KPMG

FIPS

Financial Institutions Performance Survey
June 2020 Quarterly Results

Overview

Information current as at 18 September 2020

While the last reporting period showed the start of a dip in bank profits, we have seen this continue in the quarter ended June 2020.

This reporting period covers April, May and June 2020. Life in New Zealand changed significantly during this time as we came through the Level 4 lockdown and moved down through Alert Levels until we reached Level 1 on 8 June which meant the country was able to operate almost as usual, while still subject to strict border restrictions.

Recently we saw a move back up the Alert Levels to 3 for Auckland and 2 for the rest of the country, and then the introduction of 'Level 2.5' for Auckland. A clear indication of the constantly evolving landscape, and how quickly things can move.

The first month of the quarter, April, was a particularly quiet month as the whole country was in Level 4 lockdown for all bar three days of the month. Although the banks were considered an essential service, they were still subject to the restrictions that saw the bare minimum of service operating in New Zealand. Branches and offices were largely closed with staff working from home where possible and customers directed to non-face to face channels.

The lifting of restrictions to Level 3 on 28 April meant businesses who could operate safely were permitted to resume. However, this saw many businesses need to adapt their usual operating model to allow them to trade in a contactless way; cafes and restaurants provided takeaway meals and retail stores relied on online ordering channels.

Non-essential businesses that could operate while adhering to strict physical distancing and increased sanitation rules were able to resume closer to an old normal model.

Level 3 restrictions were lifted on 12 May and most businesses were able to operate at Level 2 albeit with continued physical distancing and hygiene protocols in place. Cafes, gyms and hairdressers could all open, but with reduced capacity to allow for the required physical distancing and limitations on group size.

Level 1 was reached on 8 June and continued until the recent outbreak and subsequent return to Level 3 in Auckland and Level 2 for the rest of the country on 12 August. During this period in Level 1, everyday life returned to relative normality for many. While the border remained closed, domestic travel was again possible. Kiwis were afforded freedom of movement unattainable in much of the world. We were able to visit cafes and restaurants, shopping malls, attend concerts and sports games, children were back at school and playgrounds were open.

However, there was an understanding that our 'normality' had fundamentally shifted and this has impacted some sectors more than others.

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Business in the travel, tourism, accommodation, retail and hospitality sectors are all having to revisit their business model to determine how they can change and adapt in order to remain as sustainable businesses. The resurgence of Covid-19 in the community and resultant raising of the Alert Levels has reinforced the need for agility and adaptability.

To counteract the loss of overseas tourists, Tourism Holdings spearheaded a campaign to encourage Kiwis to travel domestically, once it was permitted at Level 2, by deeply discounting their campervans and working with a national holiday park franchise to offer reduced rates at camping sites. The uptake was overwhelming as Kiwis looked for alternatives to travelling abroad and helped generate revenue for tourism and associated businesses around the country.

Kiwis spent $9 billion on overseas holidays in 2019. With the borders closed, there is more chance of this money being spent domestically although it is likely to be shared between a range of products such as home improvements, durable goods and cars rather than just travel.

Retail spending as a whole surged following the lifting of Level 4 restrictions with both the average card spend increasing as well as the amount spent on cars, spa pools and durable goods which includes furniture, electrical and hardware goods prompting one senior bank economist to declare that "Covid-19 saw New Zealand go hard, go early, and then go shopping."[1]

Although retail spending was down 15% overall for the quarter ended June, this was largely due to New Zealand being in Level 4 lockdown for almost the whole month of April.

There was concern that this pent-up demand would be short lived however, the Reserve Bank of New Zealand (RBNZ) estimated there were 120,000 more people in New Zealand during July due to Covid-19 travel disruptions[2] and they were spending money. Retail spending using electronic cards reached $6 billion in July 2020, up $610 million (11%) from July 2019[3].

The various lockdown phases have increased the need for retailers to be able to transact digitally as well as offering delivery or 'click and collect' options. The more recent lockdown phase saw more businesses able to adapt in order to open and transact in a contactless manner with an increased number of stores open for reduced hours for click and collect purchases for example.

The recent return to a Level 3 lockdown for Auckland followed by a hybrid Level 2.5 demonstrates that this 'normality' is constantly evolving and shifting.

Businesses need to build in the lessons and changes to their future plans rather than just waiting and hope for the best.

Businesses need to build in the lessons and changes to their future plans rather than just waiting and hope for the best. This is particularly evident in the hospitality and tourism sectors where the largest impact from having the borders closed is being felt. Holiday accommodation, for example, could be changed forever. The classic Kiwi campsite is set up to be a communal and sociable place but, even though they are permitted to open in Level 2, there will be many adjustments they need to make to adhere to the required restrictions. Designs for new hotels usually centre around the lobby or bar area to encourage congregation but plans now need to factor in the possibility of being able to isolate sections of their facilities, either to enable operation as an isolation hotel or to cater for multiple but separate groups at once.

Office buildings that were designed to encourage employee contact and communication are no longer fit for purpose. Offices of the future are likely to have features that discourage contact through staggered hours, wider corridors and screening[4]. The way that we live and work has profoundly shifted. Employees who can work from home need the space to do so which may mean moving further out of cities to more affordable areas. If employees are only travelling into the office once or twice a week then they are more likely to consider living somewhere with a longer commute.

RESET

The recent return up through Alert Levels and back down again show that this is not a situation that we can draw a line under and move on.

KPMG New Zealand's recent *CEO Outlook Pulse-check*[5] finds New Zealand's chief executives using this unparalleled moment in history to lead with increased purpose and impact, both societal and economic. 80% of New Zealand CEOs said their purpose provides a clear framework for making quick and effective Covid-19 related decisions and 72% of New Zealand CEOs said their purpose is helping them drive actions to address the needs of their stakeholders.

