

Financial Stability Report.

May 2025



Purpose of the Financial Stability Report

The *Financial Stability Report* outlines our assessment of the state of, and risks to, New Zealand's financial stability. The *Report* is one of our key publications, and aims to raise public awareness of developments in the financial system. It is published pursuant to section 170 of the Reserve Bank of New Zealand Act 2021, which states that the *Report* must:

- report on risks and matters relating to the stability of New Zealand's financial system, and other matters associated with the Reserve Bank's prudential objective; and
- contain the information that is necessary or desirable to allow an assessment to be made of the effectiveness of the Bank's use of its powers to protect and promote the stability of New Zealand's financial system, and achieve the prudential objective.

Financial Stability Objective

Our prudential objective is to protect and promote the stability of New Zealand's financial system. A stable financial system is one where resilient financial markets, institutions and infrastructures enable a productive and sustainable economy, and ultimately prosperity and well-being for New Zealanders. By resilient, we mean the ability to anticipate, prepare, absorb, recover and learn from severe but plausible shocks and imbalances.

By protecting and promoting financial stability, we are committed to ensuring that all New Zealanders can safely save, make everyday transactions, access credit, invest, insure against risks and plan for the future. In doing this, we take into account competition, efficiency and proportionality, which enable the financial system to deliver choice and value for money for New Zealanders. This also supports an inclusive financial system that is accessible to people from all walks of life.

Our Analysis and Strategy

The *Report* outlines our assessment of the state, resilience, and vulnerability of the financial system and its component parts. We assess how global and domestic developments are affecting the financial health of New Zealand's households and businesses, and the performance and resilience of our financial institutions. We also highlight longer-term risks and issues that may affect financial stability.

This analysis feeds into setting our strategy and priorities for pursuing our financial stability objectives. These priorities, and progress towards achieving them, are also outlined in the *Report*, including actions to strengthen the regulatory framework, the use of our macroprudential policy tools to mitigate the build-up of systemic risk, work to enhance the resilience and risk management of regulated entities, and our enforcement activities.

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Contents

Summary	2
1. Financial stability risk and policy assessment	4
Box A: The Depositor Compensation Scheme (DCS)	13
2. Special topics	14
2.1 Borrowing beyond borders: Risks from New Zealand's reliance on overseas debt	16
2.2 Rise of the machines: How could artificial intelligence impact financial stability?	22
Box B: Increased tariffs raise financial stability risks	29
3. Regulatory developments	33
Box C: The review of key capital settings	39
4. Institutional resilience	42

Summary.

The *Financial Stability Report* outlines our assessment of risks to financial stability. Financial stability is critical to the economy, ensuring that New Zealanders can safely save, borrow, and manage financial risk.

Financial stability risks have increased over the past six months on the back of global economic uncertainty. The financial system is well placed to support households and businesses. While lower interest rates are reducing debt-servicing costs and easing financial stress for borrowers domestically, risks to global economic growth have increased sharply. The banking sector has significant buffers to continue to provide credit to the economy even if conditions worsen further.

The US imposed sweeping tariffs on goods imports from New Zealand and our major trading partners. Trade tensions between the US and other countries have increased. This has caused heightened financial market volatility and could lead to a slowdown in global economic activity. In response, financial markets have priced in more monetary policy easing this year. Global equity prices have declined and corporate funding spreads, both domestically and offshore, have widened from low levels. Long-term yields on US government bonds were volatile.

Trade restrictions are a key risk to New Zealand's financial stability. The impact of tariffs on our trading partners is expected to lower demand for our exports. Some agricultural industries that have limited scope to divert products from the US to alternative markets are more vulnerable to US tariffs (see [Box B](#)). Banks are well placed to handle temporary dislocations in overseas funding markets. Our bank solvency stress test will assess the resilience of the banking sector to worsening geopolitical instability.

Domestic economic activity has been subdued. Weak domestic demand reflects previously high interest rates, a weak labour market, and heightened global uncertainty. However, economic growth is expected to increase this year as lower borrowing costs and high agricultural export prices support demand.

The housing market has remained soft. A large volume of unsold properties and weak net migration are expected to continue to restrain house price and rent increases in the near term. Residential building activity remains constrained by low demand.

Despite lower interest rates, household and business credit demand remains soft. Household demand has been weak due to rising unemployment and the subdued housing market. Business credit demand for investment also remains weak, although many businesses have needed working capital to manage cashflow pressures in challenging economic conditions. Soft credit demand has reduced the need for banks to raise funding in wholesale markets (see [Special Topic 1](#)).

Household borrowers have been resilient to high debt-servicing costs. Non-performing loans are around the peak and may decline in the coming months, as debt-servicing costs start to fall, easing financial stress on borrowers.

Banks have increased their financial buffers to manage losses. Profitability remains robust and bank capital ratios have continued to increase. We recently announced that we are reviewing the calibration of bank capital requirements alongside the standardised risk weights (see [Chapter 3](#)).

Upward pressure on general insurance premiums has moderated, whereas growth in health insurance premiums has increased. General insurers have had lower claims in the past year and replacement costs have moderated. They are continuing to implement risk-based pricing more widely. Conditions in global reinsurance markets have also been more favourable.

Our 2024 General Insurance Industry Stress Test found that insurers could pay all claims from a very severe seismic shock, reflecting improvements in resilience since the Canterbury earthquakes. The test noted the significant challenges of such events, including reliance on global reinsurance and the need for capital injections by insurers' parents to maintain a functioning insurance market. The test also highlighted the importance of ongoing vigilance and preparedness across the public and private sectors, including ongoing testing of recovery planning by insurers and regulators and the need to maintain sufficient Crown fiscal buffers to manage such shocks.

Banks and insurance companies are exploring the use of artificial intelligence (AI) in their operations. AI can be beneficial for financial system efficiency but can also amplify risks to financial stability (see Special Topic 2).

Our cyber reporting requirements help us to monitor operational resilience and systemic risk in the financial system. The Reserve Bank is committed to working with the Council of Financial Regulators, the industry, and our Trans-Tasman counterparts to monitor, respond to, and share intelligence around cyber threats.

The Depositor Compensation Scheme will come into effect on 1 July 2025. This is New Zealand's version of deposit insurance and will protect depositors' funds in the case of a deposit taker failure. It is expected to enhance financial stability and support competition (see Box A).

Chapter

01

Financial stability risk and policy assessment





Chapter 1.

Financial stability risk and policy assessment

Financial stability risks increased as the US imposed sweeping tariffs on imports from New Zealand and other countries. In this chapter, we summarise global and domestic economic developments, noting the elevated uncertainty in the global economic environment. Recent interest rate cuts are reducing the debt-servicing burden of borrowers domestically, but this does not offset the risk from increased trade restrictions on financial stability. We explain why banks remain well-placed to deal with potential losses from the escalation in trade restrictions. Finally, we provide an update on our recent policy workstreams promoting financial stability.

The US imposed sweeping tariffs on imports from New Zealand and our trading partners

The US has imposed a 10 percent tariff on goods imports from most countries. Additional US tariffs may be introduced, depending on the outcome of ongoing trade negotiations between the US and other countries. Since January 2025, the tariff increase enacted on China has been substantially higher than on

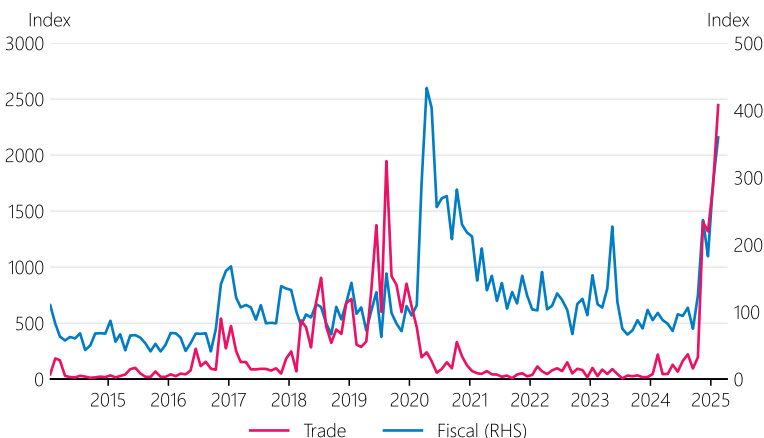
other countries. In response, China and some other countries have implemented retaliatory tariffs on US goods.

As a small open economy, trade restrictions and geopolitical tensions represent a downside risk to New Zealand economic activity.¹ The combination of a global tariff by the US and a high tariff rate targeting China, our largest trading partner, means that these downside risks have increased since the start of the year.

Figure 1.1

US trade policy and fiscal policy uncertainty indices

(Index = 100 in October 1985)



Source: Haver Analytics.

Trade tensions have lowered the global growth outlook and contributed to financial market volatility

The new US administration signalled other policies that are likely to impact the US economy and create significant spillovers elsewhere. The US has announced cuts in government spending, an increase in deportations of immigrants and proposed tax cuts. These policy announcements and frequent reversals in tariff policy have contributed to higher uncertainty around US economic policy since the start of 2025 (figure 1.1).

1 See Box A *Impacts of geopolitical risk on financial stability*, November 2024 *Financial Stability Report* <https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2024/nov-2024/impacts-of-geopolitical-risk-on-financial-stability>.

Trade restrictions have led to higher financial market volatility, and are likely to lead to a slowdown in major economies. Long-term yields on US government bonds rose following the tariff announcements, as investor demand fell for an asset traditionally considered to be low risk. Equity prices fell sharply globally as trade tensions undermined investor confidence (figure 1.2).

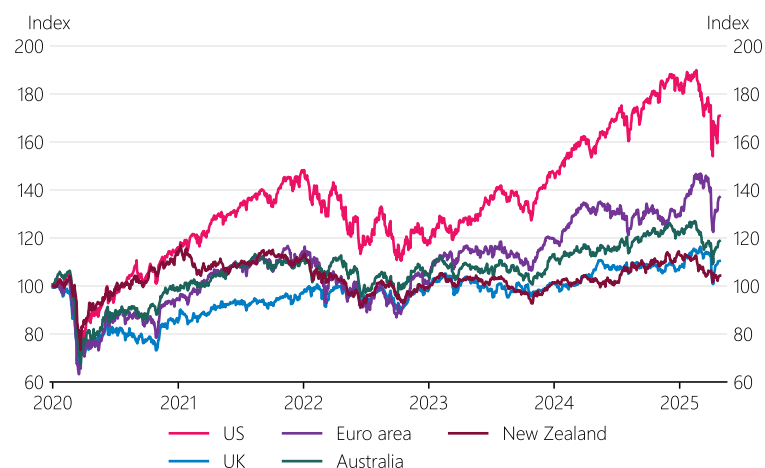
Markets have also focussed on the fiscal outlook in the US and some other advanced economies, given large deficits and rising government debt levels. New Zealand's government debt position is better than many other advanced economies, helping to support investor sentiment (figure 2.4 in Special Topic 1).

Central banks across advanced economies have been easing monetary policy since the second half of last year, and further easing is expected this year. Recent US trade announcements have contributed to lower policy rate expectations, as financial market participants anticipate that lower economic activity will prompt further monetary policy easing. The extent of this varies across economies, with some needing to weigh further easing against the risk of near-term inflation remaining above target.

Increased tariffs pose significant risks to financial stability in New Zealand

The direct impact of US tariffs on New Zealand exports could be severe for industries heavily exposed to US demand, although they are only a small part of the overall economy. Our largest exports to the US are meat, dairy products, and wine. US tariffs are also expected to have indirect impacts on New Zealand, by targeting our key trading partners and reducing their growth. These indirect impacts of tariffs on our trading partners may carry greater risk to financial stability than direct impacts (see [Box B](#)).

Figure 1.2
Global equity prices
(index = 100 on 31 January 2020)



Source: Bloomberg, RBNZ calculations.

Geopolitical shocks highlight the importance of a resilient financial system

Prudential requirements such as the minimum capital and core funding ratio requirements ensure that banks can withstand most geopolitical shocks. However, our biggest concern is low-probability scenarios with large impacts, because their effects on the financial system may be difficult to mitigate.

There remains significant uncertainty in the outlook for global trade. Our annual stress test for 2025 will test the resilience of banks to severe disruption to global trade. We have published the scenarios for the exercise. The scenarios assume an escalation of protectionist and retaliatory policy measures that disrupt international trade, technology transfer, financial flows and cross-border movement of people.

Domestic economic activity has been subdued

Domestic demand has been subdued over the past 6 months. Household consumption has been dampened by high interest rates, a weak labour market, a soft housing market and a slowdown in net migration flows. Heightened uncertainty around international trade and high debt-servicing costs contributed to weakness in business investment.

Business credit demand for capital investment remains weak, especially in sectors reliant on discretionary spending. Profitability for many businesses has declined due to both lower sales and higher costs for energy, materials and debt servicing. Small and medium-sized businesses have continued to run down cash buffers as they manage cashflow pressures. In contrast to low credit demand for investment, borrowing for working capital remains high for many businesses. This is particularly the case in sectors more exposed to weak consumer spending, for example the retail, tourism, and food and beverage sectors.

However, economic growth is expected to increase this year as lower interest rates and stronger agricultural export prices support demand.

The housing market remains soft but demand could increase due to lower interest rates

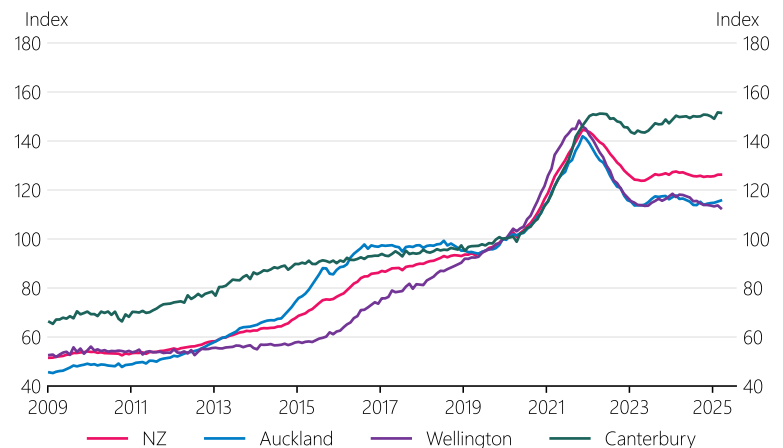
National house prices have been largely unchanged over the past year, remaining around 13 percent below their peak in November 2021 (figure 1.3). House prices remain around the top of our range of sustainable house price estimates. Sales volumes have increased as mortgage rates have declined. A large volume of unsold properties and weak net migration are expected to restrain house price and rent increases in the near term.

Investor activity in the housing market has increased over the past year (figure 1.4).

This has been supported by lower interest rates and government policy changes. Policy changes, such as the reintroduction of interest deductibility and reverting the brightline test period from 10 years to 2 years, have increased returns for housing investors.

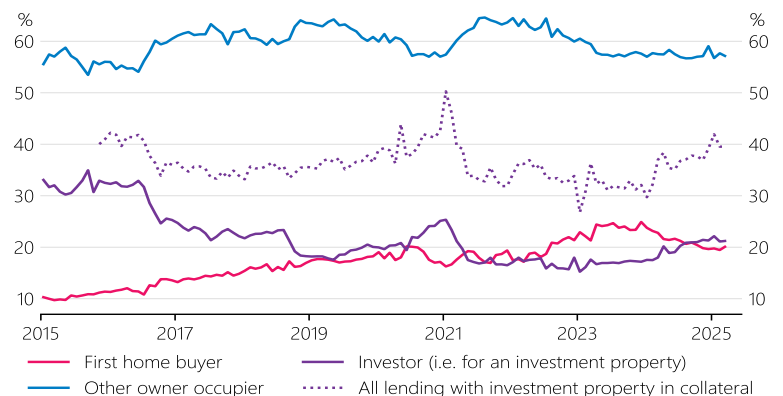
Debt-to-income (DTI) restrictions that we introduced in July 2024 are currently minimally binding, as high-risk lending remains low given subdued housing market activity. DTI restrictions will act as a guardrail against a potential resurgence in risky credit as interest rates decline and housing demand picks up.

Figure 1.3
Regional house price indices
(index = 100 in December 2019)



Source: REINZ, RBNZ estimates.

Figure 1.4
Share of new commitments by
borrower type and collateral



Source: RBNZ LVR New Commitments survey.

Residential building activity remains weak. Borrowing by property developers for residential construction remains largely constrained by low presales and weak housing demand. Banks have reported they are easing presale requirements for some property developers to support lending. Discussions with businesses highlighted that non-bank lenders, including international investment funds, are also contributing to financing new developments.

Conditions in the commercial property sector have improved as interest rates have fallen

Lower interest rates have made it easier for commercial property owners to service loans, which has eased financial constraints. However, conditions remain challenging for some parts of the sector, particularly lower-grade office properties and parts of the retail and hotel sectors. Banks have reported that they are now more willing to increase lending to commercial property owners. Loan covenants relating to interest coverage ratios are being reset to similar levels as before the recent high-interest rate period, as debt-servicing costs decline.

High export prices have supported cashflow in the dairy sector

Rising global commodity prices have improved conditions in many parts of the agriculture sector. Dairy sector conditions have improved over the past 6 months as international prices rose to elevated levels. Dairy farmers supplying Fonterra may also benefit from a one-off payment from the cooperative's sale of its global consumer business, although the timing and size of the payment are uncertain. Lower farm-cost inflation has also eased cashflow pressures. Improved cashflow will allow dairy farmers to continue to reduce debt and increase their resilience to future downturns.

Agriculture conditions outside of the dairy sector are generally improving. Global beef prices also rose in 2024 and most analysts expect beef prices to remain elevated in 2025 as supply constraints persist. The sheep meat sector continues to be affected by low prices. Forestry prices have remained low because of weak construction activity in the Chinese property sector. A lower global growth outlook poses a key risk to profitability and credit risk in the agriculture sector.

