Box C

Trends in bank deposits through the period of monetary policy tightening

Deposits are an important part of banks' funding, making up around 63 percent of New Zealand banks' total funding, alongside wholesale and other funding (28 percent) and shareholders' equity (9 percent). This box examines the ongoing normalisation in banks' liquidity and funding positions given a higher interest rate environment, and the influence of this normalisation on net interest margins.

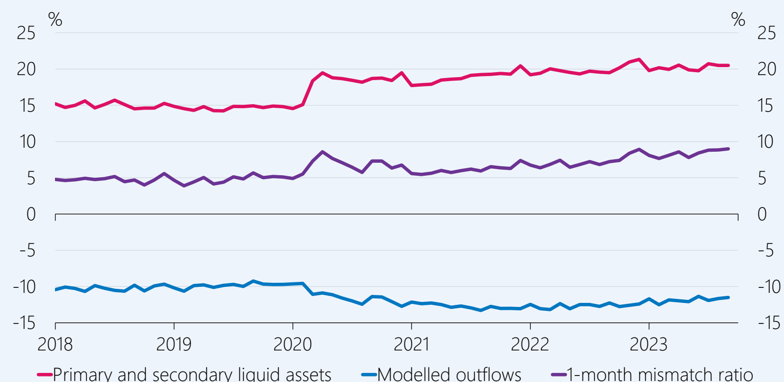
Bank deposits grew strongly during the early stages of the COVID-19 pandemic, driven by both fiscal support measures such as the wage subsidy and our Large Scale Asset Purchase (LSAP) programme. By purchasing government bonds in the secondary market, LSAP operations created both an asset for commercial banks (settlement balances with the Reserve Bank) and a liability (newly created deposits for customers who sold their bonds). Our Funding for Lending Programme (FLP) also provided a low-cost marginal source of long-term stable funding for banks.

The FLP increased banks' settlement balances and placed downward pressure on competition for deposits.[36] In turn, lower bank funding costs supported the transmission of monetary policy as banks passed these on to lower lending rates for households and businesses.

An environment of strong deposit volume growth relative to lending growth, and abundant liquid assets, led to a significant boost to the banking system's core funding and liquidity mismatch ratios (figure C.1). Banks seek to carefully manage their assets and liabilities to ensure they have adequate liquidity buffers. Our liquidity mismatch ratios require banks to model the net funding outflows they could see during a specified liquidity stress scenario and hold a sufficient buffer of liquid assets to offset this. A more stable funding profile, for example having a high share of term deposits, reduces a bank's modelled outflows and consequently the level of liquid assets the bank needs to have.

Policy actions over 2020, including the FLP, LSAP operations and fiscal stimulus, combined to effectively relax the constraint imposed by the mismatch ratios, by increasing the stability of banks' liabilities and raising the level of liquid assets in the financial system via higher settlement cash balances. The high level of liquid assets in the banking system meant that banks could comfortably operate with a higher share of their deposits kept at call, even though this meant their deposit funding was less stable than before (figure C.2). In part this was achieved through offering a lower interest rate premium on term deposits relative to on-call savings accounts (figure C.3), with the typical premium of around 200bps declining to around 60bps by early 2021. A lower compensation for locking in savings for long durations contributed to a decline in term deposit balances.[37] The share of all savings balances in term deposits fell from 70 to 56 percent.

Figure C.1
Components of banking system 1-month liquidity mismatch ratio
(percent of funding)



Source: RBNZ *Liquidity survey.*

36 See Box A in the November 2020 *Financial Stability Report* for discussion of the mechanics of LSAP and FLP, https://www.rbnz.govt.nz/hub/publications/financial-stability-report/financial-stability-report-for--november-2020.

37 Other factors, such as a preference to hold more liquid assets in an uncertain economic environment, may also have contributed to the switch from term deposits to transaction and on-call accounts.

As monetary policy has tightened since late 2021, these trends are gradually reversing. The interest rate premium on term deposits relative to on-call savings accounts has returned to pre-pandemic levels. Given this, a rising opportunity cost for holding deposits in transactional and on-call savings accounts has seen large shifts towards term deposits in banks' deposit funding over the past 18 months (figure C.4).

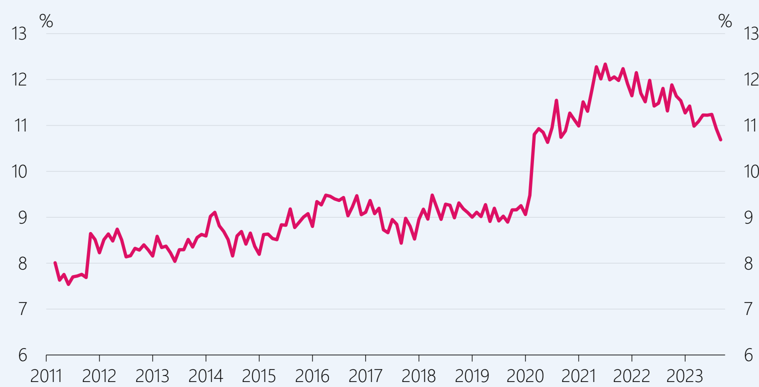
However, with deposit funding remaining strong relative to credit growth, bank competition for deposits overall has remained limited so far. As a result, returns on deposits and particularly for on-call savings accounts have been low relative to wholesale interest rates. Banks anticipate increasing competition for deposits over coming years as the sector repays funding through the FLP and credit growth picks up. Given this, bank demand for term deposits is starting to increase and the spread between 6-month term deposit rates and wholesale reference interest rates has risen, partly reversing the decline seen during the 2020 to mid-2022 period (figure C.5).