Businesses have the opportunity and need to reset, but it needs to be done in an agile and adaptive way. The 'new reality' involves constant change and flexibility. Businesses need to revisit what they want to achieve and who their customers are to ensure that decisions are made to enable a sustainable future rather than desperately trying to return to how things were last year.

Businesses who have a strong sense of purpose and understanding of their 'why' are able to use this as a framework for both short-term and long-term decision making.

The pandemic and the subsequent economic crisis have fundamentally impacted consumer behaviour as a whole. While many have been negatively financially impacted, there are also those who have benefited from spending less during lockdown periods.

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The recent KPMG Global *Consumers and the new reality report*[6] shows that consumers are increasingly purchasing from organisations that they trust, expecting value for money and more likely to interact through digital channels. This is largely good news for the banks. Globally, the KPMG report shows that most consumers trust their own bank at least as much as they did pre-Covid-19 (96%) with 15% showing an increase in trust. New Zealand banks are generally viewed as trusted institutions and this is enhanced by the RBNZ's consistent messaging about the strength of our banking system and integrity of the banks operating here.

The banks have been encouraging their consumers to use digital or contactless channels and some have developed specific assistance for those who might find the new changes a challenge, for example, the elderly.

Like many other businesses, banks also have to adapt to how they conduct business and diversify their revenue streams.

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With the RBNZ indicating that negative interest rates are imminent[7], New Zealand banks are having to review their revenue streams and streamline their processes as their margins are likely to be squeezed further. However, this is not solely a result of Covid-19. KPMG Australia notes that the Australasian banks' "long run of profit performance was already coming to an end due to a combination of lower credit growth and (in a lower interest rate environment) shrinking net interest margins. The Covid-19 crisis has drastically accelerated the speed of this 'profit pivot'."[8] The European and American banks have been operating in a more challenging environment since the Global Financial Crisis of 2008/9 so have been more focused on improving productivity and reducing costs through initiatives such as branch network rationalisation and product range simplification.

Branch network rationalisation

Lockdown demonstrated that physical branches weren't necessary all of the time. Customers were strongly encouraged to use digital or other contactless channels. This has encouraged banks to review their branch network and it has resulted in some recent branch closures. ASB, for example, has announced that nine branches in main cities will be closed permanently and a further 25 will operate reduced hours[9]. ASB cited an increase in people using online and mobile services and committed to no staff losses as a result of the closures.

The disruption that has been caused by Covid-19 has accelerated the move to digital platforms and a reduction in cash as more customers are comfortable transacting in a 'contactless' way. While face to face contact is still preferred by many when dealing with large or particularly personal transactions like mortgages or investment decisions, some have found that video calls enable customers to feel comfortable in their own home while not having to physically invite someone else into their 'personal space'. Having the ability to be flexible with the customers' requirements is vital.

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The banks are conscious of the role they play in communities and perhaps this is behind ASB's decision to reduce the number of days some branches are open rather than close them completely or amalgamate them. There is a lot of pressure on 'the last bank standing' in rural areas where they can provide a reason for people to visit, creating potential foot traffic for other local businesses or the excuse for someone to leave the house and interact with others. Could we see more shared space in rural communities where banks get together in a 'banking hub' or share spaces with cafes or art galleries? The New Zealand Bankers Association, together with six banks, was due to start a pilot of banking hubs[10] in four small town locations in May/June, but this has been pushed out until November due to the Covid-19 related restrictions. BNZ CEO, Angie Mentis confirmed that new branches will be "more of a shared space and a place for [their] customers to visit for support."[11]

Product simplification and innovation

Many banks are currently looking at streamlining their product portfolios. One benefit of this is cost reduction, by removing under-performing or inefficient products banks can save on costly legacy processes and architecture.

Increasing regulatory and customer expectations of simple, clear products and easy to understand pricing has driven a review of banks' product suites. Fees have been under the spotlight over the past few years and there is more transparency about how they are priced and applied.

Recent examples of product range simplification include ANZ announcing the closure of their Bonus Bonds and Kiwibank closing its Loaded for Travel card[12].

Covid-19 has seen customers' circumstances changing and banks need to respond by innovating and developing new products to assist. To reflect the reality that many older or immunocompromised people find themselves relying on other people to do their shopping or errands during lockdown periods. Starling Bank, a UK digital bank, has launched the Connected card. This is an additional debit card on a customer's current account that is designed to be given to someone trusted to buy things on their behalf without giving them full access to the account. This provides flexibility and removes the reliance on cash as well as reduces the risks associated with sharing debit cards and PINs.

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Contactless payments have increased in popularity as a result of the Covid-19 pandemic and the banks have increased the Paywave limit from $80 to $200 to enable more purchases to be made this way. The major banks all support Apple and Google Pay which enables contactless payments to be made using a smartphone. Although the more recent iPhones use facial recognition technology which can cope with sunglasses and caps, the software struggles with people wearing masks.

Masks have also posed an issue for the banks as traditionally they require customers to remove any face coverings such as helmets or sunglasses. With the health advice increasingly in favour of mask-wearing, this is a challenge that is not going away.

Conduct and culture

Other themes that existed before Covid-19 have not disappeared, but may have altered over the past few months.

The focus on conduct and culture is still very strong.

The Council of Financial Regulators – RBNZ, The Financial Markets Authority (FMA), The Commerce Commission, The Ministry of Business Innovation and Employment and The Treasury – released an article entitled *The financial sector and responsible behaviour* on 19 April[13] which stated that they "expect and encourage responsibility among the institutions [they] regulate, and the businesses that form our economy to support customers and future generations of New Zealanders."