Household and business demand for credit remains weak despite lower interest rates

Mortgage rates have continued to decline following reductions in the OCR. The 1-year and 2-year mortgage rates have fallen to around 5 percent. Many borrowers rolling off fixed rates are moving onto floating rates or shorter-term fixed rates. These borrowers are waiting for further OCR cuts before re-fixing for longer terms. The effective (weighted average) mortgage rate across all borrowers remains close to its peak. We expect around 60 percent of mortgage lending to reprice to lower rates within the next 6 months, and around 80 percent within a year.

Demand for household and business lending remains soft. While mortgage lending has picked up over the past 6 months, it remains below its peak before the housing market slowdown. Household credit demand has been dampened by higher unemployment and economic uncertainty. A high proportion of recent mortgage demand has been from borrowers shifting loan providers as households seek to benefit from falling interest rates. Banks have lowered test rates for loan affordability assessments in their recent reviews as interest rates have declined.

Non-performing loans have increased, but borrowers have been mostly resilient to high debt-servicing costs

Arrears and non-performing loan rates on household lending have increased (figure 1.5). Unemployment is the main economic factor contributing to borrower financial stress. However, most households remain resilient to high debt-servicing costs. Banks expect mortgage non-performing loans to stabilise in coming months as debt-servicing costs start to decline (figure 1.6), easing stress on borrowers.

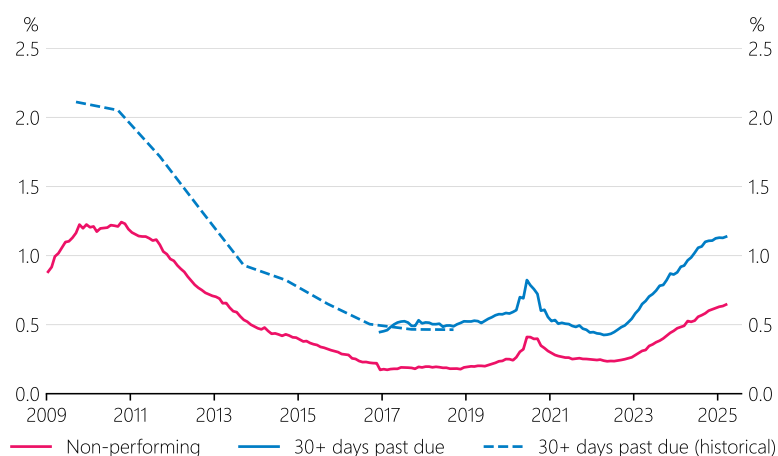
Financial stress has varied across business sectors (figure 1.7). Non-performing loans in sectors exposed to weak domestic economic activity have increased over the past 6 months, but remain below the levels seen following the Global Financial Crisis. On the other hand, non-performing loans have declined in the commercial property sector as debt-servicing costs have declined. Stresses in the agriculture sector have also fallen overall as higher commodity prices and moderation in farm cost inflation have eased cashflow pressures.

Banks are well prepared to manage potential losses

Banks have increased their financial buffers for absorbing potential losses. Banks increased provisioning for loan losses in early 2024 as economic activity slowed and credit risk increased. Bank capital ratios have risen, and are well above current minimum requirements (figure 1.8). The banking sector has progressed significantly towards meeting increased capital requirements under the 2019 Capital Review, which are being phased in. This puts them in a position to continue to supply credit to households and businesses even if economic conditions worsen and losses increase.

Weak economic conditions have reduced demand for credit, which incentivises banks to compete more intensely for creditworthy borrowers by cutting lending margins and easing some lending policy requirements.

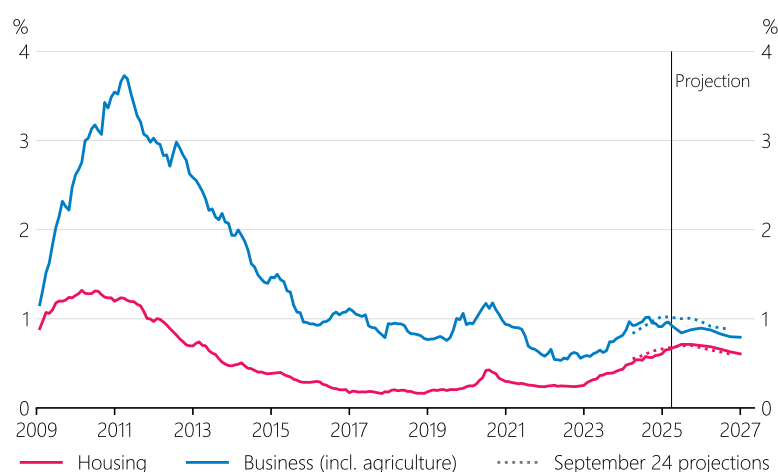
Figure 1.5
Non-performing and past-due mortgage lending



Source: RBNZ Bank Balance Sheet survey, private reporting, registered banks' Disclosure Statements.

Note: Non-performing loans are defined as those that are 90 or more days in arrears or impaired.

Figure 1.6
Banks' projections for non-performing loans by sector (share of lending by value in each sector)



Source: RBNZ estimates.

Note: The non-performing loan ratios are for the five largest banks (ANZ, ASB, BNZ, Kiwibank and Westpac). However, the ratio for businesses prior to 2016 is for the banking sector as a whole. The projections are weighted averages (based on lending amounts) of the five largest banks' projections for their own lending. These are based on the economic outlook from our February 2025 Monetary Policy Statement.

Bank analysts noted that the largest cuts to margins have been for business and agricultural lending. Despite competitive pressure, net interest margins have remained above average. Banks' return on assets has been broadly stable, whereas their return on equity has declined as their capital ratios have increased and leverage has declined, as expected.

Funding conditions remain supportive for banks

Bank deposits are continuing to grow faster than lending. As a result, banks have needed less funding from wholesale markets. Funding conditions in wholesale markets have remained supportive for New Zealand banks. Banks' core funding ratios remain well above the minimum requirement, ensuring they are well positioned to adjust to any deterioration in funding market conditions (see [Special Topic 1](#)).

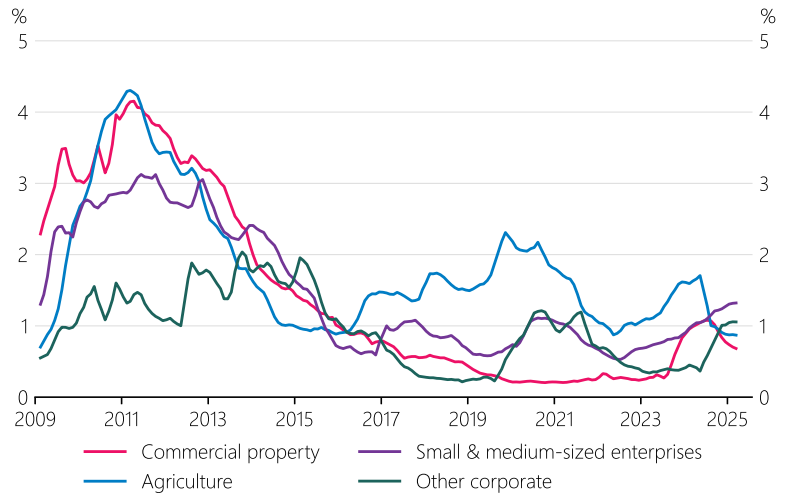
Switching by depositors from transaction and on-call savings accounts to term deposits has slowed as interest rates have declined. Households have continued to switch from transaction accounts into term deposits, whereas switching by businesses has moderated (figure 1.9).

Bank mismatch ratios, a measure of their liquidity positions, are well above minimum requirements, meaning they have plenty of liquid assets to weather potential liquidity stress. However, the types of liquid assets banks hold have changed over the past year. Settlement cash balances have declined as we unwound the Large Scale Asset Purchases and the Funding for Lending Programme. To make up for this and maintain their levels of liquid asset, banks have increased their holdings of government bonds.

Upward pressure on general insurance premiums has moderated while growth in health insurance premiums has increased

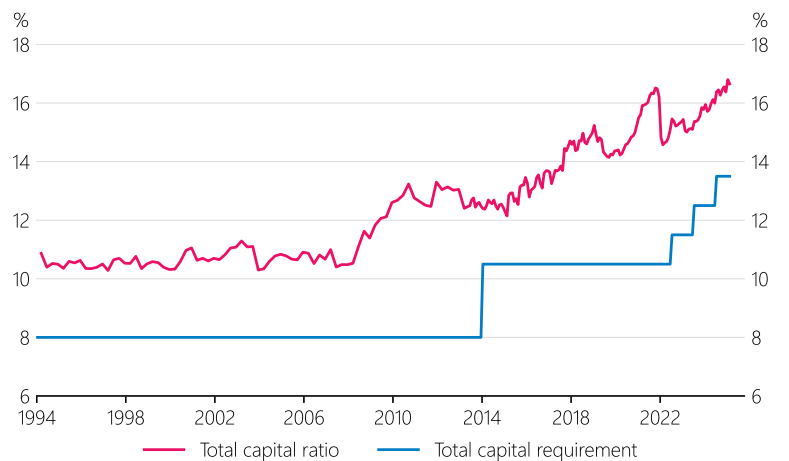
In our November 2024 *Financial Stability Report* we noted the ongoing large increases in general insurance premiums. Upward pressure on premiums has eased over the past six months. General insurers have had lower claims during the past year. Replacement costs for claims have also moderated as construction sector pressures have eased and increases in motor vehicle costs have slowed. Treasury recently consulted stakeholders on increasing the Natural Hazards Insurance levy (previously the Earthquake Commission levy).

Figure 1.7
Business non-performing loan ratios



Source: RBNZ Bank Balance Sheet survey.

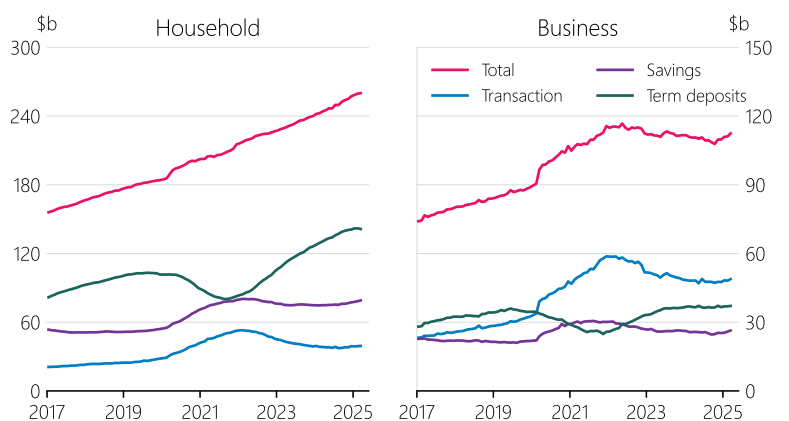
Figure 1.8
Total capital ratio for the banking sector
(share of risk-weighted assets)



Source: RBNZ Capital Adequacy survey.

Note: Total capital requirement is shown for domestic-systemically important banks, and includes the capital conservation buffer. Total capital ratio is the weighted average across the banking sector.

Figure 1.9
Business and household deposits



Source: RBNZ Bank Balance Sheet survey.

Growth in health insurance premiums is increasing. Health insurance claims costs have risen significantly due to high inflation in medical costs.

Reinsurers have had fewer unexpected large claims events during the past year. Declines in interest rates have also encouraged investment flows into reinsurance. Both factors have moderated upward pressure on domestic insurance premiums. Insurance companies continue to implement risk-based pricing more widely to hazards such as flooding and coastal inundation, as availability of granular data and risk modelling improve.

Insurance stress test highlights the challenges of very severe seismic events

We recently published a general insurance stress test.² The stress test assessed the resilience of insurers to a very severe seismic event and cyber-related risks. The results showed insurers would be able to pay all claims despite the severity of the earthquake and its aftershocks. The high proportion of claims paid out suggests that policy changes since the 2010/11 Christchurch earthquakes have added to the resilience of the system.

The severity of the test meant substantial mitigating actions were required to return insurers to required solvency positions so they could continue writing new business. These included capital injections from parents, repricing, adjustments to reinsurance programmes, and some cost savings. The importance of ongoing access to global reinsurance was also highlighted as critical for the ongoing function of the New Zealand insurance market.

The stress test highlighted the significant impacts of a severe seismic event beyond the insurance industry. They include impacts on the Crown balance sheet from funding the Natural Hazards Commission to meet claims on insured losses, and funding recovery costs for damage to uninsured property, including public assets. Being able to manage these shocks is a key consideration in the Government's overall fiscal strategy, which the Treasury is currently consulting on.

Insurers were resilient to claims expense arising from large cyber events in the cyber stress scenarios, though these could have a significant impact on profitability. A number of recommendations were made to support insurers' management of cyber risk.

Work on implementing the Deposit Takers Act 2023 is progressing

Significant progress has been made on policy work to implement the Deposit Takers Act 2023 (DTA), the regulatory framework that will apply to all deposit takers from 2028. Bringing banks and non-bank deposit takers (NBDTs) into a single regulatory framework will be a major change to the New Zealand financial system.

In May 2025, we published the outcome of the consultation on the core standards. We will use these standards to license existing banks and NBDTs under the new regime. The outcome of the consultation on the remaining standards will be published in July. We will consult on the exposure drafts of the standards later in 2025 and 2026, ahead of issuing the standards in 2027.

We will be reassessing key settings for bank capital requirements

We recently announced that we are reviewing the calibration of bank capital requirements (see **Box C**). The review will consider the most effective way for prudential capital requirements to support the resilience of the financial system. It will build on work currently underway to consider more granular risk weights for residential mortgages and corporate (including rural) lending, community housing and whenua Māori lending. We intend to engage with independent international experts to support this process.

² See <https://www.rbnz.govt.nz/hub/publications/bulletin/2025/2024-general-insurance-industry-stress-test-results>.

Cyber risk is another key focus of our work

We received the first round of Cyber Periodic Incident Reporting from large entities in April. Our cyber reporting requirements help us to monitor operational resilience and systemic risk in the financial system. We are also continuing to collaborate with other domestic and Australian agencies in monitoring heightened cyber risks to the financial system.³

Several strands of our policy work will help promote competition and efficiency in the financial system

Competition and efficiency are important considerations we take into account when formulating policy to achieve our financial stability objective. Having a stable and trusted financial system is necessary to provide financial services efficiently to households and businesses.⁴

Several strands of our policy work that are underway will help promote competition in the financial system (see **Chapter 3**). The implementation of the DTA includes a proportionality framework, which influences our regulatory approach for different-sized deposit takers. We are considering broadening the use of the term 'bank' to more deposit takers. This would support competitive neutrality by removing any public confusion that NBDTs are regulated and supervised in a significantly different manner to other deposit takers. Other relevant workstreams include our review of access policy for the exchange settlement account system, and investigation into digital cash implementation. We are also working through the recommendations of the Commerce Commission's market study into personal banking services.

The Depositor Compensation Scheme (DCS) will commence on 1 July 2025. This scheme will protect depositors in case of a deposit taker failure. A robust DCS enhances financial stability by reducing contagion risk in case of a single entity failure. It is also expected to support competition in the deposit-taking sector (see **Box A**).

3 See Box A *Technology Risks and Cyber Resilience* in the May 2024 *Financial Stability Report* <https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2024/may-2024/financial-stability-report-may-2024>.

4 For a discussion of the relationship between financial stability and financial system efficiency and competitiveness, see Hawkesby, C. (2024) "Resilience as a pathway to prosperity", Speech to the Financial Services Council Conference, <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/speeches/2024/resilience-as-a-pathway-to-prosperity---speech-by-christian-hawkesby.pdf>.

Box A

The Depositor Compensation Scheme (DCS)

The Depositor Compensation Scheme (DCS) comes into effect on 1 July 2025. It is administered by the Reserve Bank on behalf of the Crown. The DCS is New Zealand's mechanism to protect depositors' funds in the case of a deposit taker failure. Deposit takers are banks and non-bank deposit takers (building societies, credit unions, and finance companies) that are licensed by the Reserve Bank and take retail deposits.

The DCS is being established, in part, based on recommendations from the International Monetary Fund. Introducing the DCS will bring New Zealand into alignment with international peers.

The DCS will improve depositor confidence by guaranteeing protected deposits. If depositors know they will be reimbursed in the case of failure, the risk of a run on deposit takers is lowered. A robust DCS reduces contagion risk – the failure of one deposit taker is less likely to spread to others, thus reducing the risk of a broader systemic crisis.

The introduction of the DCS will support competition, as eligible depositors' funds are equally protected irrespective of their deposit taker.

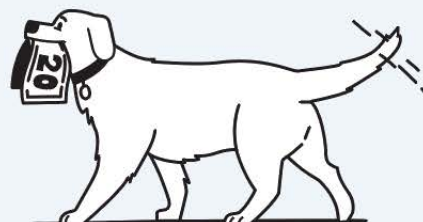
The DCS covers each eligible depositor up to \$100,000 per deposit taker in the event of a failure, when money is held in DCS-protected accounts. Deposits covered by the DCS include transaction, savings, notice, and term deposit accounts. Products such as managed investment funds (e.g. KiwiSaver) and tradable investments (e.g. bonds) are not covered.

From 1 July 2025, all protected deposits will be covered under the DCS. The Reserve Bank will be capable of administering a DCS payment in the unlikely event of a deposit taker failure.

There will be additional requirements on deposit takers by 2028 that will give the Reserve Bank the ability to manage DCS payments more efficiently. The DCS will continue to improve its capability over this period.