Through this transition period banks have experienced higher than average net interest margins (NIMs), as the interest income earned on their assets has grown faster than the interest costs paid on their funding. To some extent, this may reflect a degree of inertia among depositors. The share of deposits in transaction and on-call accounts is still above pre-COVID levels, despite the increased opportunity cost (see Special Topic 3 of the May 2023 *Financial Stability Report*).[38]

Figure C.2

Deposit outflows in 1-month mismatch ratio

(share of deposit funding)

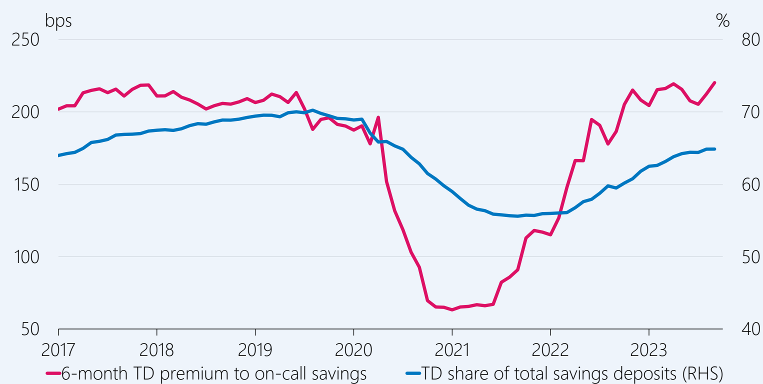


Source: RBNZ *Liquidity survey.*

Note: Figure shows the proportion of non-market funding (largely deposits) which is assumed to be withdrawn during the 1-month stress scenario, using the parameters set out in the Reserve Bank's liquidity policy (BS13).

Figure C.3

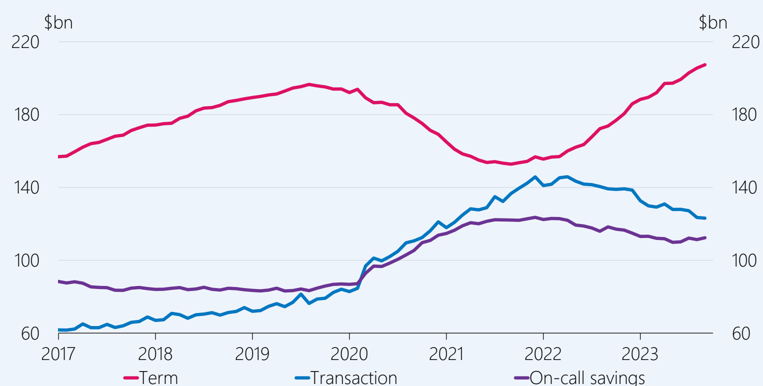
Interest rate premium on term deposits and term deposit share



Source: RBNZ *Bank Balance Sheet survey, Income Statement survey,* RBNZ estimates.

Figure C.4

Bank deposits by type

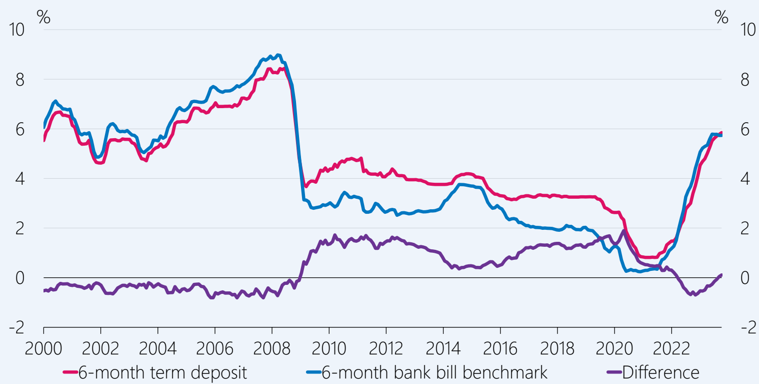


Source: RBNZ *Bank Balance Sheet survey.*

38 https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2023/may-2023/fsr-may-23-special-topic-3

Figure C.5

6-month term deposit and wholesale interest rates



Source: Reuters, interest.co.nz.

Over time, as demand for deposit funding increases, banks are likely to compete more aggressively for deposits, resulting in higher overall funding costs. This could see NIMs decline closer to their long-term averages and could put downward pressure on bank profits, depending on the future path of lending rates.