaborative in approach with industry. There are important challenges to making disclosure effective in meeting New Zealand's carbon reduction objectives - including standardised measures and climate scenarios, and sound data management and interpretation. But the scale of the climate issue to financial stability and the environment means we need to move forward, we can't let the perfect be the enemy of the good.

Bank breach disclosure

We have also been carrying out some policy work on the public disclosure of bank breaches of our regulatory requirements. The majority of this work was consulted on in 2019 and under the new approach, a bank will have to report promptly to the Reserve Bank when it has breached or possibly breached a requirement in a material manner, and will have to report all minor breaches to the Reserve Bank every six months. Only actual material breaches will then be published on the Reserve Bank's website, and banks will no longer have to include minor breaches in their disclosure statements. Implementation of the bank breaches policy and guidance on materiality thresholds are expected later this year.

Conclusion

The Reserve Bank has worked closely with the Government and industry to respond to the COVID-19 pandemic. The initiatives that we have rolled out have helped support financial stability and the ability of banks and insurers to support their customers.

Our strong commitment to transparency and disclosure might have been tested through such times. For example, disclosing the results of the severe stress tests presents communication challenges for both ourselves and industry. But we have instead seen that disclosure is key to giving participants the ability to manage their own risks. This event has reinforced our view of the importance of disclosure. With initiatives such as the insurance Dashboard, we will continue to expand the frontiers of disclosure and to champion best practice.