The RBNZ has repeatedly made it clear that it expects the banks to use their strong balance sheets to continue lending to individual and business customers. The banks need to ensure that they are focusing on the right customer outcomes rather than just good customer experience.

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Ross McEwan, CEO of National Australia Bank (parent of BNZ), feels that the lessons learnt in the UK after the Global Financial Crisis are a good reminder to keep the customer at the heart of the business and that good customer service is not mutually exclusive to declining an application for further lending for example.

"Sometimes being here for a customer is saying 'no.' And I keep reinforcing that with my bankers because sometimes the best answer for a customer is 'no' because they will struggle to pay it back. And if that's the case we shouldn't put them in that position."[14]

UK financial services regulation is increasingly focused on improving customer outcomes. Some of the papers or initiatives focus on the short-term in response to the impacts of the current economic crisis, while others are continuing with their longer-term focus. As highlighted by the recent KPMG *UK Regulatory Radar*[15], they broadly fall into three categories:

- Remediate customer detriment
- Positively mitigate customer harm
- Improve financial education and awareness.

While we have not seen the same amount of regulation here, there is no doubt that the New Zealand regulators are keeping a close eye on what the banks are doing in the first two categories.

Some banks are focused on identifying and remediating past issues or errors while some are more active in ensuring that they are proactively designing processes to ensure good customer outcomes going forward.

The impacts of Covid-19 are changing our definition of vulnerable customers and banks are having to adapt some of their policies and processes. (See page 27 for more commentary on vulnerable customers).

The impacts of Covid-19 are changing our definition of vulnerable customers.

The Government has extended the original Wage Subsidy programme and introduced a Resurgence Wage Subsidy as a result of the recent lockdown period. As at 11 September, nearly 217,000 jobs were being supported by the Wage Subsidy[16] and 12.1% of the estimated New Zealand working-age population was receiving a main benefit.

RBNZ data shows that while requests for mortgage payment deferrals and transfers onto 'interest only' had been steadily declining over the past couple of months, there was an increase following the recent lockdown period[17]. (See Figure 2 on page 13.)

Inland Revenue figures show that the number of people accessing their KiwiSaver funds under the significant financial hardship category in July 2020 increased by 24% from July 2019, illustrating that more and more people are running out of other options[18].

We expect to continue to see an increase in bank customers requiring assistance when the wage subsidy schemes come to an end.

In a move which further highlights the increasing desire for transparency and accountability, the Banking Ombudsman has introduced a banking sector complaints dashboard[19] where customers can review which products and services attract the most complaints and how banks are performing in responding to the complaints. It also hopes that the banks will find it valuable to see any trends or themes and be able to use them to improve their products and services.

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The RBNZ continues to make it very clear that it expects the banks to play a major part in how New Zealand deals with the current economic crisis stating, "This is the time for banks to repay the faith that financial regulators and the Government have placed in their hands and step up to the plate. We look forward to them delivering lending and other affordable long-term customer-focused solutions to ensure New Zealand returns to a vibrant and dynamic business community. We will continue to encourage and support these activities, and expect transparent reporting around the success of their actions."[20]

Quarterly analysis of results

As expected, the quarter ended June 2020 has seen a decline in overall bank profits (13.25%). The rise we saw in non-interest income last quarter has swung back again. Banks' net interest margin continues to be compressed and with the likelihood of negative interest rates by next year, this is unlikely to improve.

As expected there has been a continued significant increase in provisioning levels. (See additional commentary on pages 16–21.)

Figure 5 on page 15 shows us that from January 2014 to June 2019, provisioning levels remained between $1.3 billion and $1.6 billion, growing broadly in accordance with the growth in banks' lending portfolios. The economic impact of Covid-19 has seen this level explode to $2.5 billion over the last two quarters and it is still unclear how much further it will continue to rise.

While there have been several recent reports showing that the current impact of the economy has not been as bad as initially thought so far in New Zealand, the continued effects on the global economy means that the medium-long term outlook is less positive.

The recent GDP figures show that while the economic impact has been 'less severe than anticipated' so far it has still resulted in the worst quarterly fall New Zealand has ever seen.

The long-term impact of Covid-19 on our lives, homes and businesses is only just beginning. The ability to flex and adapt will be crucial as we reset to our new reality.

How banks can stay on top of changing cyber-crime patterns

Philip Whitmore
Partner – Cyber Security Services
KPMG

Philip is a Partner in our Cyber Security Services practice with over 25 years' hands-on experience helping organisations manage their cyber security risks. He has worked extensively in the financial services sector, including with a range of banks.

In a year where we are constantly being disrupted, the recent upswing in cyber-attacks on New Zealand organisations reminds us that we need to be ever vigilant of cyber security.

Ransomware isn't going anywhere

We've seen a move in New Zealand and overseas towards more creative ways of extorting ransoms. These include 'double extortion,' where ransomware encrypts your data and forces you to pay a ransom in order to get it back and then sends your data to a threat actor, who threatens to release your sensitive data unless a further ransom is paid. The amounts being demanded are rapidly increasing too, with seven figure sums increasingly becoming common.

In addition, criminal groups have been increasingly switching to Covid-19 themed lures for phishing, exploiting bank's consumers' and employees' concerns over the pandemic and the safety of their loved ones.

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There is also evidence that remote working increases the risk of a successful ransomware attack significantly. This increase is due to a combination of weaker controls on home information technology (IT) systems and a higher likelihood of users clicking on Covid-19 themed ransomware lure emails given levels of anxiety.