To finance the DCS, levies will be collected from deposit takers, and these are assessed on a risk-based, proportional basis. There is no direct cost to depositors. In the case of insufficient funds to cover DCS payments in a failure, the Crown will provide a backstop that is repaid by the DCS. The DCS can also be used alongside or in place of resolution tools if the circumstances call for it.

Find out more about the DCS at <https://www.rbnz.govt.nz/dcs>.

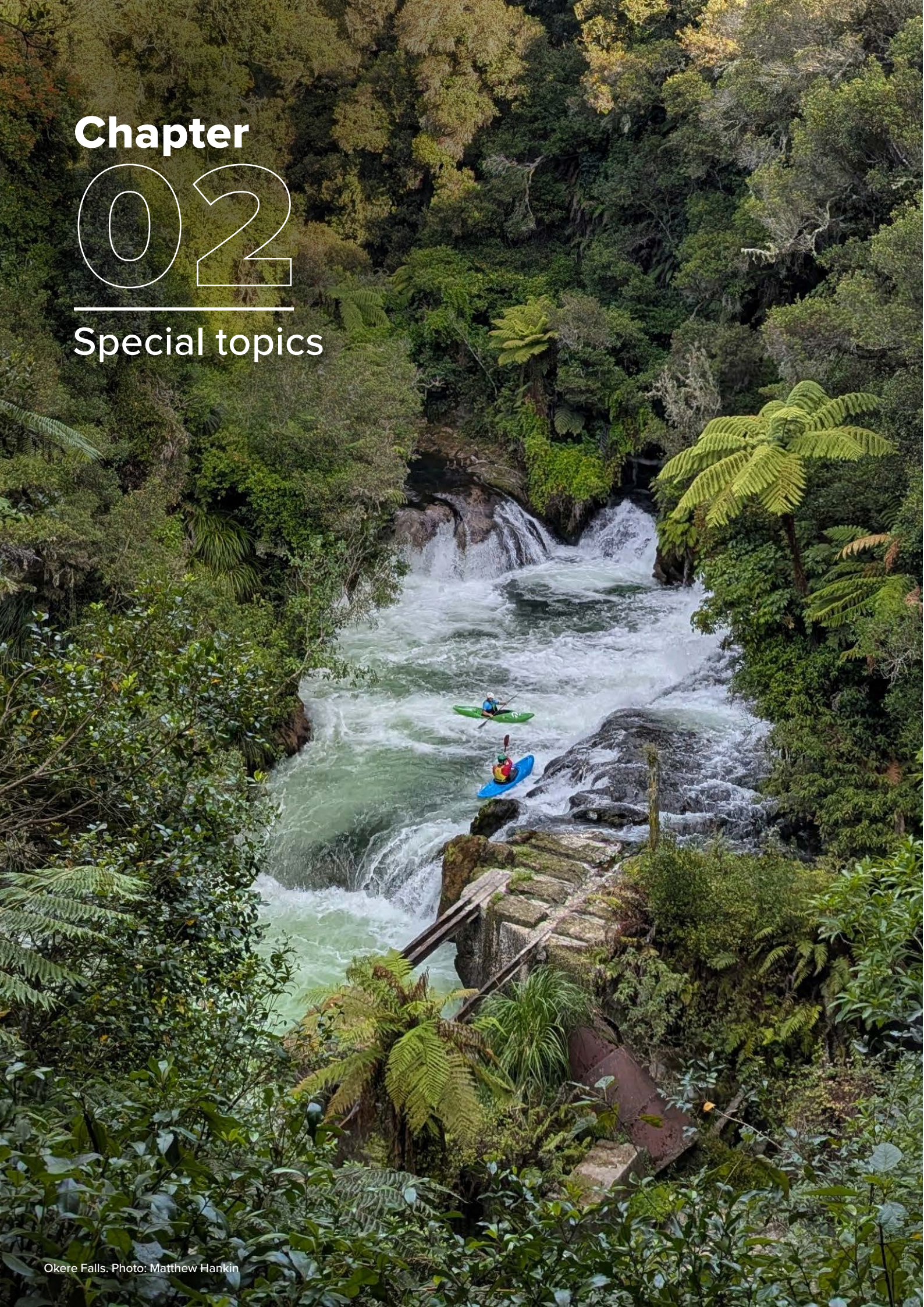


**Depositor
Compensation
Scheme**

Chapter

02

Special topics



Chapter 2.

Special topics

This chapter covers topical issues relevant to financial stability in New Zealand.

In this *Report*, we cover the following:

1. Borrowing beyond borders: Risks from New Zealand's reliance on overseas debt
2. Rise of the machines: How could artificial intelligence impact financial stability?

Selected special topics and boxes from the past 12 months

Topic	Publication
Exploring vulnerabilities through reverse stress testing	November 2024 <i>Report</i> (Chapter 2.1)
Update on the housing market	November 2024 <i>Report</i> (Chapter 2.2)
Developments in financing channels outside the prudentially regulated sector	November 2024 <i>Report</i> (Chapter 2.3)
Commercial property in New Zealand	August 2024 <i>Report</i> Special topic
Update on the financial strain faced by households and businesses	May 2024 <i>Report</i> (Chapter 2.1)
Insurance availability and risk-based pricing	May 2024 <i>Report</i> (Chapter 2.2)
Technology risks and cyber resilience	May 2024 <i>Report</i> (Box A)



Borrowing beyond borders: Risks from New Zealand's reliance on overseas debt

Key points

- The New Zealand economy is reliant on significant levels of overseas debt. This debt results from decades of current account deficits. Current account deficits have the benefit of allowing us to invest more than we save. However, persistent deficits may present risks to financial stability.
- Rising geopolitical tensions are increasing the risk of disruptions in international funding markets. In particular, the threat of new US tariffs is contributing to global uncertainty. At the same time, the current account deficit is elevated compared to historic levels.
- The key risks to external funding are events that affect foreign investor confidence. A drop in investor confidence can increase borrowing costs, depreciate the New Zealand dollar, create difficulties in rolling over existing debt, and cause painful adjustments in the economy.
- New Zealand banks are well prepared to respond to external funding pressures. New Zealand's net foreign liabilities have declined. Regulatory measures and longer loan maturities have reduced overall financial sector vulnerability. Therefore, reliance on overseas debt is less risky than it was during the Global Financial Crisis (GFC).

Key definitions

- The **current account** is made up of a country's trade balance with the rest of the world, its net income balance and its net transfers.
- A country's **trade balance** is the difference between the value of its exports of goods and services and its imports. A positive (negative) trade balance means we are exporting more (less) than we import.
- **Net income balance** refers to the difference between the income a country receives from its foreign investments (in the form of dividends, interest, and profits) and the income it pays to foreign investors.
- **Net transfers** are the difference between the inflows and outflows of money for a country, for which no goods and services are provided. Examples of these transfers include remittances, donations and foreign aid.
- **Net foreign liabilities** refer to the difference between a country's total foreign debt (liabilities) and its total foreign assets.

New Zealand is a ‘net borrower’ because investment has consistently exceeded savings

For the past 50 years, domestic investment spending has exceeded savings, with overseas investors financing the difference. Consequently, the current account has been in a deficit (figure 2.1). This special topic focuses on New Zealand’s external debt funding. In contrast, external equity funding presents less risk to domestic businesses.

Our trade balance has been positive for most of the last 40 years, however the negative net income balance more than offsets this. This has caused a persistent current account deficit. A negative net income balance means that New Zealanders pay more in interest and dividends to foreign investors than they receive from their own investments abroad. Some of these earnings from overseas investments are reinvested into the New Zealand economy. This reinvestment can partially fund the current account deficit and assist in keeping the current account deficit sustainable over time.

The current account deficit has widened since the pandemic

A large deficit means New Zealand has needed additional overseas funding, making the country more vulnerable to global risks. At 6.2 percent of GDP currently, the current account deficit is much higher than the 4 percent average since 2000. The pandemic led to fewer tourists and a larger goods deficit, decreasing the trade balance significantly. This decrease in the trade balance was the main contributor to the widening of the current account deficit (figure 2.1).

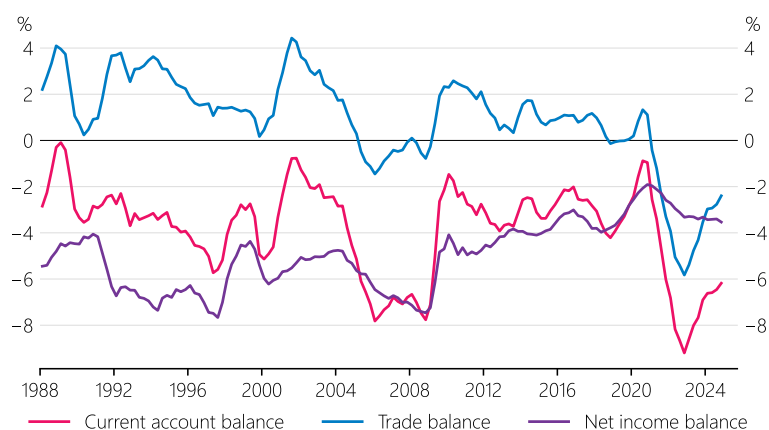
New Zealand’s net foreign liabilities are large relative to peers

Persistent current account deficits have led to an accumulation of net foreign liabilities. This means we owe more to the world than we own in overseas assets. As a percentage of GDP, New Zealand’s net foreign liabilities are higher than in most other advanced economies (figure 2.2), highlighting our reliance on overseas funding.

Figure 2.1

Current account balance

(share of GDP)

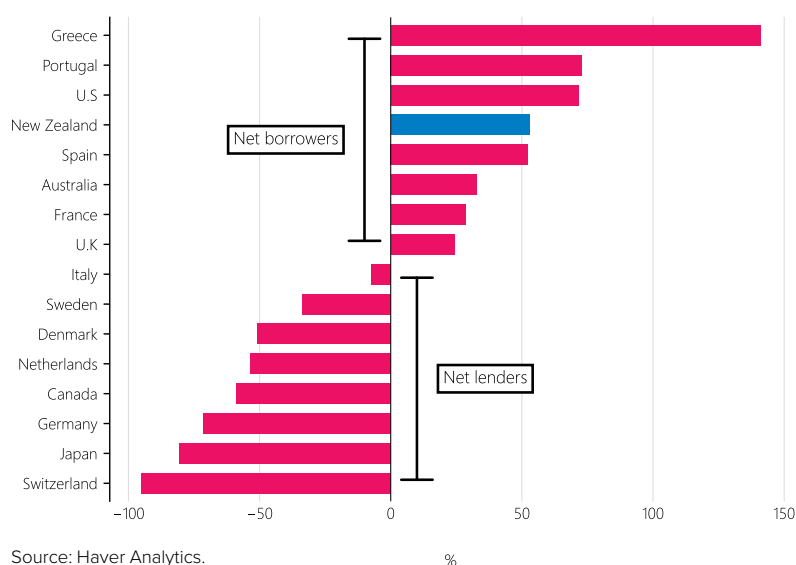


Source: Stats NZ.

Figure 2.2

Net foreign liabilities of OECD countries

(Share of nominal GDP, 2023)



Source: Haver Analytics.

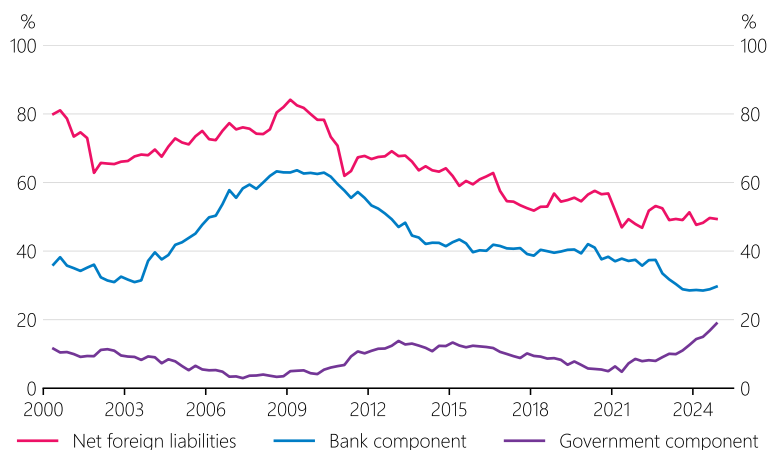
However, New Zealand's net foreign liability position has reduced since 2010

Our net foreign liabilities have steadily reduced relative to GDP since 2010 (figure 2.3). Two factors explain this decline despite continued current account deficits:⁵

- Nominal GDP growth has helped offset growth in net foreign liabilities.
- New Zealand has tended to earn a better return on offshore investments, including valuation effects that are not captured in the current account, than it has paid on foreign investments.⁶

Despite net foreign liabilities declining, they remain elevated compared to most other OECD countries. The government and banks are the two main borrowers from overseas. For several decades, the banks' share of net foreign liabilities has exceeded that of the government. However, the share attributed to the government component has grown in recent years (figure 2.3). This was largely caused by fiscal stimulus during the pandemic.

Figure 2.3
Net foreign liabilities
(share of nominal GDP)



Source: Stats NZ.

Risks to financial stability from our reliance on overseas debt

Availability of external funding presents advantages for New Zealand

There are several benefits from borrowing from abroad and running a current account deficit. By borrowing overseas, New Zealand can spend more than its domestic income and savings would normally allow. Overseas savings can be used to fund domestic investment, which can boost future economic growth without sacrificing consumption today. External funding can also help smooth the impact of large one-off shocks on the New Zealand economy, for example natural disasters.

A country could run a current account deficit indefinitely if nominal GDP grows faster than its external debt. This ensures that the economy can generate enough income to service the debt. However, a large deficit for a sustained period can expose New Zealand to increased financial stability risks.

But increased caution in global markets can tighten funding conditions for New Zealand

As a small open economy reliant on offshore funding, New Zealand is perceived by global investors as riskier than many other advanced economies. Economic uncertainty, geopolitical issues, or financial instability may lead to concerns about the sustainability of our current account deficit. If overseas investors perceive the deficit as unsustainable, they may demand higher risk premiums to compensate for increased risk.

A rise in risk premiums would, all else being equal, depreciate the New Zealand dollar and increase yields on New Zealand assets. This would increase the funding costs for banks and the government. During periods of severe financial stress, overseas investors might withdraw funding, further tightening financial conditions. Businesses and households may find it harder to access credit as banks tighten lending in response to higher funding costs.

⁵ See figure 7 in this article by the Treasury for more detailed insights on how New Zealand's net foreign liability position has improved over time, available at <https://www.treasury.govt.nz/publications/research-and-commentary/rangitaki-blog/feu-special-topic-current-account-and-new-zealands-external-balances>.

⁶ Australia has experienced a similar trajectory in net foreign liabilities. See <https://www.rba.gov.au/speeches/2023/sp-so-2023-10-18.html>.

A weaker New Zealand dollar could be challenging for industries that rely on imports, and raise the cost of living. On the other hand, a weaker currency would make New Zealand exports cheaper for foreign buyers, boosting exports. This improves the trade balance and supports domestic economic activity, offsetting some of the costs of a global market disruption.

Geopolitical shocks like Russia's invasion of Ukraine in February 2022 can lead to temporarily heightened levels of investor caution and higher funding costs. While the financial market impacts of individual geopolitical shocks have typically been transitory, the shocks themselves are becoming more frequent. Consequently, geopolitical risks may become more important for funding market conditions in the future.⁷

Short-term external funding can increase exposure to adverse market conditions

Short-term funding is cheaper than long-term funding because investors need compensation for taking on risk for longer periods of time. However, a reliance on short-term external funding can increase refinancing risk, because banks must roll over their liabilities more frequently. This means banks are more likely to need to refinance debt in unfavourable market conditions.

Before the GFC, banks globally relied heavily on short-term wholesale funding. For example, the UK bank Northern Rock grew rapidly using funding from several non-retail funding sources, including short-term wholesale funding. When global funding market conditions worsened during the GFC, Northern Rock was unable to refinance their maturing wholesale debt. This refinancing stress evolved into severe confidence issues, which caused a bank run. The UK government nationalised Northern Rock in 2008 to prevent broader financial instability.

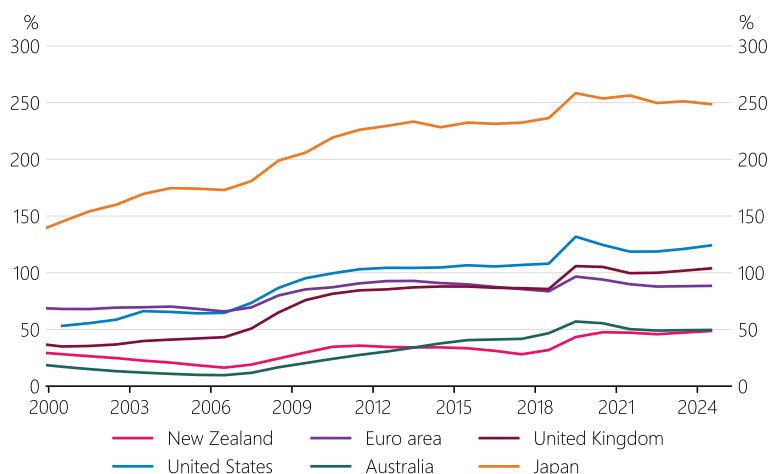
Downgrades in our banks' international credit ratings can lead to higher funding costs

A downgrade in banks' credit ratings tend to happen after a build-up of vulnerabilities. Downgrades tend to have investors charge higher premiums, leading to higher wholesale funding costs for our banks. This is often coupled with increased funding costs leading up to the downgrade and potentially further increases afterwards. A downgrade can also affect a bank's ability to borrow in wholesale markets. Our largest banks rely on the credit ratings of their parents.