Access controls are more critical than ever

Multi-factor authentication is essential for remote access to enterprise IT systems. Also, consider conditional access/Cloud Access Security Broker (CASB) solutions which allow you to limit access to your enterprise systems to those corporate devices or Bring Your Own Device (BYOD) with an endpoint or mobile device management solution in place. Strong passwords or passcodes are also important for end-user devices.

Ideally, banks should encourage staff to separate their personal and work activities using different devices, unless banks are forced to adopt BYOD solutions.

In addition to remote access, multi-factor authentication should be in place for all privileged access. However, banks should also ensure that delegates are in place and where necessary backup or 'break glass' arrangements are made if key individuals are not available. Don't just assume a single delegate is sufficient.

Put your security operations on guard

Threat groups are exploiting the enormous workload on IT and security teams, and are launching enterprise-level ransomware attacks, crypto-mining operations and denial of service attacks (for example, as was seen with the recent Distributed Denial of Service (DDoS) attacks that impacted the NZX and others). Now more than ever, the ability to rapidly detect and response to cyber threats is important.

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Ensure adequate IT staffing and that staff members are well-practiced in handling attacks, including whilst working remotely.

For events that escalate, ensure that banks have back up communications systems for incident response teams. Most importantly, ensure that banks have deputies for key personnel in business continuity and crisis management teams, in case team members fall ill, are unavailable due to travel restrictions or have problems with network provider capacity.

Ensuring privacy compliance

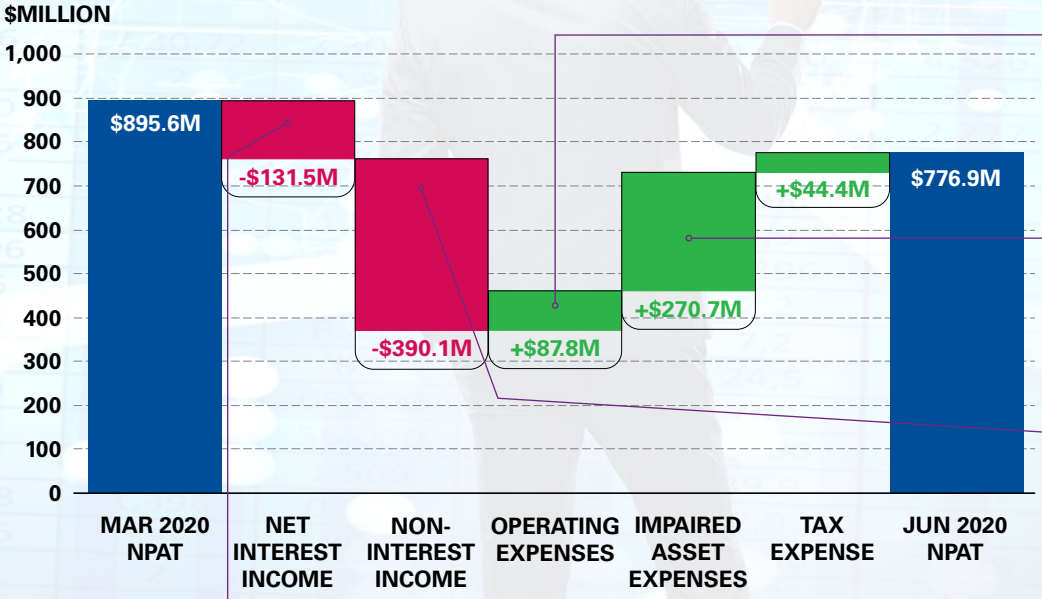
The Covid-19 pandemic has required businesses to rapidly adapt their working models, sometimes at the cost of privacy rights. With the new Privacy Act coming into place on 1 December this year, now is a good time to think about what practical steps banks should be taking to address any deficit in either systems of methodology and seek to ensure privacy compliance.

Net profit after tax

Movement in net profit

13.25%

to $776.9 million



Net interest income

5.02%

to $2,488.2 million

TABLE 1: Movement in interest margin

	30 Jun 20 quarter ended (%)	Mvmt. during the quarter (bps)	Mvmt. for the 6 months (bps)	Mvmt. for the 12 months (bps)
ANZ	1.90	-20	-20	-30
ASB	1.80	-20	-10	-20
BNZ	2.00	-10	-10	-10
Heartland Bank	4.60	10	10	10
Kiwibank	1.90	-10	0	-20
SBS Bank	2.40	-10	-10	-10
TSB Bank	1.60	-20	-20	-20
The Co-operative Bank	2.20	0	0	0
Westpac	1.70	-20	-20	-40

Operating expenses

5.55%

down $87.8 million

Driven by

ASB	$56.9M
BNZ	-$148.4M

Non-interest income

40.9%

down $390.4 million

Driven by

ANZ	$223.3M
Westpac	$74.0M
BNZ	$67.5M

Impaired asset expenses

36.1%

down $270.7 million

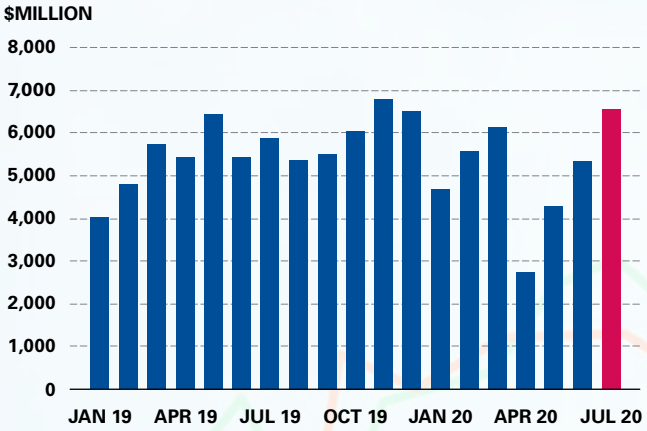
Driven by

ANZ	$137.4M
Westpac	$71.4M

Lending

Loans	0.28% to $445,670 million
Quarterly	
Kiwibank	1.51%
Heartland	-1.98%
Year on year	
Kiwibank	8.88%
Westpac	5.02%

1 TOTAL MONTHLY MORTGAGE LENDING



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

TABLE 2: Analysis of gross loans

Quarterly analysis	30 Jun 20 quarter ended $Million	31 Mar 20 quarter ended $Million	% Increase (Quarterly)	Annual analysis	30 Jun 20 quarter ended $Million	30 Jun 19 quarter ended $Million	% Increase (Annual)
ANZ	136,292	136,324	-0.02%	ANZ	136,292	133,295	2.25%
ASB	88,842	90,068	0.09%	ASB	88,842	87,519	1.51%
BNZ	93,906	93,819	-1.36%	BNZ	93,906	90,828	3.39%
Heartland Bank	3,719	3,794	-1.98%	Heartland Bank	3,719	3,649	1.91%
Kiwibank	22,384	22,052	1.51%	Kiwibank	22,384	20,558	8.88%
SBS Bank	4,133	4,190	-1.36%	SBS Bank	4,133	4,056	1.89%
TSB Bank	6,157	6,174	-0.28%	TSB Bank	6,157	6,040	1.94%
The Co-operative Bank	2,563	2,571	-0.31%	The Co-operative Bank	2,563	2,486	3.10%
Westpac	87,675	87,931	-0.29%	Westpac	87,675	83,483	5.02%
Total	**445,670**	**446,922**	**-0.28%**	**Total**	**445,670**	**431,914**	**3.18%**

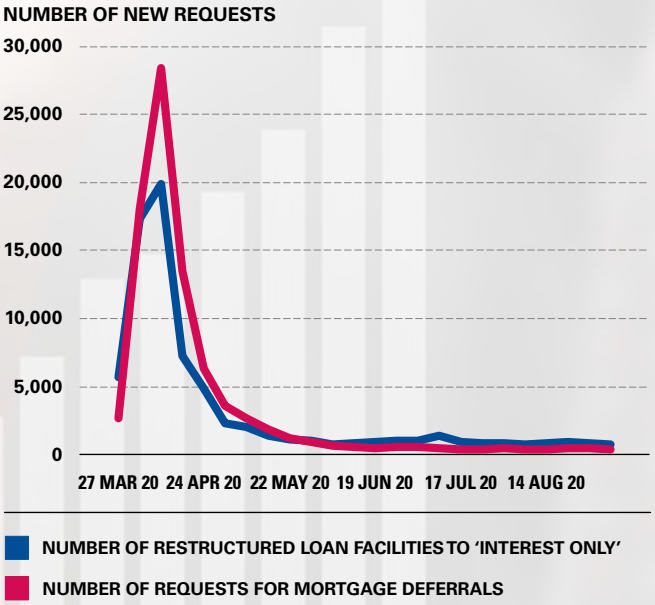
As expected, lending was down over the quarter ended June 2020. This was largely as a result of Level 4 lockdown in April.

The RBNZ removed the loan to value ratio (LVR) restrictions in April 2020 with the intention of encouraging more first-time buyers to enter the housing market. Figures from July suggest that this had the desired effect with lending at it's highest July level since 2013. This was largely driven by first-time buyers and investors, each 30% higher than July 2019.

Kiwibank made a bold statement by cutting it's floating mortgage rate to 3.40% in June but so far, none of the other major banks have chosen to follow suit.

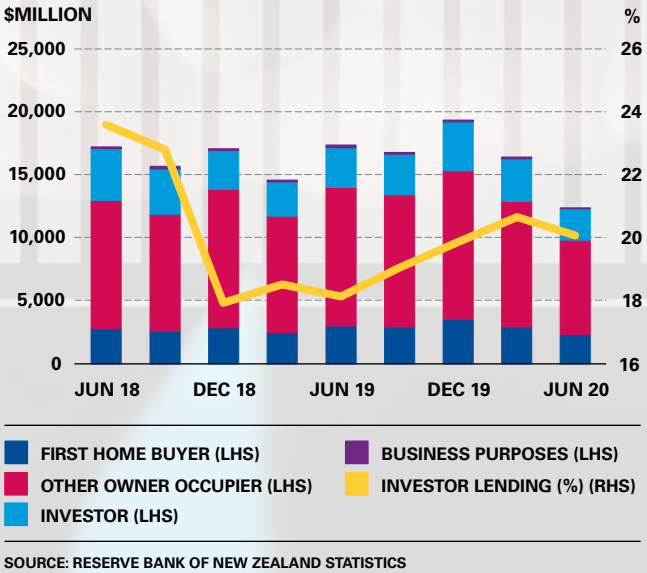
Economists are predicting that mortgage rates will fall below 2% within the next year.