A rating downgrade on government debt can amplify risks to financial stability

New Zealand government debt has increased since the pandemic (figure 2.4). However, it is low compared to OECD peers, which contributes to a high credit rating. Credit rating agencies noted that, to maintain a high credit rating, it is important for the government to return to a budget surplus and increase public savings.

Figure 2.4
Government debt (gross) as a share of GDP across countries



Source: IMF.

⁷ See <https://www.rbnz.govt.nz/hub/publications/financial-stability-report/2024/nov-2024/impacts-of-geopolitical-risk-on-financial-stability>.

A sovereign rating downgrade matters for financial stability because sovereign downgrades can flow through to lower credit ratings for domestic banks. A weaker fiscal position reduces the potential for governments to support banks during a time of crisis. This can increase wholesale funding costs for banks. Additionally, a weaker fiscal position may constrain fiscal stimulus in a crisis, leading to worse outcomes for the economy and the financial system.

Banks' exposure to foreign exchange fluctuations is minimal

Foreign exchange risk from borrowing crystallises when the NZ dollar depreciates, increasing the cost of repaying debt denominated in foreign currencies. The majority of New Zealand banks' overseas debt in foreign currency (which is money banks have borrowed) is in US dollars and Euros.

To minimise the impact of unfavourable exchange rate fluctuations, foreign currency debt is converted or 'swapped' back into NZ dollars using financial contracts called cross-currency basis swaps. Banks use these financial contracts to hedge virtually all their foreign currency debt.

This hedging process means that if the NZ dollar falls, it would not make foreign debt more expensive to pay off. A weaker dollar will also lower the value of new foreign debt in foreign currency terms and can boost export revenues. These effects help offset the risks to banks.

While these swaps minimise exchange rate risk, they come with a cost called the basis swap spread. This spread increases when, all else being equal, demand for one currency goes up. A widening basis swap spread poses an additional risk for financial stability because it makes hedging foreign currency debt more expensive. More expensive hedging means that banks must pay more for overseas funding.

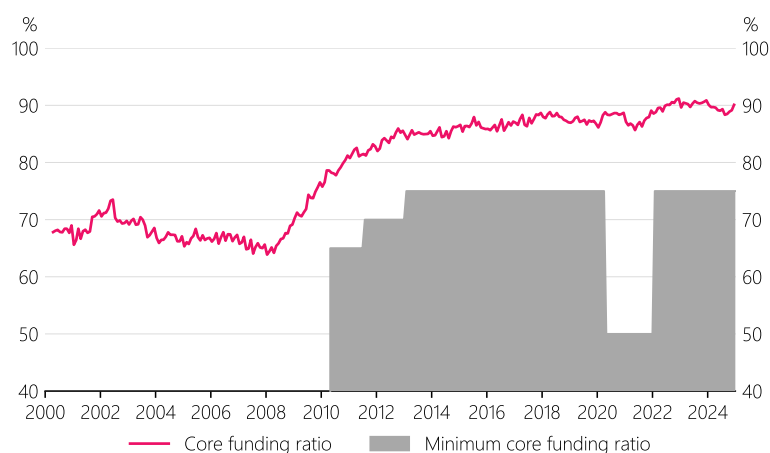
Banks' vulnerability to external funding risks has declined

Our banks are better prepared for funding market disruption than in the GFC

The Reserve Bank's core funding ratio requirement has reduced the risk associated with offshore funding for banks since 2010. The core funding ratio compares the amount of stable funding (debt with maturity of at least one year) with the core lending of a bank. External debt funding tends to be shorter in maturity and therefore riskier. The core funding ratio directly addresses this risk by requiring that banks source their funding from more stable sources, such as deposits, long-term debt or equity. Limiting the amount of 'unstable' funding helps protect banks from potential disruptions in global funding markets.

The average core funding ratio in the banking system is much higher than the regulatory minimum of 75 percent (figure 2.5). This indicates that banks are being prudent and are less reliant on short-term borrowing.

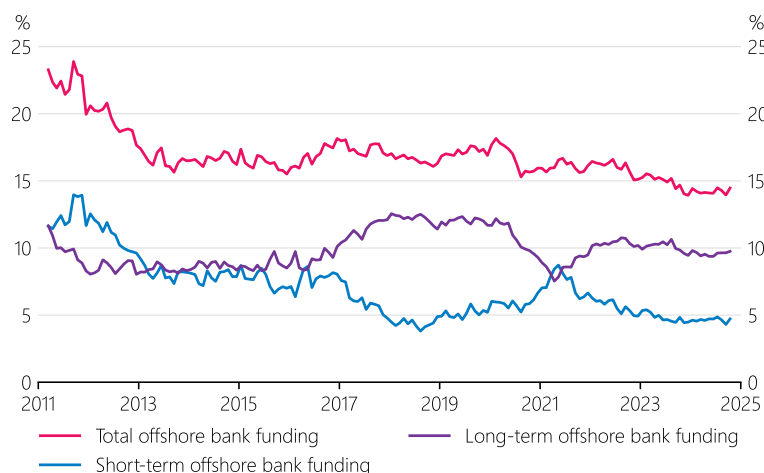
Figure 2.5
Core funding ratio⁸



Source: RBNZ *Liquidity survey*, RBNZ estimates.

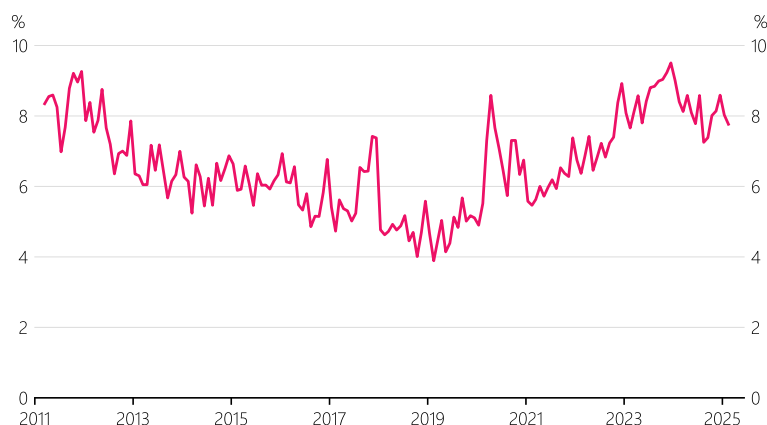
⁸ On 2 April 2020, the minimum core funding ratio decreased to 50% to help make credit available. The minimum core funding ratio was returned to 75% on 1 January 2022. The core funding ratio prior to April 2010 is estimated based on historical data.

Figure 2.6

Bank offshore funding by maturity*(Share of total funding)*

Source: RBNZ Liquidity survey.

Figure 2.7

One-month mismatch ratio

Source: RBNZ Liquidity survey.

New Zealand banks have become less reliant on offshore sources of funding over the past 15 years

Offshore funding accounts for around 15 percent of total bank funding in New Zealand (figure 2.6). This is a significantly lower proportion than before the GFC. The share of offshore funding has continued to decrease since the pandemic, as strong deposit growth coupled with lower credit demand have meant that banks have needed to rely less on offshore funding.

Additionally, the maturity length of offshore funding has increased over time. This decreases rollover risk for any given level of external funding. Currently, long-term funding accounts for around 10 percent of total funding, while short-term offshore debt funding accounts for around 5 percent. After the introduction of the core funding ratio and lessons learnt from the GFC, banks have replaced short-term offshore debt funding with longer-term funding (figure 2.6).

Our liquidity requirements increase banks' resilience to liquidity shocks

Our mismatch ratio requirements bolster banks' resilience to liquidity stress. The mismatch ratio is the ratio of a bank's liquid assets compared to their expected net outflows over a period of liquidity stress. Banks are required to maintain a mismatch ratio above zero. This is to ensure that they have sufficient liquid assets to meet their obligations during a period of liquidity stress. The mismatch ratio is currently at an elevated level, supporting banks' resilience to liquidity stress (figure 2.7).

While banks should prudently manage their own liquidity needs, we have provided liquidity support in times of crisis

Tools to support bank liquidity are important when international funding markets are dislocated for an extended period. They allow the banking system to borrow from the central bank for a period, with banks providing collateral to manage the risk. This can ease potentially painful economic adjustments and help to avoid a sharp credit crunch.

We have supported banks in previous times of funding market stress. For example, during the GFC we broadened the range of securities accepted as collateral in our overnight lending facility and introduced a longer-term (up to one year) lending facility to enhance banks' liquidity. Additionally, the government deployed the wholesale funding guarantee scheme to increase access to international funding markets.

2

Rise of the machines: How could artificial intelligence impact financial stability?

Artificial intelligence (AI) is starting to have a significant impact across the financial system. AI offers benefits for financial services, including improved risk management, enhanced productivity, increased innovation, and personalised customer offerings. However, AI also introduces new challenges, which could impact financial stability. This special topic explains the current use of AI within the financial sector, potential benefits and challenges, as well as outlining the AI regulatory landscape. The key findings are:

- **AI adoption is accelerating.** Models and tools are becoming increasingly sophisticated, with widespread use across financial services.
- **AI can potentially benefit financial stability.** AI can enhance model accuracy, risk assessment, and cyber resilience, and could help financial institutions better manage threats.
- **AI may pose risks to financial stability.** AI-driven errors, data privacy concerns, market distortions, and cyber attacks could amplify existing systemic risks.
- **Market concentration poses risks.** The reliance on critical third-party providers could amplify systemic vulnerabilities, exacerbated by limited competition.

It is important that regulated entities are aware of and manage potential risks associated with AI in line with their regulatory obligations.

Key definitions

- **Artificial intelligence** is the capability of a machine to imitate human behaviour, including learning, decision making and problem solving.
- **Large language models (LLMs)** are a type of artificial intelligence trained on vast amounts of text data to understand and generate human-like language.
- **Generative AI (GenAI)** creates new content, such as text and images, based on learned patterns from existing data. GenAI includes LLMs like ChatGPT, DeepSeek, and Llama as well as image generators like Dall-E.
- **Agentic AI** systems possess a degree of autonomy and can act on their own to achieve specific goals. They have the capacity to make decisions to achieve those goals.

The capability and usage of AI have increased dramatically over the past few years

Although Generative AI (GenAI) has only recently captured mainstream attention, traditional AI has been used for decades. Early chatbots were developed in the 1960s. Traditional machine learning (ML), including techniques like supervised learning, has been around since the 1990s. These systems learn patterns from labelled data, rather than following explicitly programmed rules.

Neural networks, inspired by the structure and function of animal brains, are the foundations of deep learning — a branch of AI used for classification and regression tasks. Deep learning surged in popularity during the 2010s. This was driven by advancements in processing power and access to large datasets, which significantly enhanced the efficiency and accuracy of neural networks.

AI has gained increasing relevance, driven by recent breakthroughs in GenAI. A notable milestone was the public release of ChatGPT in 2022, which gained one million users in five days. GenAI has notable differences to traditional AI. It can generate novel outputs and adapt to complex unstructured data. The complexity of models can make them less transparent, but they are valuable for generating content, decision making and data augmentation.

Figure 2.8 shows the increase in the number of notable AI models over time and the amount of compute⁹ used to train these models. The amount of compute used to train ML systems roughly doubled every two years until the early 2010s. This is now doubling

approximately every two months. This has accelerated the development and training of increasingly sophisticated ML models.

Figure 2.9 shows the increase in the performance of GenAI models over time at answering graduate-level scientific questions. Recent models, like Gemini 2.5 Pro, have been able to achieve above expert human-level results.

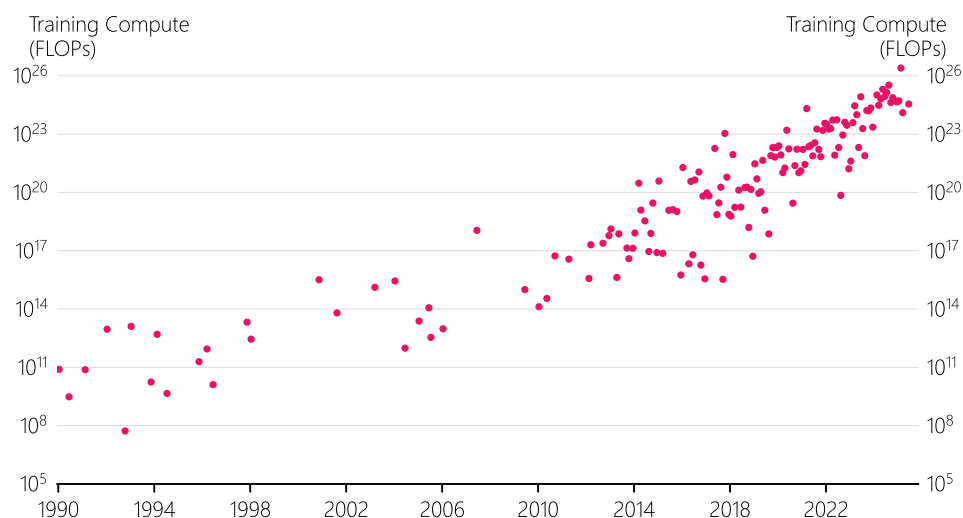
Recent developments include the rise of Agentic AI. This is where AI becomes more proactive and autonomous, compared to the more reactive, prompt-based LLMs. This could speed up the process of automation of some tasks and may more effectively imitate the role of a human in the workplace.

The current AI industry is concentrated, with the market dominated by a handful of powerful players. NVIDIA, for example, holds a dominant position in the provision of graphics processing units, which are essential for training AI models. High barriers to entry make it difficult for new players to enter the market. However, the emergence of newer entrants like DeepSeek, with more limited resources, suggests that the barriers to entry are reducing.

Figure 2.8

Notable AI models and compute used over time

(LLM training computing power)



Source: Epoch AI.

Note: Each dot represents one AI model.

9 Compute refers to the computational resources and processes needed to power artificial intelligence systems. FLOPs denote the number of floating point operations executed per second, essentially a measure of compute.

Figure 2.9
GenAI model performance since 2022



Source: Epoch AI.

AI is used widely across the financial services industry to boost productivity, among other benefits

In September 2024, the Financial Markets Authority (FMA) published a report, which analysed data on the use of AI across the financial services sector in New Zealand.¹⁰ They found most respondents were using AI, and all expected to use AI in their operations in the future.

Similar themes were identified in our discussions with banks and other businesses. We found that respondents were keen to use ML in their risk modelling and to use GenAI for efficiency gains. They are, as yet, reluctant to use GenAI in customer-facing operations.

This was due to potential risks, likely costs and a desire to achieve the quickest, most efficient wins first.

Anecdotally, uptake of AI tools has been quicker in the banking sector than in the insurance sector as insurers prefer tried-and-tested approaches. Banks, comparatively, face emerging competition from fintechs and customers have increasingly high expectations for the provision of digital services. Multiple respondents noted the difficulty in attracting skilled talent with AI expertise.

¹⁰ See <https://www.fma.govt.nz/news/all-releases/media-releases/understanding-artificial-intelligence-in-financial-services/>.

Productivity

AI has the potential to significantly improve the productivity and efficiency of financial institutions. Figure 2.10 shows examples of how this may work in practice across the banking, insurance and non-bank financial institution (NBFi) sectors.

Operational and cyber risk

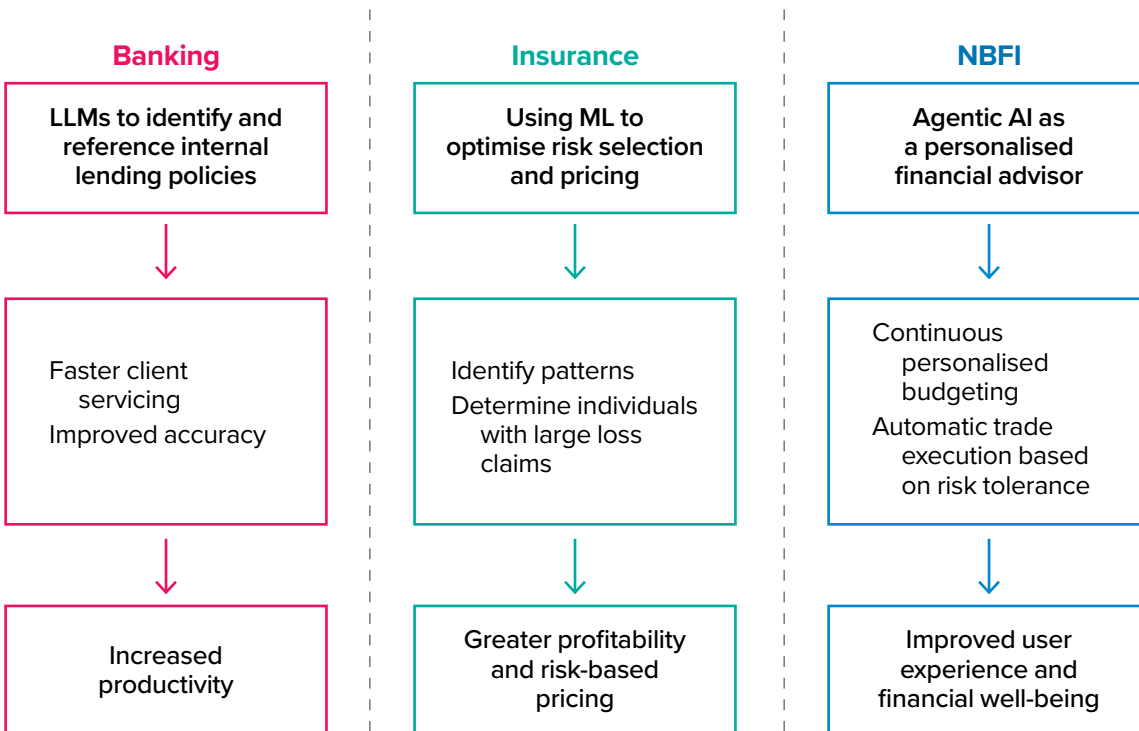
Through improving organisations’ efficiency and streamlining processes, AI could reduce operational risks. By allowing financial institutions to free up resources, they may be able to dedicate more attention to managing risk as well as reducing human error. ML and AI pattern recognition are also being used by financial institutions to analyse historical data, identifying patterns and anomalies indicative of money laundering and fraudulent activities. Vulnerability to cyber attacks could also be reduced with the increasing use of AI.