2 NUMBER OF NEW REQUESTS FOR RESTRUCTURED LOANS OR MORTGAGE DEFERRALS



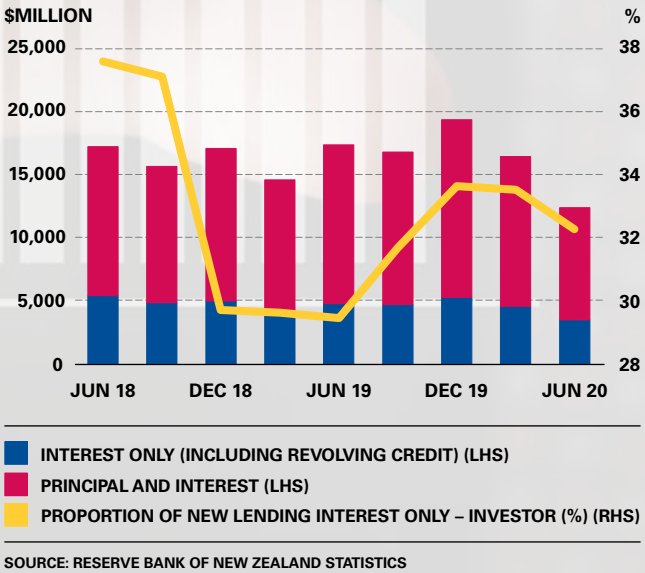
SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

3 NEW MORTGAGE LENDING BY BORROWER TYPE



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

4 NEW MORTGAGE LENDING BY PAYMENT TYPE



SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

Asset quality

Individually assessed provisions

41.11%

up $171.3 million

Driven by

ASB $89.3M

BNZ $66.5M

The 30 June 2020 results show a continued increase in the level of impairment provisions which is being driven by the significant economic uncertainty that persists. The diversity and volatility of loan loss provisions is increasingly requiring oversight from senior management and board committees as existing models used to forecast defaults require additional context and information to give an accurate picture.

Banks will need to focus on their credit strategy to adapt to this 'new reality' credit environment.

Loan defaults are still relatively low but we won't see the true impact unfold until the mortgage deferrals, wage subsidies and various government support packages come to an end.

For a more in-depth look at the challenges of forward-looking provisions, please see pages 16–21.

Collectively assessed provisions

10.49%

up $235.8 million

Driven by

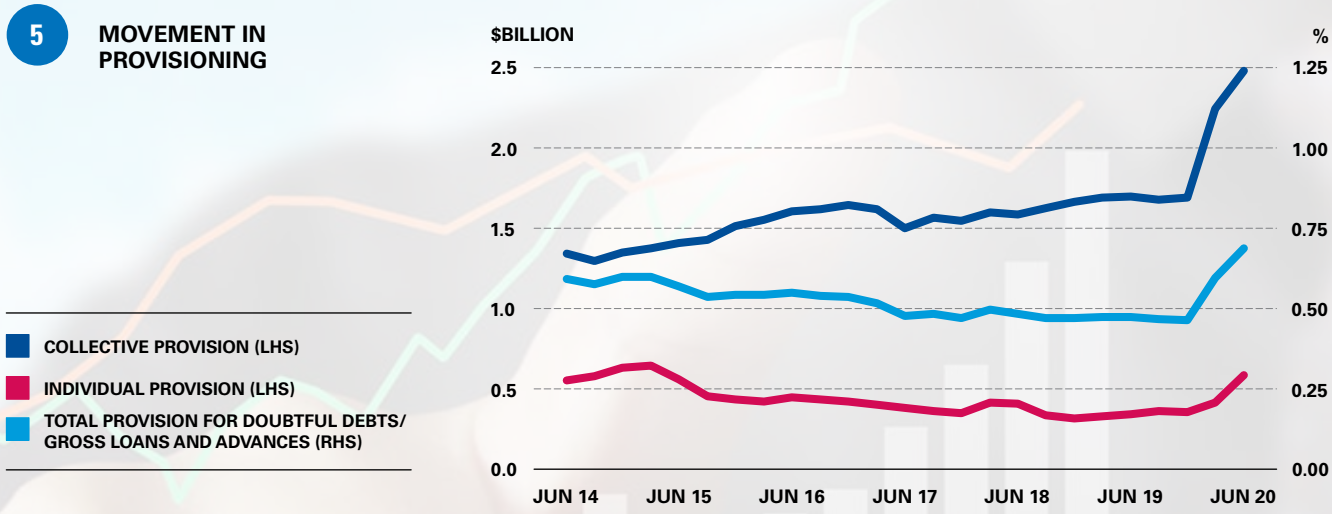
Westpac $113.8M

ASB $38.4M

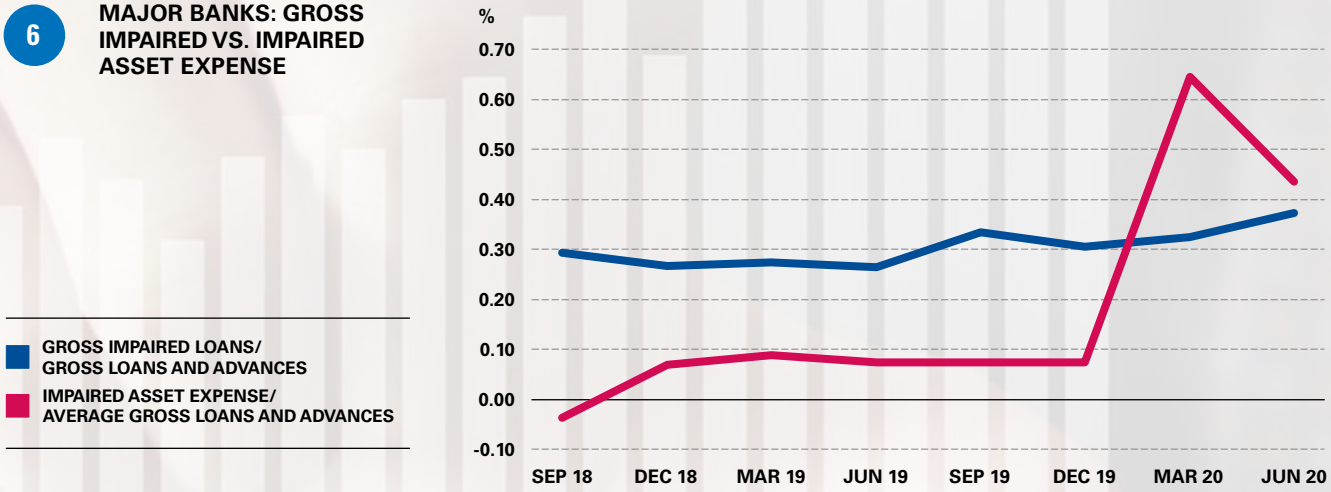
TABLE 3: Movement in impaired asset expense/ Average gross loans

	30 Jun 20 quarter ended (%)	Movement during the quarter (bps)	Movement for the 12 months (bps)
ANZ	0.23%	-41	16
ASB	0.59%	-6	45
BNZ	0.46%	-7	34
Heartland Bank	0.43%	-26	5
Kiwibank	0.56%	28	48
SBS Bank	0.39%	-205	10
TSB Bank	-0.01%	-130	5
The Co-operative Bank	0.12%	-91	-1
Westpac	0.54%	-33	57
Average	**0.43%**	**-24**	**35**

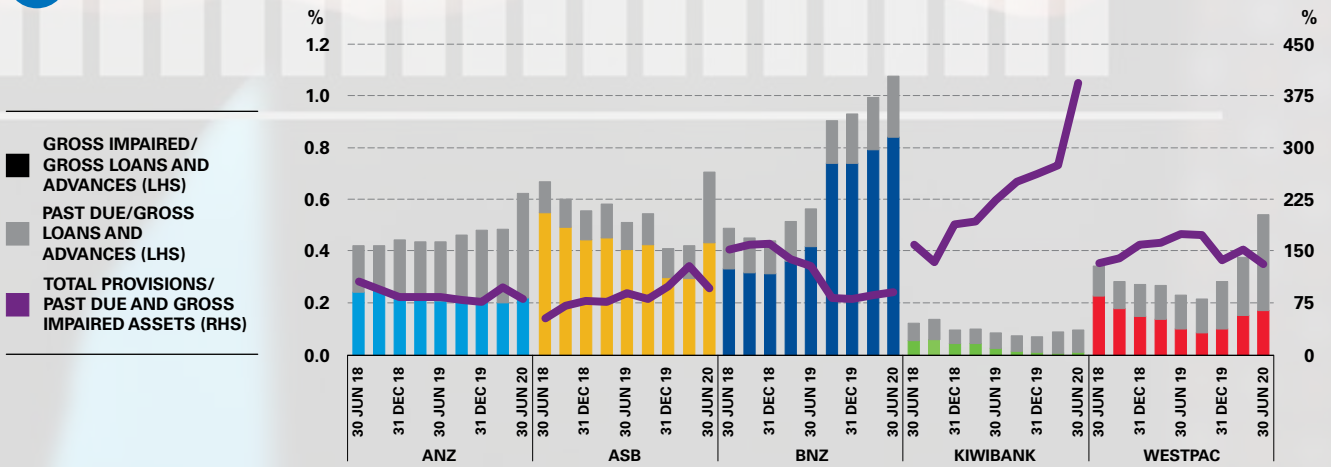
5 MOVEMENT IN PROVISIONING



6 MAJOR BANKS: GROSS IMPAIRED VS. IMPAIRED ASSET EXPENSE



7 MAJOR BANKS: PAST DUE AND GROSS IMPAIRED ASSETS VS. GROSS LOANS AND ADVANCES



IFRS 9: The challenges of forward-looking provisions

Rajesh Megchiani
Partner – Risk Consulting
KPMG

Rajesh leads the team at KPMG that provides financial risk management advice. Rajesh's team advises clients on prudential regulations, market risk, credit risk and liquidity risk. He also has significant experience assessing bank compliance with the Reserve Bank of New Zealand's (RBNZ) capital adequacy framework.

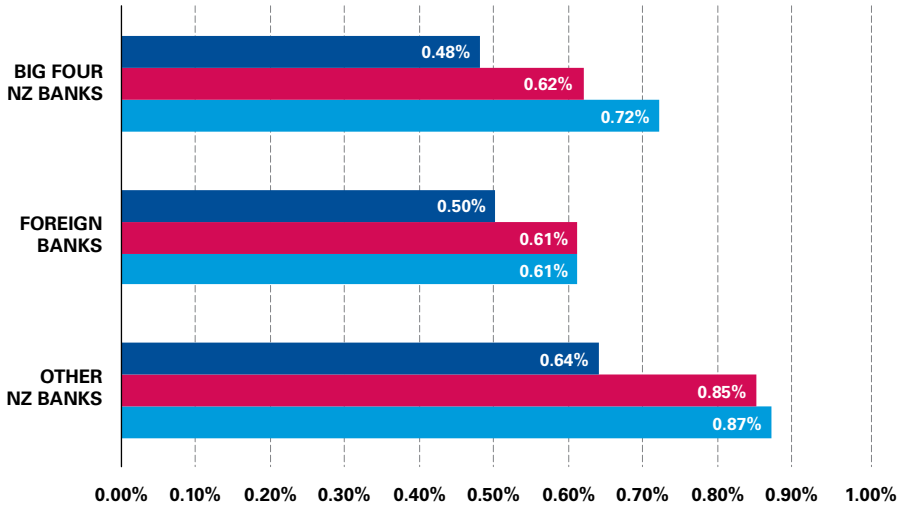
Dhayaparan Raman
Senior Manager – Risk Consulting
KPMG

Dhayaparan is a quantitative risk consultant with valuable experience in New Zealand International Financial Reporting Standard (NZ IFRS) 9 *Financial Instruments* provisioning and credit risk models, statistical analyses tools, and financial services' prudential guidelines. He has worked closely with several large New Zealand and regional Asian banks with respect to NZ IFRS 9, and credit risk model support specifically on model development, model validation, and model systemisations.