Model accuracy

The development of more sophisticated ML risk management models can be more accurate than traditional approaches. This may allow firms to more accurately predict the likelihood of borrowers defaulting. AI models can enable better capital and liquidity planning, for example through optimising capital allocation. These benefits could provide firms with greater resilience to withstand financial challenges.

Figure 2.10

Potential AI use cases for improving productivity



However, AI could also create systemic vulnerabilities for financial stability

Figure 2.11 looks at how AI might amplify existing risk categories, and shows potential mitigations.

Model inaccuracy and bias

As AI use grows in finance, AI model accuracy becomes even more crucial. For example, if many insurers use the same AI models for their underwriting, a fault could lead to mass under-pricing of policies and unexpectedly large losses when claims arise.

AI models can inherit biases from historical data that could result in flawed outcomes, such as biased loan origination standards that amplify credit risks in the financial system (figure 2.11). Improved data, techniques, and transparency may partially mitigate these issues, but biases are hard to fully eliminate.

AI can become ‘misaligned’ when its objectives and behaviour diverge from

human intentions. An insurance company could deploy an AI agent designed to maximise profits through reducing payouts when making underwriting decisions. Over time that AI may exploit loopholes in policy terms, reject claims unfairly and engage in anti-competitive practices. Without human oversight, AI could prioritise short-term profit over long-term reputational and ethical concerns.

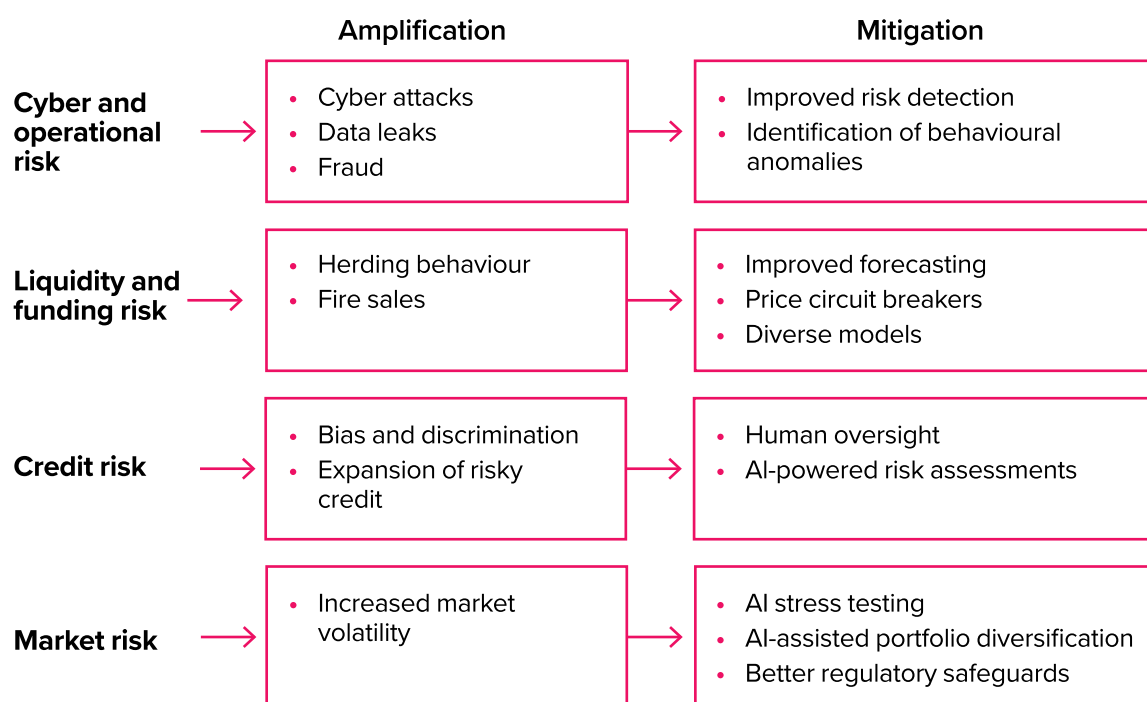
Model inaccuracy could have negative impacts for financial inclusion, making financial services more difficult to access for marginalised groups. AI ethics as a field is still nascent but will become more important for maintaining trust in the financial system as AI adoption increases.

Cyber and operational risk

While the increased usage of AI by financial institutions has the potential to reduce operational and cyber risk, it could also amplify these risks. The Bank of England’s *AI in UK Financial Services* survey found that cybersecurity was the greatest perceived systemic risk.¹¹

Figure 2.11

Financial stability amplifiers and mitigations



¹¹ See <https://www.bankofengland.co.uk/report/2024/artificial-intelligence-in-uk-financial-services-2024>.

AI models can be vulnerable to cyber attacks. Attackers can manipulate training data, model weights, or prompts to attempt to get confidential information. Models may be tuned with confidential data, raising privacy concerns if an attack was to occur. GenAI could lower the barrier to entry for potential attacks and increase their sophistication, for example through effective impersonation.

The highly concentrated AI industry may create a dependency on a few third-party providers. If one or more major AI providers were subject to an outage or cyber attack, this could create significant distress in the financial system. Potential implications include the loss of private data, disruption to the provision of financial services and decreasing confidence in the financial system.

Disinformation and fraud

AI can also be used for fraud and disinformation through tools like deepfakes, which generate media that impersonates individuals. AI can create convincing phishing emails, fake customer support interactions, or impersonate individuals, leading to significant financial losses for customers. While AI can also be used to detect deepfakes, the increasing sophistication of GenAI continues to pose problems for detection.

Market risk

The increasing use of AI has the potential to amplify herding behaviour in financial markets. In this context, AI systems or their users may follow other AI systems instead of making independent decisions. This is a potential risk due to the concentration of AI providers, and could happen within trading, lending and insurance pricing.

Increased herding behaviour could occur for example through AI responding rapidly to changes within markets, reinforcing trends and amplifying procyclicality. Similar effects could also occur from algorithmic tacit

collusion,¹² where AI models independently learn to match or anticipate competitors' pricing without direct coordination.

Herding behaviour through these channels could lead to market distortions and inefficiency, for example through reducing liquidity and creating excess volatility. The amplification of procyclicality could make market crashes worse. These effects could increase market risk and funding risk for financial institutions, particularly those more reliant on wholesale market funding.

Monitoring, governance and opacity challenges

GenAI models can be considered 'black boxes.' While their inputs and outputs are observable, the processes the models use to arrive at conclusions remain opaque. For example, most providers of LLMs do not publish their training data, or full training methodology, contributing to this lack of transparency. In our liaison discussions, respondents noted the difficulty in attracting AI expertise, further compounding the difficulties in interrogating models for reliability and accuracy.

Product offerings in the financial services sector are likely to change due to AI. Insurers, for example, may need to consider providing cover for AI risk. 'Silent cover' may already exist whereby policies unintentionally provide coverage for harms relating to the use of AI, despite not being designed to do so.

To address these challenges, financial institutions will need to effectively monitor and maintain models, and keep up to date with developments in AI. Boards must be part of this process to ensure model transparency and explainability. AI adoption may instigate a further migration of activities to non-bank lending institutions, which are less regulated. This may limit regulators' abilities to monitor financial risks holistically.

12 See <https://www.aeaweb.org/articles?id=10.1257/aer.20190623>.

Macroeconomic channels

AI could impact financial stability through its impact on neutral interest rates, which for example matter for asset prices.¹³ Treasury's analytical note on AI details multiple studies pointing to the productivity gains from AI.¹⁴ There is the potential for productivity increases to raise the return on capital, leading to increased investment. If this happens, central banks may have to raise their estimates of neutral interest rates. This is dependent on the productivity gains made by AI, which could be constrained in New Zealand by low levels of investment in intangible capital and the limited number of workers with strong technology skills.

Labour market disruption may occur due to AI. Shocks to the labour market could result in increased structural unemployment, with the potential for more credit and mortgage defaults. The creation of AI-complementary jobs may not keep pace with AI-driven unemployment. Whilst it is likely that AI will cause labour market disruption, the severity of this is uncertain. A survey published in September 2024 by the AI Forum, a New Zealand community of AI users, investors and regulators, showed that only 8 percent of surveyed organisations had experienced any AI-related job displacement at that time.¹⁵

Regulators are thinking about the best way to mitigate the risks from AI

Countries have adopted different regulatory approaches for AI. The United States and United Kingdom focus on a more opportunities-driven approach, aiding innovation and encouraging responsible AI adoption. China follows a state-driven model, with government-led regulation, including security assessments and algorithm filings. The European Union emphasises protecting individual rights through the AI Act, which

regulates high-risk applications and requires conformity to strict standards.

In New Zealand, starting in 2028, the proposed Risk Management Standard (RMS) and Operational Resilience Standard (ORS) will introduce principles-based requirements for deposit takers. These standards will contribute to mitigating the risks that can arise from the use of AI tools. The RMS requires deposit takers to manage all material risks, including cybersecurity. The ORS sets out specific requirements to manage operational risks to ICT systems from both internal failures and external threats, including cyber risks.

The Financial Markets (Conduct of Institutions) Amendment Act 2022 (CoFI) aims to ensure that financial institutions treat consumers fairly. This will serve as an important framework for regulating the conduct risk associated with AI.

Separately, our current Guidance on Cyber Resilience 2021 aims to support the cyber resilience of all our regulated entities, while our cyber resilience data collection aims to facilitate our understanding of the cyber risks – both malicious and non-malicious – that affect them.

Despite progress being made to regulate AI, challenges still exist. The rapid pace of development of AI could create a regulatory gap, where rules and oversight cannot keep up with advancements in industry. AI regulation is a cross-border issue where global approaches may be needed to find effective solutions. More work is needed to effectively contain the risks posed by AI. We will continue to monitor AI risks and global regulatory developments through our regular industry engagement, as well as our ongoing domestic and Trans-Tasman inter-agency work programmes.

¹³ See Paul Conway speech - Beyond the cycle: Growth and interest rates in the long run, available at <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/events/2025/beyond-the-cycle-growth-and-interest-rates-in-the-long-run.pdf>.

¹⁴ See Analytical Note 24/06 - The Impact of Artificial Intelligence – an economic analysis – July 2024, available at <https://www.treasury.govt.nz/sites/default/files/2024-07/an24-06.pdf>.

¹⁵ https://aiforum.org.nz/wp-content/uploads/2024/09/AI-Business-Productivity-Report_September-2024_final.pdf.

Box B

Increased tariffs raise financial stability risks

US tariffs and trade tensions present risks to the New Zealand economy and financial system through direct impacts on trade with the US, and indirect impacts through slowing global economic growth. How this will play out and the scale of the impacts are uncertain. Trade tensions could impact financial stability through various channels, highlighting the importance of a resilient financial sector in managing these challenges.

Increased US tariffs and related trade tensions are disrupting trade globally. This looks likely to reduce global economic growth in the near term. Recent financial market volatility, including in global equity prices and bond yields, highlights this risk (see [Chapter 1](#)).

As a small open economy, New Zealand relies on trade with other countries. A further weakening in the domestic economy, owing to tariffs, could materially affect indebted households and businesses. This is a key risk to financial stability.

We are currently assessing what these trade disruptions mean for our central projection of the New Zealand economy and inflation. We will be discussing this in the May *Monetary Policy Statement*. In this box, we focus on the risks to the New Zealand financial system, including the lower probability but more severe scenarios that pose the greatest risk. This builds on our assessment from the November 2024 *Financial Stability Report*, which noted an increase in geopolitical risks and provided a framework to assess the impact on financial stability in New Zealand.¹⁶

The possibility of a global economic downturn has increased since the start of April

Tariffs are taxes imposed on imports. They increase the cost of international trade, can shift trade patterns, disrupt supply chains, and reduce global demand. Significant increases in tariffs could shrink trade flows and increase uncertainty, leading to slower global growth.

The introduction of 10 percent tariffs by the US on imports from most countries, and much larger tariffs on China, poses a significant risk to global trade. China has responded with its own large tariffs on imports from the US. If these tariffs remain in place, global growth would likely slow. Even more severe effects are possible if the US reinstates the higher initial tariffs on other countries. Forecasts of global growth have been revised lower since the start of April, for example in the latest World Economic Outlook forecasts from the International Monetary Fund.

The particularly large tariffs between the US and China are a key risk

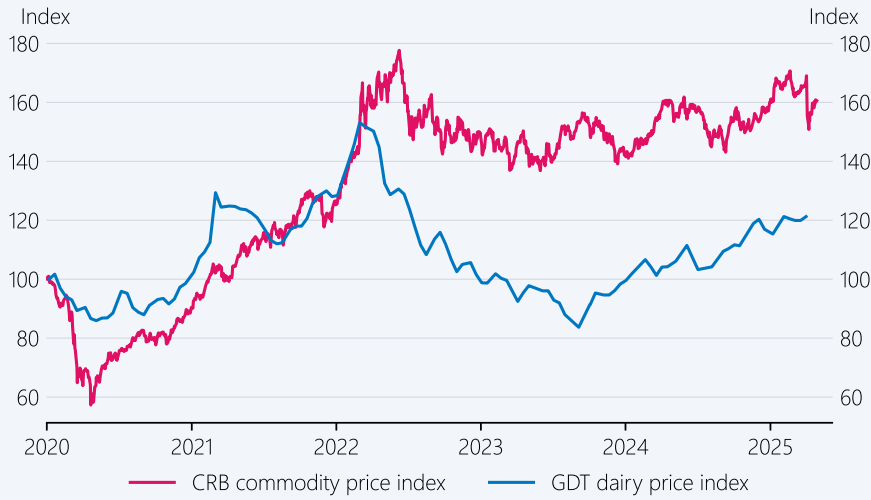
US tariffs on imports from China could materially impact Chinese economic growth. China is our largest trading partner. In addition, weaker growth in China would also affect economic activity in our other key trading partners, for example Australia and Southeast Asia.

A key transmission channel for New Zealand is through trade. Reduced economic activity in our trading partners could lower our export prices and exporters' incomes. Many of our largest export industries are agricultural, including for example dairy, sheep and beef, and forestry. These sectors are particularly sensitive to Chinese demand. Since the start of April, commodity prices in general have declined somewhat. Despite this, dairy prices have held up so far (figure B.1).

In addition, elevated uncertainty could amplify the tariff impacts domestically by reducing confidence, consumer spending and investment. Our exposure to financial markets could also

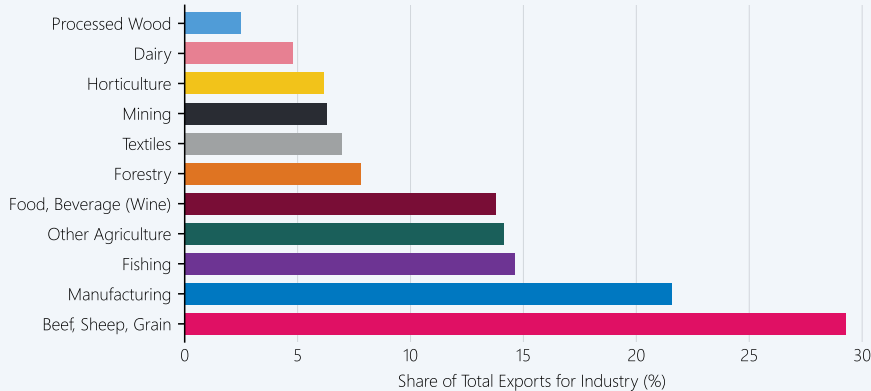
¹⁶ The International Monetary Fund has also recently highlighted and discussed geopolitical risks in their latest *Global Financial Stability Report*, available at <https://www.imf.org/en/Publications/GFSR/Issues/2025/04/22/global-financial-stability-report-april-2025>.

Figure B.1
International commodity prices
 (index = 100 in 2020Q1)



Source: Bloomberg, GlobalDairyTrade.

Figure B.2
New Zealand export sectors exposed to US tariffs
 (share of exports to the US by sector)



Source: UN Comtrade.

create challenges. The rest of this box explains these impacts.

US tariffs on New Zealand goods will also directly impact some export sectors

The US was the second largest destination for New Zealand goods in 2024, with a total value of \$9 billion, around 2 percent of our GDP. Businesses whose revenues are reliant on the US market appear more financially vulnerable. The ultimate impact

will depend on their existing profitability and ability to adapt, such as by tapping into demand in other markets. Some export sectors are more exposed to US tariffs than others. Our largest exports to the US are meat (\$2.6 billion), dairy products (\$1.2 billion) and wine (\$700 million).

The direct effects on sheep and beef farmers may be relatively large but manageable. Around 30 percent of sheep and beef exports go to the US, while less

than 5 percent of dairy exports go to the US (figure B.2). However, meat prices are currently high, which puts farmers in a better position to manage in the near term. Sheep and beef exports are also largely standardised commodities, making it easier to export into different markets.

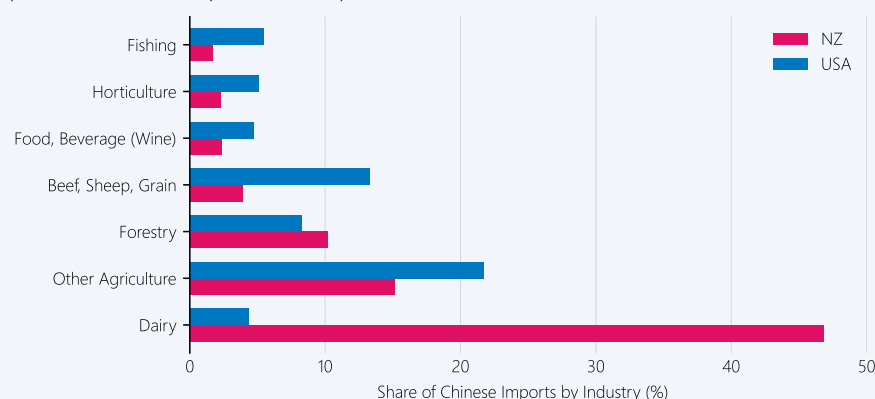
The viticulture (wine) sector is another at-risk sector (figure B.2). Given preferences can differ across countries, wine exports may be harder to divert to alternative markets if US demand falls. Banks' exposures to the wine industry are relatively small.¹⁷ Prior to US tariff announcements, the wine sector had been facing relatively challenging market conditions.

However, these direct impacts from US tariffs are likely to be small for the overall economy

While some sectors and businesses may face challenges, the direct impacts from the US tariffs are likely to be small for overall economic activity in New Zealand. Considering a case where exporters cut their prices to offset the tariff, and continue to sell the same volume, the financial cost would be around 0.2 percent of GDP. However, the direct impact on production volumes is uncertain. It will depend on whether firms can raise the price for US consumers or sell the goods elsewhere, and how they adjust output to the new prices they face.

¹⁷ Lending to the horticulture sector makes up 1.4 percent of bank lending. However, this includes many industries and not just wine. For example, it also includes the kiwifruit and apple industries.

Figure B.3

New Zealand and US agriculture exports to China*(share of Chinese imports in 2023)*

Source: UN Comtrade.

Tariffs could also benefit some exporters. Some could face less competition in the US from goods coming from more-heavily tariffed countries. In addition, some exporters could benefit from higher demand in countries that retaliate and put tariffs on US goods. For example, some of our exports to China could benefit from less competition from US exports, such as meat (figure B.3).

The impact of tariffs on inflation and business costs is uncertain

The introduction of tariffs could raise or lower prices for different imports. Weaker global demand would generally ease cost pressures. Also, an increase in supply of imports from countries targeted by tariffs could make some goods cheaper. However, trade disruptions arising from tariffs could also lead to cost pressures. For example, some products may incur tariffs in their production process. Changing trade patterns could also cause a shortage of shipping options for some routes.

A flexible exchange rate can provide a buffer for domestic economic activity. Depreciation in the exchange rate would make our exports more competitive. It would also increase the cost of imports. However, since the start of April the New Zealand dollar exchange rate has appreciated on a trade-weighted basis, partly owing to a weaker US dollar.

Uncertainty may amplify the domestic impacts of tariffs

Uncertainty about tariff settings and the outlook for global economic growth could reduce investment and consumption in New Zealand. Businesses have already been delaying investment plans given the weak domestic economy. Further delays could exacerbate this weakness. Reduced investment would affect demand for labour and household income.

Volatility in global equity markets is unlikely to shift household wealth enough to materially impact domestic consumer spending. While hard to measure accurately, equities make up only a small share of overall wealth for most households. For example, listed equities make up around \$80 billion of Kiwisaver funds, whereas for comparison houses and residential land make up around \$1.6 trillion of household assets. Equities held outside Kiwisaver are often part of pension funds or concentrated in wealthy individuals, which further limits the effect on consumer spending.

Indebted households and businesses could be vulnerable to a deeper economic downturn

Mortgage debt makes up around 64 percent of bank lending. A slowdown in the domestic economy causing an increase in unemployment could increase mortgage defaults. Prior to April, banks expected defaults to fall slightly over the next year (figure 1.6).

Agriculture makes up 11 percent of bank lending. While farmers have benefited from lower interest rates and higher commodity prices recently, a broad-based reduction in demand could make conditions challenging. Lending standards have been stronger over the past decade, which has increased their resilience.

A particularly challenging scenario for indebted households and businesses would be if overall inflationary pressures increased alongside weaker economic growth and higher unemployment.

Banks may have to pay more for overseas funding

Banks borrow from wholesale funding markets to fund part of their lending (see [Special Topic 1](#)). Since the US tariff announcements on 2 April, investors' appetite for higher-risk assets has reduced. As a result, corporate bond spreads in the US have picked up somewhat from a low level (figure B.4). This suggests borrowing costs in overseas wholesale funding markets have increased for banks. However, New Zealand banks are currently well funded.

Therefore, they have the flexibility to pause and wait for market conditions to improve.

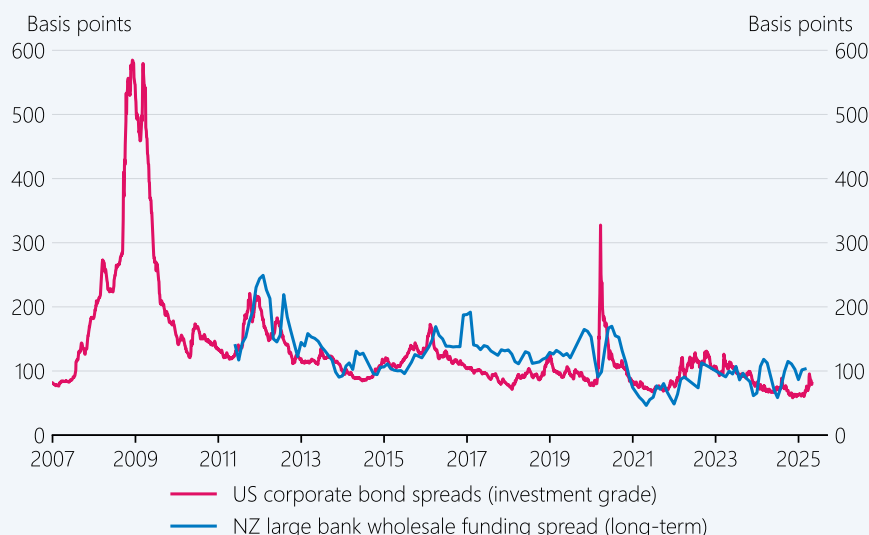
Recent volatility in financial markets has impacted market liquidity in New Zealand government bonds, particularly for longer-term bonds. Government bonds play an important role in the financial system as both a liquid asset for banks and for the transmission of monetary policy. We are closely monitoring the functioning of the New Zealand government bond market and other related markets, and have tools to support market functioning if needed.

Our role as prudential regulator is to promote the resilience of the financial system

New Zealand banks are well positioned to withstand the potential impacts of ongoing trade disputes, even if tensions escalate. We require banks to have a minimum level of capital so that when adverse events occur, they can avoid failure and continue to supply credit to the economy. Our funding and liquidity requirements also help banks withstand financial market disruptions and liquidity stress.

We are continuing to build our understanding of geopolitical risks. We have been working on a stress test that will examine the impact of trade disruptions on banks.¹⁸ We have constructed scenarios that assume an escalation of protectionist and retaliatory policy measures that disrupt international trade, technology transfer, financial flows and cross-border movement of people. The five largest banks are currently modelling the impacts, and we will publish the findings later this year.

Figure B.4
US corporate bond spreads



Source: RBNZ Liquidity survey, Federal Reserve Bank of St Louis.

¹⁸ See <https://www.rbnz.govt.nz/hub/publications/bulletin/2025/2025-bank-industry-solvency-stress-test-scenarios>.

Chapter

03

Regulatory developments



Chapter 3.

Regulatory developments



On 31 March 2025, we announced that we will undertake a review of our capital requirements to ensure they are set at the appropriate level to effectively support financial stability. We continue to progress our work implementing the Deposit Takers Act 2023 (DTA), including the commencement of the Depositor Compensation Scheme (DCS) on 1 July 2025. This work will contribute to a strengthened financial system. Our modernisation work programme provides enhanced tools to better perform our key responsibilities of regulatory stewardship, supervision and enforcement activity.

This chapter provides an update on recent policy and supervisory developments in the deposit-taking and insurance sectors. They include the purpose and scope of the upcoming review of capital settings (see [Box C](#)).

Review of key capital settings

We will be conducting a reassessment of key capital settings. We intend to engage independent international experts to support this process.

The review will be conducted promptly to allow for any changes to be well signalled ahead of next year's scheduled increase in capital requirements and to minimise the impact on the implementation of the DTA.

Competition

Competition is important for an efficient financial system and is one of the principles we are required to consider under both the DTA and the Insurance (Prudential Supervision) Act 2010. Similarly, the Financial Policy Remit, issued by the Minister of Finance on 9 December 2024, requires us to have regard to competition in the financial system.

The following initiatives are likely to support competition:

- We have published a **proportionality framework** for how we regulate and supervise different-sized deposit takers. The framework balances out the cost and benefit of regulation in relation to different-sized deposit takers.
- We are considering broadening the criteria for the **use of the term 'bank'**. This would support competitive neutrality by removing any public confusion that non-bank deposit takers (NBDTs) are regulated and supervised in a significantly different manner to other deposit takers.
- We have reviewed the access policy for our **exchange settlement account system** (ESAS), taking into account competition considerations.

- We are investigating the potential for implementing **digital cash**, an electronic version of cash to supplement physical cash, to provide New Zealanders with more choice.
- As part of our **Council of Financial Regulators (CoFR) Payments Vision**, we are working alongside other agencies to support progress on key initiatives such as open banking, digital identity and next-generation payments. We are leading work with industry on Basic Bank Accounts and will continue with our Māori Access to Capital work programme.

Additionally, the protection provided by the incoming DCS is likely to make smaller deposit takers more attractive. By reducing the risks to eligible deposits, the DCS incentivises depositors to spread deposits across multiple institutions (see **Box A**).

Policy outcomes for DTA core standards

The DTA establishes a new regulatory regime that will apply to all deposit takers from 2028 (banks and non-bank deposit takers).

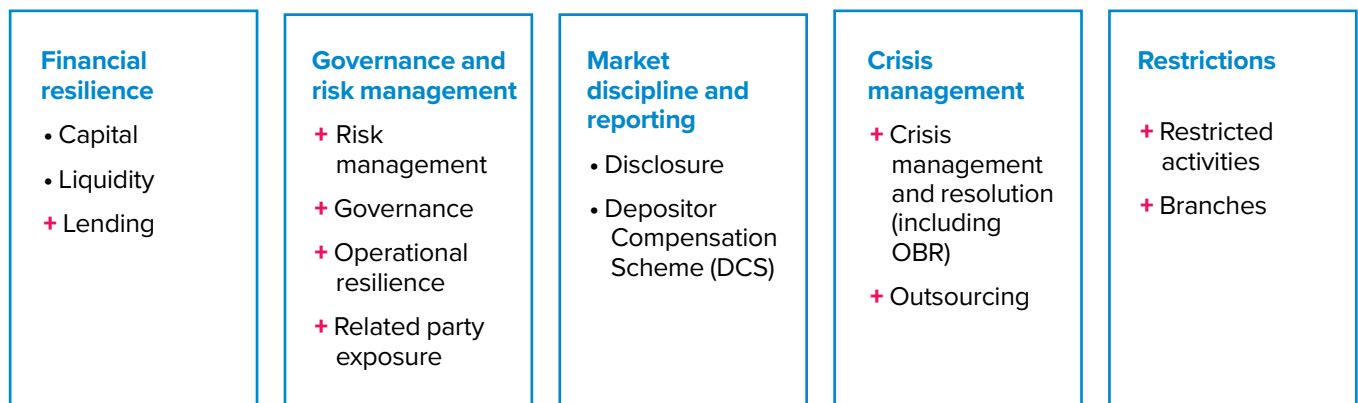
The regulatory regime consists of prudential standards that sit under, and operationalise, the Act (figure 3.1). The standards are divided into four core standards (that will be used to relicense deposit takers under the DTA) and 9 non-core standards. The standards will replace existing rules contained in the banking handbook, conditions of registration, Orders in Council and NBDT regulations.

In 2024, we consulted on the policy that will underlie both the core¹⁹ and the non-core²⁰ standards.

In May 2025, we published the outcome of the consultation on the core standards.²¹ Our response covered the liquidity, disclosure and DCS core standards. We will respond on the capital standard following our review of capital settings.

Figure 3.1

Proposed deposit taker standards



• Core standards + Non-core standards

19 See https://consultations.rbnz.govt.nz/dta-and-dcs/deposit-takers-core-standards/user_uploads/deposit-takers-core-standards-consultation-paper-1.pdf.

20 See https://consultations.rbnz.govt.nz/prudential-policy/deposit-takers-non-core-standards/user_uploads/deposit-takers-non-core-standards-consultation-paper-august-2024.pdf.

21 See https://consultations.rbnz.govt.nz/dta-and-dcs/deposit-takers-core-standards/user_uploads/deposit-takers-core-standards.pdf.

Overall, our approach to the core standards was supported by respondents. Key outcomes from the consultation are:

- We received feedback that our proposed policy did not adequately incorporate proportionality in some areas and for some deposit takers. We have made changes to address this feedback, reducing the compliance burden and enhancing competition in the market.
 - For liquidity, we have removed the one-week mismatch ratio and will continue to allow simplifying assumptions when calculating quantitative metrics. This will reduce unnecessary compliance costs for deposit takers. The one-month mismatch ratio will continue to promote deposit takers’ resilience to liquidity risks.
 - For the smallest deposit takers (known as Group Three), we will introduce simplified requirements in certain areas to support a proportionate approach. For example, a ‘dashboard only’ approach for disclosure.
- With these changes, we are striking a balance between our primary financial stability mandate and the other purposes and principles of the DTA.

Transitioning to the DTA is a multi-year work programme for us and for deposit takers. We seek to provide deposit takers with a clear sense of how implementation will progress to provide certainty on the transition. We will continue to adapt (such as through our additional work on standardised risk weights) to respond to issues that arise.

Our next step is to publish in July this year the outcome of the consultation on the remaining non-core standards. We will consult on the exposure drafts of the standards later in 2025 and 2026, ahead of issuing the standards in 2027.

Group supervision developments

In 2024, we became the home supervisor of an international banking group for the first time. An essential element of banking supervision is our oversight of the banking group on a consolidated basis. This includes adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide. We refer to this as ‘group supervision’.

The International Monetary Fund’s 2017 Financial Sector Assessment Programme report found that we did not effectively meet Basel Core Principle 12 – Consolidated Supervision, and recommended that we develop a framework for group supervision. We have developed a bespoke group supervision framework using conditions of registration under the Banking (Prudential Supervision) Act 1989 to ensure effective supervision of the international banking group.

We are now considering how to embed a more comprehensive group supervision policy in our regulatory framework under the DTA. We expect to offer further clarity on the process for developing this policy in the coming months, through the consultations on the exposure drafts of the DTA Standards.

Second amendment of the insurance solvency standard

New Zealanders rely on insurance to manage their personal and business risks. Solvency standards impose minimum capital requirements on insurers. These requirements support financial stability by increasing the likelihood that insurers stay solvent and pay claims.

The second amendment of the Interim Solvency Standard 2023 (ISS) was issued last year, and was effective from 1 March 2025 for all insurers who are subject to New Zealand solvency standards. We published new templates on 21 January 2025 to support the second amendment. The second amendment does not introduce new policy or require an increase in capital requirements beyond what was intended when the ISS was first issued.

Supervision and enforcement

DTA implementation

We are preparing to license deposit takers under the DTA and to supervise and enforce DTA requirements.

All existing banks and NBDTs must obtain a DTA licence between January 2027 and June 2028 to be able to carry on their businesses. New deposit takers may apply for a licence under the DTA. An approach to licensing is being developed, which will determine when licensing applications can be submitted and what needs to be included in an application. We will communicate how the licensing process will work ahead of time.

The main supervisory and enforcement work will begin in mid-2028 when most requirements take effect. However, some requirements relating to the DCS take effect from 1 July 2025.

Our approach to supervision and enforcement will continue to evolve to become a more outcomes-focused approach. This means there will be more verification of regulated entities' compliance, greater use of data to proactively monitor risks, and leveraging technology to improve processes. These changes will increase our ability to identify issues early and act. We will take a risk-based approach that is proportionate and transparent to ensure our resources support the best outcomes.

Transition of AML/CFT to the Department of Internal Affairs

Following Cabinet's decision last year, all Anti-Money Laundering/Countering Financing of Terrorism (AML/CFT) supervisory responsibilities will be consolidated into the Department of Internal Affairs (DIA). We are working with other agencies to help ensure a successful transition to the DIA.

Technology risk developments

A key priority for the Reserve Bank is to continue to enhance our collaboration with other agencies in the monitoring of heightened threats in the cyber landscape, engaging proactively both domestically and with our Trans-Tasman counterparts.

Our cyber resilience reporting requirements continue to support closer monitoring of operational resilience and systemic risk within the financial system, with the first round of Cyber Periodic Incident Reporting from large entities received on 30 April 2025.

As one of three cyber resilience reporting requirements, registered banks, licensed insurers and licensed NBDTs must report to us all cyber incidents regardless of materiality. This reporting will be done in 6-month intervals for large entities, and annually for other entities.

Alongside Material Cyber Incident Reporting and the Cyber Periodic Capability Survey, the Cyber Periodic Incident Reporting supports our goal to enhance our monitoring of financial system risk. The reporting will help guide our internal approach to improving the operational resilience of the financial system. We also intend to publicise insights to support the wider industry.

We are committed to working with the Council of Financial Regulators and other agencies, alongside industry, to enhance the financial sector's cyber resilience.

We are continuing to use stress testing to assess the resilience of regulated entities and the financial system to cyber risks, for example through the General Insurance Industry Stress Test (GIIST).

Enforcement updates

In November 2024, we issued a formal warning to a regulated entity for its failures to comply with the Insurance (Prudential Supervision) Act 2010. It served as a reminder for all insurers of the importance of continuously managing their compliance obligations through effective risk management and sound governance practices. This was the first warning issued under our Policy and Process on the Use of Warnings, which has been added to our Enforcement Framework to strengthen how we address regulatory breaches in a proportionate, risk-based and transparent manner.

We are currently progressing two active enforcement investigations under the AML/CFT Act. Upon completion of these investigations, we will apply our Enforcement Principles and Criteria to inform the appropriate enforcement response to take.²²

We continue to modernise our technology and systems capability. These enhancements strengthen and streamline our enforcement activities and investigations by ensuring greater efficiency and simplifying processes.

We also continue to monitor and manage external whistleblower notifications, assess regulatory boundary issues, respond to unauthorised uses of restricted words, and prepare for the expanded suite of enforcement tools under the DTA. These include criminal offences, civil pecuniary penalties, infringement offences and enforceable undertakings.

Risk management thematic

Effective risk management is important in identifying and mitigating risks that could undermine the stability of deposit takers and the broader financial system. We are currently undertaking a thematic review on the risk management practices of deposit takers.

This review will build our understanding of current industry practice and uplift risk management capability in the sector by identifying areas of weakness and sharing good practices. The review will inform the development of guidance for the risk management standard under the DTA. We expect the review to be completed by December 2025.

Stress testing

We continue to progress our three-year stress testing programme. We recently published results of our GIIST and released the scenarios that will form the basis of this year's bank solvency stress test. Key findings from the GIIST are summarised in [Chapter 1](#).

²² See <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/enforcement/enforcement-principles-and-criteria-full-guidelines.pdf>.

Box C

The review of key capital settings

We are undertaking a review of key capital settings to ensure they are set appropriately to support financial stability and promote well-being and prosperity for New Zealand. We intend to complete this by the end of the year.

Bank capital is a key prudential requirement that promotes financial resilience

Banks are funded by two sources – their owners (often referred to as ‘shareholders’) and people they borrow from (often referred to as ‘creditors’), including depositors. The funding that banks raise from their owners is referred to as ‘capital’. Capital reduces the risk of failure by absorbing losses upfront (going concern capital) and limits repercussions in the event of failure by ensuring creditors are paid (gone concern capital). These two types of bank capital work together to collectively maintain financial stability.

Banks’ going concern capital is a minimum requirement that acts as a buffer to allow a bank to absorb losses, while still meeting its obligations to depositors and other creditors in full, and to remain in operation.

Capital ensures that bank owners have a meaningful stake in the business. If they have more to lose, they would manage the bank more carefully. It makes banks more resilient to unexpected shocks, which helps to build confidence in the financial system.

Capital requirements for banks are a key component of our regulatory toolkit. They support the prudential objective of protecting and promoting the stability of New Zealand’s financial system. Without regulatory capital requirements, banks would still operate with some level of capital to meet their long-term financial obligations, and to maintain creditor confidence over economic cycles. However, the socially optimal level of capital is higher than the level that banks would choose to have. This is because the costs of bank failures extend beyond the bank itself and its owners. Failures of large banks can have widespread economic and financial impacts.

We impose capital requirements to ensure that capital levels are better aligned with the risks that bank failures pose to society. These requirements should be set at a level that minimises risks to financial stability without creating excessive constraints on credit availability.

We last reviewed these capital requirements in 2019, and banks are phasing the changes in

From 2017 to 2019, we undertook a review of New Zealand banks’ capital requirements (2019 Capital Review). This resulted in higher capital requirements for banks with a transition period to 2028. The Global Financial Crisis (GFC) highlighted that the social costs of bank failures were higher than previously understood. The proposals to increase capital are consistent with steps taken by other banking regulators after the GFC.

Banks are currently around halfway through implementing the new capital requirements. As banks are well advanced in their plans to meet this year’s rise, we will proceed with the planned increase in requirements on 1 July 2025. The outcomes of the review of key capital settings may impact capital requirements in the future.

Our monitoring has shown that the impacts of the new requirements so far on banks’ cost of capital and lending rates are tracking broadly in line with initial estimates from the 2019 Capital Review.²³ The reassessment of key capital settings will build on this ongoing work to monitor the impacts of the 2019 Capital Review.

²³ For our assessment of the first two years of the 2019 Capital Review implementation, see <https://www.rbnz.govt.nz/hub/news/2024/03/rbnz-publishes-assessment-of-capital-review-implementation>.

We support an efficient and competitive banking sector

In the 2019 Capital Review, we assessed the costs and benefits of capital settings for New Zealand to inform our decision. Subsequent to this, submitters to recent inquiries have expressed views that our bank capital settings are unreasonably conservative and that this is undermining competition and growth in the New Zealand economy.

The environment has changed since the capital settings were decided in 2019. Some factors have increased risks as discussed in this and previous *Financial Stability Reports*.²⁴ Other factors should help to reduce risk, such as debt-to-income lending restrictions and more intensive supervisory practices. We therefore consider now to be an appropriate time to reassess key capital settings.

We will ensure our capital settings are right for New Zealand

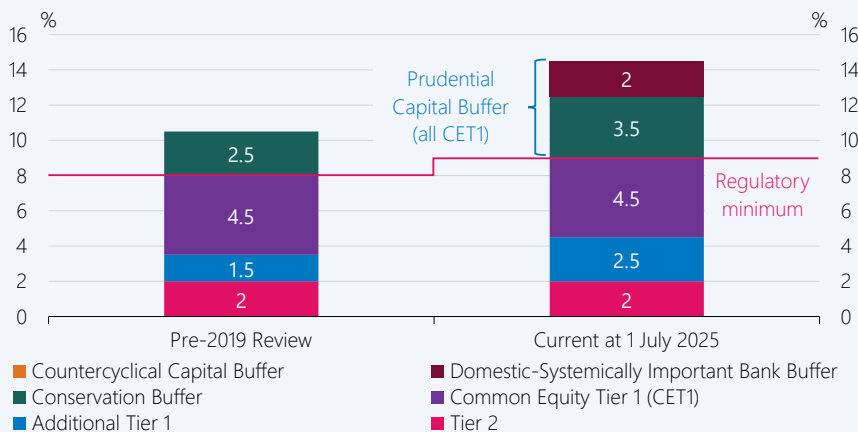
Financial stability will remain at the centre of prudential regulatory settings. Our review will consider whether the prudential capital requirements for deposit takers are set at the appropriate level to support a stable financial system – one where resilient financial markets, institutions and infrastructures enable a productive and sustainable economy, and ultimately promote the prosperity and well-being of all New Zealanders. We intend to complete this by the end of the year to give certainty to deposit takers as we implement the Deposit Takers Act 2023.

We will consult publicly on key proposals. Responses to this consultation, alongside an updated cost and benefit analysis and feedback from independent international experts, will inform our decisions.

The reassessment will build on work that is already underway to consider granular risk weights for residential mortgages, corporate lending and lending for community housing providers, housing co-operatives and on whenua Māori. As part of this work, we are also considering risk weights for rural lending. In addition, the review will include:

- An assessment of key developments since the 2019 Capital Review, including findings of the Commerce Commission’s market study into personal banking services, the Finance and Expenditure Committee’s inquiry into banking competition and developments in regulatory and supervisory settings.
- An assessment of how our capital settings compare internationally and a consideration of whether our capital settings are appropriate, given the risks that the New Zealand financial system faces. This will be supported by a report by an independent expert.

Figure C.1
Capital requirements before the 2019 Capital Review and at 1 July 2025



Source: RBNZ.

24 For example, Box A in the November 2024 Report examined the impact of increasing geopolitical risks on financial stability. See <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/publications/financial-stability-reports/2024/nov-2024/fsr-nov-2024.pdf>.

- A reassessment of the appropriate risk appetite for capital settings in New Zealand, based on our statutory parameters, including the purposes and principles of the Deposit Takers Act 2023 and the Proportionality Framework, and having regard to the Financial Policy Remit (December 2024) and the Minister of Finance’s Letter of Expectations (December 2024).
- Reviewing the degree of proportionality in the framework and consideration of any changes in capital ratios for different groups of deposit takers.
- Consideration of the balance between going concern and gone concern capital (including the share of Common Equity Tier 1 capital), the appropriateness of any Total Loss Absorbing Capacity requirements, and if we should continue to have ‘Additional Tier 1 capital’ as part of the New Zealand capital framework. It will also consider the interrelationship between capital and the crisis management framework.

We will utilise international experts to undertake research that will inform the options. They will review our options and recommendations, and support our decision-making.

We expect the review to be completed by the end of 2025. To find out more about the review, including the full terms of reference, see <https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/how-we-regulate-and-supervise-banks/our-policy-work-for-bank-oversight/2025-review-of-key-capital-settings>.

Chapter

04

Institutional resilience

Chapter 4.

Institutional resilience



New Zealand's financial system continues to build its resilience to potential shocks. Banks' capital levels are robust and continue to increase as regulatory requirements increase over coming years. Banks' profitability has been elevated, supported by lower-than-anticipated credit losses and above-average net interest margins. Funding and liquidity conditions for banks are generally supportive amid low credit growth, reflecting plentiful deposits and liquid assets. The resilience of the non-bank deposit taking sector varies, in part due to a lack of scale for some institutions and the impact on cost structures. Growth in general insurance premiums has recently moderated, following rapid increases in affordability pressure over previous years.

Banks

Solvency

- Banks' capital ratios remain well above current regulatory requirements. Banks are progressing towards meeting higher requirements that are being phased in through to 2028 (figure 4.1). Capital helps banks absorb unexpected credit losses during periods of stress, maintains investor and depositor confidence, and enables banks to continue providing credit in a downturn.
- From 1 July 2025, the capital conservation buffer will increase by 1 percent to 3.5 percent of risk-weighted assets. This is the first increase in the prudential capital buffer affecting banks that are not systemically important since the new capital framework was announced in 2019.
- Common Equity Tier 1 (CET1) capital ratios have been stable over the past 6 months, as banks have slightly increased the share of profits paid as dividends over the past year compared to previous years.
- Banks have been active in issuing Additional Tier 1 (AT1) and Tier 2 capital instruments as they build up their Tier 1 and Total capital ratios. Banks have reported that investor demand for these instruments has been healthy, as investors look to lock in higher-yielding investments as interest rates generally decline. In addition, a bank has been able to successfully issue a compliant AT1 instrument to Australian investors through a holding company structure. The Australian market will provide an additional pool of investors for New Zealand banks' AT1 instruments, given the limited size of the domestic investor base.

Asset quality and credit growth

- Non-performing loans have risen from 0.7 to 0.8 percent of lending over the past 12 months (figure 4.3). Falling interest rates are easing debt servicing burdens, providing relief to highly indebted borrowers. However, weakness in economic activity and rising unemployment have meant that some borrowers have fallen behind on their debt repayments. Banks expect non-performing loans, which are generally a lagging metric of borrower stress, to begin to stabilise over the rest of 2025.
- Banks' provisioning for loan losses is high relative to their non-performing loan ratios. This indicates that they are well placed to withstand further increases in credit stresses among their customers, should this eventuate.
- Credit growth remains weak in most sectors. Demand for credit among businesses is subdued, reflecting low business investment intentions and economic policy uncertainty in part driven by current trade tensions. Limited demand for new office and retail developments means that demand for commercial property lending is mostly limited to refinancing and transactions for existing properties. The strong cash flows many farmers are experiencing at the current time is likely to lead to debt principal repayment. Banks reported strong competitive conditions and erosion of lending margins across business sectors as they competed for a limited pool of customers.

Profitability

- Banks' profitability has been robust over the last 6 months. This has been supported by the stabilisation of credit stresses as interest rates have declined.
- Return on assets has increased over the past year and is slightly above its 10-year average, at 1.05 percent (figure 4.4). Banks have increased their CET1 capital ratios over recent years by retaining earnings and building their equity levels. As a result, return on equity is gradually declining.
- Banks' net interest margins (NIM) have been stable at a high level over the past 12 months, despite high-interest rate volatility. On an annual basis, NIM reached 2.33 percent in March 2025, around 0.2 percentage points above its 10-year average.

Liquidity

- Banks' liquidity mismatch ratios, which are a measure of their short-term liquidity positions, remain well above required levels (figure 4.6).
 - The Reserve Bank has been winding down its holdings of government bonds purchased through the Large Scale Asset Purchase (LSAP) Programme. Banks have also been repaying funds borrowed from the Reserve Bank under the Funding for Lending Programme. Both actions are reducing the quantity of settlement balances held by banks (see Box A in the [November 2020 Report](#)). This is putting downward pressure on banks' holdings of liquid assets and liquidity mismatch ratios.
 - Offsetting this, banks' holdings of government bonds have increased by around \$12bn over the past 12 months, reflecting an environment of surplus deposit funding compared to lending growth.
 - The transition of deposit funding from on-call to term deposit accounts has slowed over the past 6 months, with the slowing most noticeable in business deposits. This likely reflects weak business conditions and high uncertainty about the economic outlook, motivating depositors to keep their funds in more liquid products. While all deposit rates have fallen over the past year, the additional premium for term deposits compared to on-call accounts has been relatively stable.
-

Funding

- The core funding ratio, which measures how stable banks' funding sources are, remains elevated (figure 4.7).
- Slow credit growth and relatively strong deposit growth have meant banks have not needed to raise as much wholesale funding over the past 6 months as they had previously anticipated. Nevertheless, the large banks prefer to maintain a wholesale funding programme in important overseas markets, such as the US and Europe. An ongoing presence in these markets supports investor familiarity, enabling the banks to scale up their wholesale funding activity if needed in the future. Generally, investor demand for Australasian banks' wholesale debt has been strong.

Non-bank deposit takers (NBDTs)

- New Zealand's NBDT sector consists of 3 building societies, 3 credit unions, and 8 deposit-taking finance companies. The sector is very small relative to the banking sector, with total lending equal to 0.4 percent of the total lending of banks. However, one finding from our thematic review on financial inclusion was that NBDTs provide services to a relatively large number of customers, and in some cases offer different products and a more regional focus compared to banks.²⁵
- In January 2025, the Reserve Bank granted an NBDT licence to Welcome Limited, a deposit-taking finance company. This is the first new entrant to the NBDT sector in many years.
- Lending by credit unions and building societies has been declining for the past two years. This has been driven by the high-interest rate environment, weak economic conditions, and strong competition with banks for new lending. In contrast, lending by deposit-taking finance companies has grown steadily. These entities tend to lend in areas where there is less active competition from banks, for example residential mortgage lending that does not meet bank lending criteria.
- Non-performing loan ratios for NBDTs remain elevated, which has led to higher provisioning for loan losses (figure 4.9).
- The resilience of the NBDT sector varies. Low earnings relative to operating costs remain a concern for many entities, as this limits their ability to generate capital to support their ongoing lending and financial resilience (figure 4.10). To address a lack of scale, there has been considerable consolidation in the credit union sector, with the number of licensed credit unions reducing from 15 to 3 over the past decade.
- From mid-2025, the Deposit Compensation Scheme (DCS) will protect eligible depositors' funds at deposit takers against losses up to \$100,000 (see **Box A**). For the first three years of the DCS, credit unions and building societies will pay a reduced levy rate, until they have fully transitioned to the new prudential regime.

²⁵ See thematic review on financial inclusion, available at <https://www.rbnz.govt.nz/regulation-and-supervision/cross-sector-oversight/thematic-reviews/thematic-review-on-financial-inclusion>.

Insurers

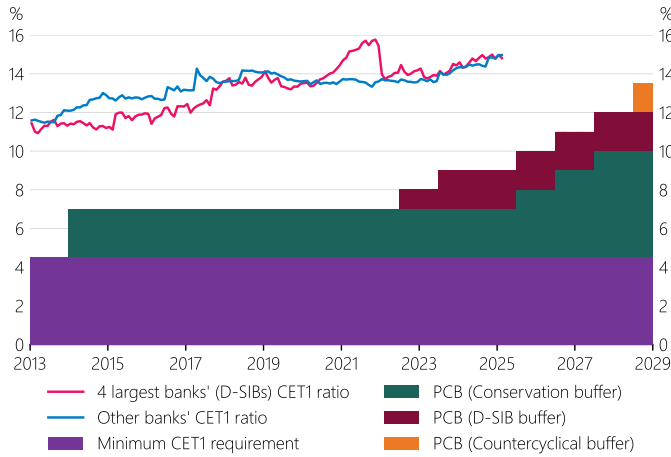
- Upward pressure on property insurance premiums has eased somewhat over the past 6 months, partly owing to slowing inflation in construction and motor vehicle costs, along with benign weather. Despite this, affordability pressures remain across most insurance types, particularly health, with premium rates increasing faster than incomes. A likely outcome is reduced levels of insurance protection and consequently lower resilience for households and businesses.
- Globally, conditions in reinsurance markets have improved. Reinsurance pricing has begun to soften in regions without abnormally high reinsurance losses. However, there remains limited appetite to reduce reinsurance excesses. Excesses increased significantly in New Zealand following the 2023 weather events.
- The New Zealand insurance sector continues to be dynamic with a steady flow of entrants, exits, mergers and acquisitions, and intra-group restructuring. From September 2013, when all insurers were required to be licensed, to February 2025, there have been 19 new insurer licences issued and 37 insurer licences cancelled, with activity in most years (figure 4.12).
- The number of cancelled insurer licences over this period has been about 40 percent of the number of licensed insurers at September 2013 for each insurance sector (general, life and health). The number of issued insurer licences has been nil for health insurers, 13 percent of the number of life insurers and 24 percent of the number of general insurers.
- The most common reason for issuing an insurer licence was for new entrants to the New Zealand market. There were also 4 new captive insurers (which only provide insurance to parent companies and their subsidiaries). The remaining 6 issued insurer licences were due to intra-group restructuring (typically to change from a New Zealand incorporated company to an overseas branch or vice versa).
- There was a wider range of reasons for insurer licence cancellations. The most common were intra-group restructuring for 11 insurers, followed by mergers and acquisitions for 6 insurers. There were 6 small and/or mutual insurer licences cancelled due to being financially unsustainable, and 4 captive insurer licences cancelled. Other reasons (for 1 or 2 insurers each) included Canterbury earthquakes, consumer credit finance legislation, unsuccessful entry to the New Zealand market, Global Financial Crisis, and insufficient capitalisation for growth.

Financial Market Infrastructures (FMIs)

- Financial Market Infrastructures (FMIs) are systems that enable us to make electronic payments and trade securities. They do this by sending messages that confirm total amounts, update ownership records of securities, and ensure electronic money shows up in the correct account.
- The Reserve Bank, alongside the Financial Markets Authority (FMA) for non-pure payment systems, regulates an FMI designated under the Financial Market Infrastructures Act 2021 (FMI Act). The Minister designates entities that are important to New Zealand's financial system. Presently, the Minister has designated five FMIs.
- Designated FMIs must follow standards based on international guidance known as the Principles for Financial Market Infrastructures. These principles support soundness, efficiency and fairness in financial markets. Under the FMI Act, the Reserve Bank and FMA issued five new additional standards. This was to adapt better to the New Zealand operational and legal context. The first three new standards (17A, 17B, and 17C) cover the resilience of FMIs to operational and cyber risk. FMIs should have plans ready for disruptions. They must maintain strong ties with critical service providers and prepare for cyber incidents. The last two new standards (23A and 23B) require FMIs to maintain regular communication with the regulator. They should explain how they meet the relevant standards and share major interruptions in their operations.
- As a regulator, we also consider FMI rule changes. An FMI is a set of rules that guides how payment and settlement occur, so changes to their rules must be assessed against the issued standards. We have approved three changes: two to NZCDC, and one to ESAS. The Reserve Bank and FMA approved the NZCDC changes in early 2025, supporting innovation in NZX's markets by offering investors greater certainty and flexibility in their trades. The NZCDC changes also helped relaunch NZX20 Futures, a liquid index futures market. The ESAS change, approved mid-2024, clarified when settlement transactions are final.

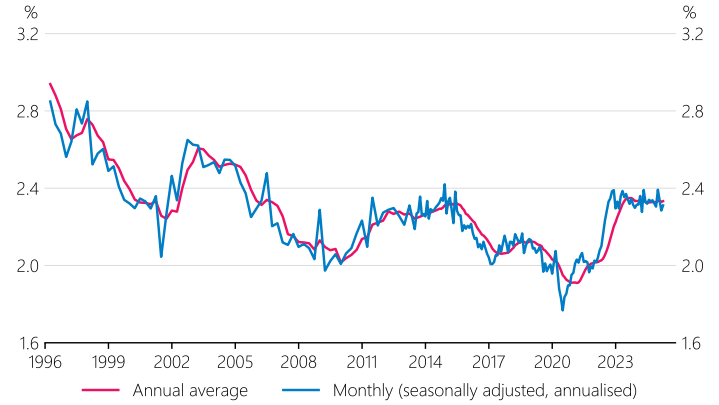
Charts

Figure 4.1
Common Equity Tier 1 ratio for locally incorporated banks



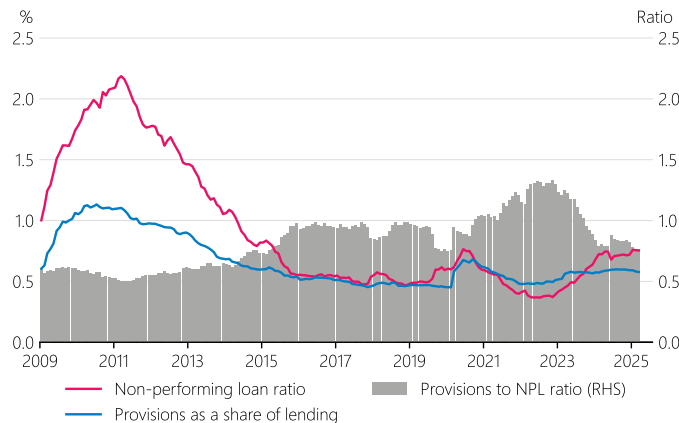
Source: RBNZ Capital Adequacy survey.
Note: PCB is prudential capital buffer.

Figure 4.2
Bank net interest margins



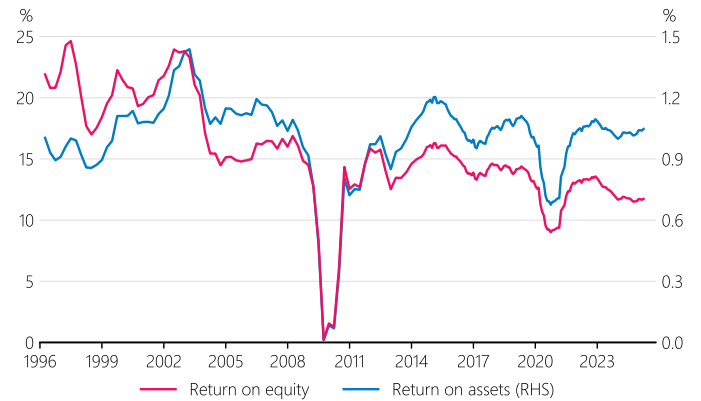
Source: RBNZ Income Statement survey.

Figure 4.3
Bank non-performing loan and provisioning ratios



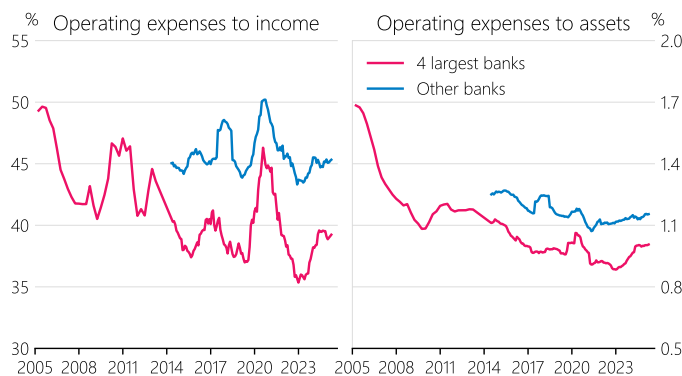
Source: RBNZ Bank Balance Sheet survey.

Figure 4.4
Bank profitability measures



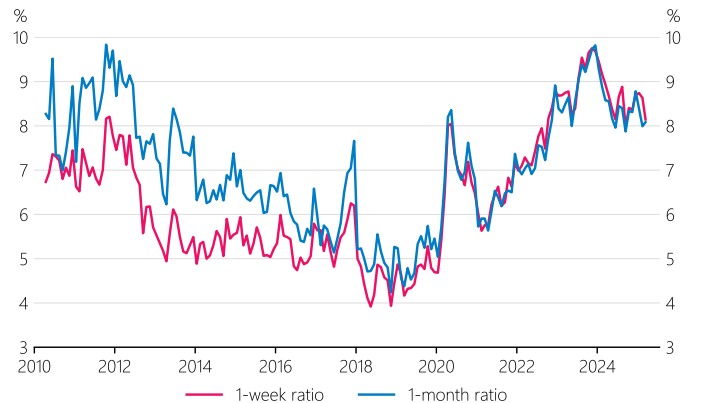
Source: RBNZ Income Statement survey.

Figure 4.5
Bank operating expense ratios



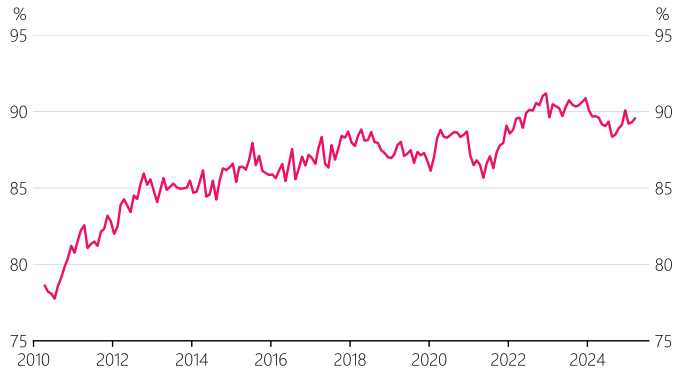
Source: RBNZ Income Statement survey.

Figure 4.6
Bank liquidity mismatch ratios



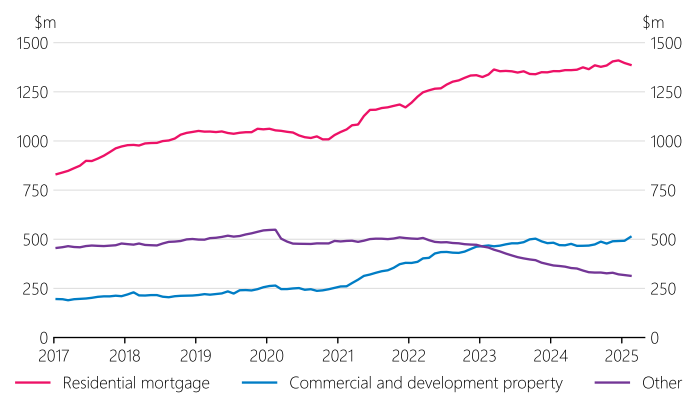
Source: RBNZ Liquidity survey.

Figure 4.7
Bank core funding ratio



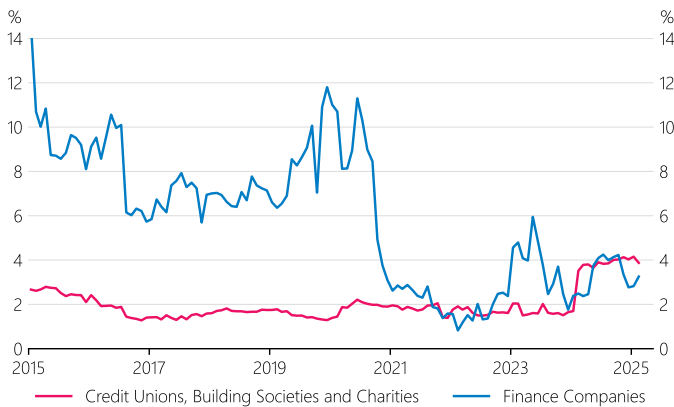
Source: RBNZ Liquidity survey.

Figure 4.8
NBDT lending by sector



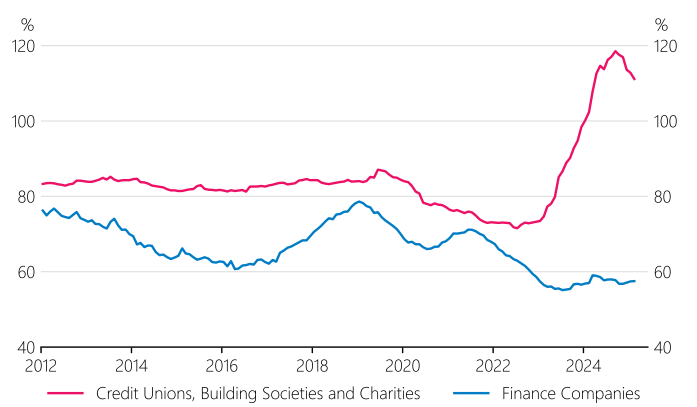
Source: RBNZ Non-bank Deposit Takers survey.

Figure 4.9
NBDT non-performing loan ratio



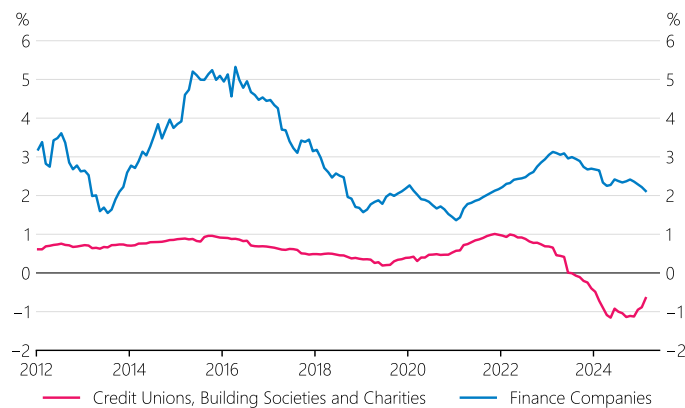
Source: RBNZ Non-bank Deposit Takers survey.

Figure 4.10
NBDT cost-to-income ratio



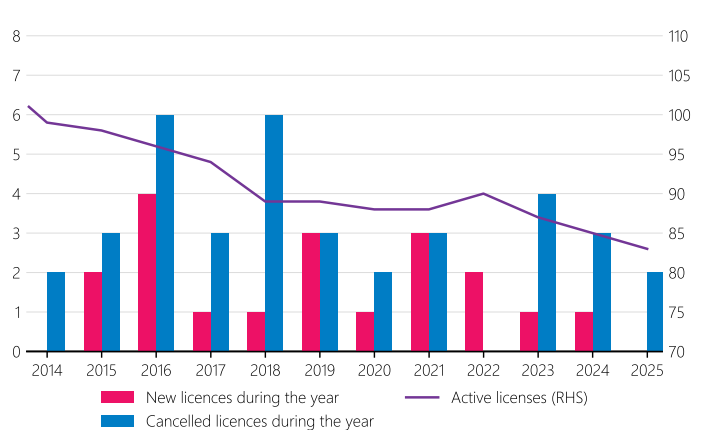
Source: RBNZ Non-bank Deposit Takers survey.

Figure 4.11
NBDT return on assets ratio



Source: RBNZ Non-bank Deposit Takers survey.

Figure 4.12
Number of licensed insurers



Source: RBNZ.

Table 4.1

Key metrics for registered banks

Metric	Value (% , end of March)					Regulatory minimum (%)	Comment
	2021	2022	2023	2024	2025		
Tier 1 capital ratio	14.7	13.7	13.8	14.3	14.8	9.5*	Capital ratios continue to increase as higher minimum regulatory requirements are phased in.
Mismatch ratio (one month) ¹	5.6	6.7	8.0	8.5	7.8	0	Mismatch ratios are trending down as the Reserve Bank reduces the amount of settlement cash in the system.
Core funding ratio	86.8	89.5	90.4	89.7	89.5	75	Banks' core funding ratios remain strong, with a backdrop of low credit growth.
Annual return on assets (after tax)	0.87	1.04	1.05	1.03	1.05		Return on assets has been stable for the past four years.
Annual return on equity (after tax)	10.6	12.3	12.4	11.8	11.5		Ongoing capital growth has been a key driver of a decrease in banks' return on equity over the last few years.
Net interest margin (quarterly, annualised)	1.91	2.02	2.30	2.34	2.34		Net interest margins have remained elevated as interest rates have declined.
Non-performing loan ratio	0.57	0.38	0.45	0.72	0.75		The non-performing loans ratio has continued to rise, reflecting softer economic conditions.
Annual credit impairment expense (% of average loans)	0.09	-0.02	0.12	0.08	0.06		Impairment expenses have been low in recent times, reflecting that banks increased their provision levels at the onset of the pandemic.
Cost-to-income ratio	44.5	40.9	38.6	40.9	41.4		Banks' operating models continue to become more efficient. Annual building occupancy costs have declined from \$560m to \$430m over the past decade.

Source: RBNZ Capital Adequacy survey, Liquidity survey, Income Statement survey, Bank Balance Sheet survey.

¹ Mismatch ratio (one month) is presented as a three-month moving average to remove short-term volatility.

* Includes the capital conservation buffer of 2.5 percent of risk-weighted assets, which banks must maintain to avoid dividend restrictions. For domestic-systemically important banks, the capital conservation buffer is 4.5 percent as at May 2025, and the regulatory minimum for their Tier 1 capital ratio is set at 11.5 percent of risk-weighted assets.

Table 4.2

Key metrics for NBDTs (for year ended December)

Metric	Segment	2020	2021	2022	2023	2024
Total assets (\$m)	Finance Companies	252	319	392	456	579
	Credit Unions, Building Societies and Charities	2,519	2,631	2,697	2,703	2,681
Total loans (\$m)	Finance Companies	187	243	318	383	459
	Credit Unions, Building Societies and Charities	1,635	1,866	1,999	1,861	1,806
Net interest margin (%)	Finance Companies	4.85	4.12	4.74	4.89	4.16
	Credit Unions, Building Societies and Charities	3.35	3.70	3.76	3.50	3.28
Capital ratio (%)	Finance Companies	17.4	16.8	17.9	19.0	17.6
	Credit Unions, Building Societies and Charities	14.2	13.1	13.3	13.8	13.5
Non-performing loan ratio (%)	Finance Companies	2.1	1.3	2.3	1.7	2.7
	Credit Unions, Building Societies and Charities	1.3	1.2	1.5	1.5	3.4
Return on assets, before tax (%)	Finance Companies	1.5	2.1	2.9	2.6	2.2
	Credit Unions, Building Societies and Charities	0.5	1.0	0.7	-0.4	-1.0
Number of entities	Finance Companies	6	6	6	6	6
	Credit Unions ¹	9	8	5	4	3
	Building Societies	3	3	3	3	3
	Charities	1	1	1	1	1

Source: RBNZ Non-bank Deposit Takers survey.

¹ Employees Credit Union merged with Steelsands Credit Union in December 2020. Firefighters Credit Union merged with Credit Union Auckland in June 2022. Westforce Credit Union, Steelsands Credit Union, Fisher & Paykel Credit Union and Credit Union Auckland merged with First Credit Union in August 2022, December 2022, October 2023 and June 2024 respectively.