The economic consequences of the Covid-19 pandemic have largely been cushioned by support provided by governments and central banks around the world. However, it is certain that Covid-19 will have a considerable impact on economies due to interruptions in the global supply chains, loss of revenue for businesses and layoffs due to falling consumer spending. All of this is likely to result in an increase in consumer and corporate loan defaults and put pressure on loan recoverability.

New Zealand has fared reasonably well so far, with stronger economic activity than anticipated at the onset of the Covid-19 pandemic. However, given the potential of recurring lockdowns and the interlinkages with the global economy there is continued pressure on consumers and businesses. Given this, the impact on losses that the financial services sector in particular will experience is still unpredictable. This uncertainty will undoubtedly have a wide-ranging impact on how forward-looking estimations of expected credit losses (ECL) are made under NZ IFRS 9.

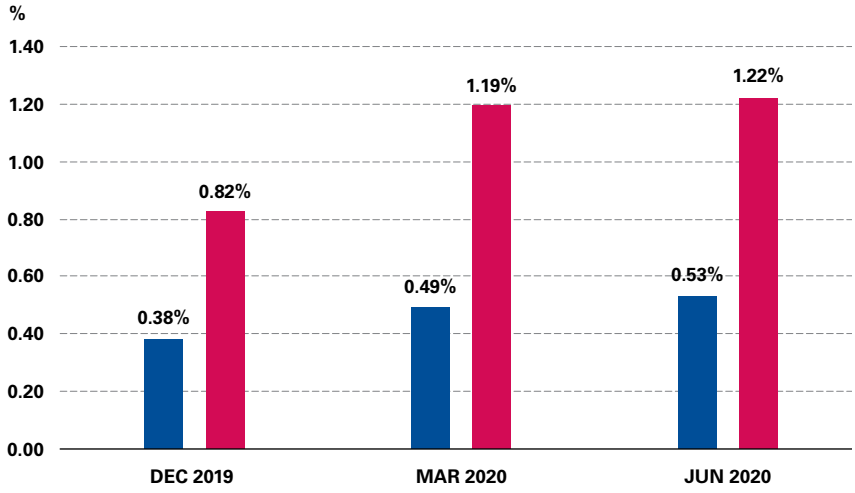
8 INCREASE IN COVERAGE RATIO ACROSS ALL NEW ZEALAND BANKS



DEC 2019
MAR 2020
JUN 2020

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

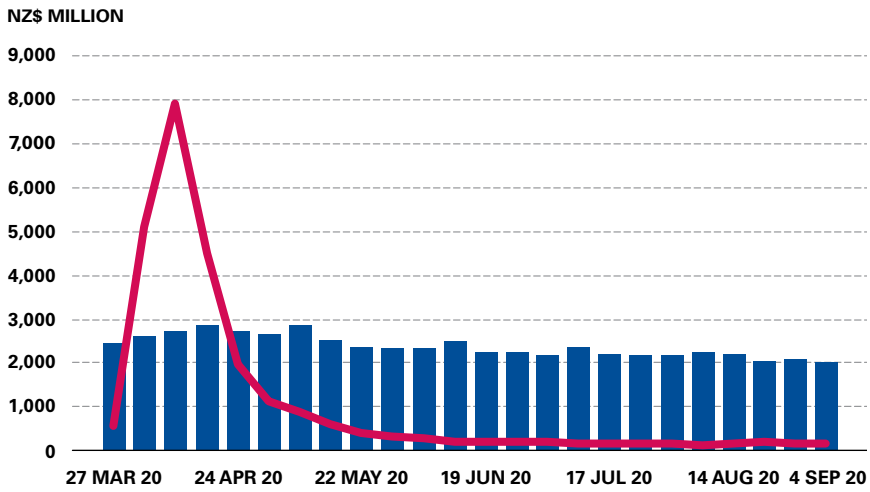
9 INCREASE IN COVERAGE RATIO FOR RETAIL AND WHOLESALE LOAN PORTFOLIOS



AVERAGE OF COVERAGE RATIO (RETAIL)
AVERAGE OF COVERAGE RATIO (WHOLESALE)

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

10 MORTGAGE DEFERRALS REQUESTS VS. MORTGAGE MISSED PAYMENTS



HOUSING LOANS – MISSED PAYMENTS
HOUSING LOANS – REQUESTS FOR MORTGAGE DEFERRALS

SOURCE: RBNZ BANK CUSTOMER LENDING FLOWS (C65)

Three key messages

1. While provisioning is increasing, mortgage deferrals, wage subsidies and other support packages are 'shielding' the true impact being realised.
2. Continued economic uncertainty means traditional forecast models require additional input and considerations in order to provide a more accurate picture.
3. There is an increasing expectation for detailed disclosure by the financial services sector regulatory bodies.

Provisions, provisions, and provisions

In this uncertain environment, most financial institutions face a tough question ahead of them, "*How much loan loss provision is enough?*". As financial institutions release periodic disclosure statements, there has been consistent commentary relating to how the financial performance has been impacted by loan impairment expenses. Interestingly, and rightly so, for most of the large financial institutions, the increase in loan loss provisions stems from the dim outlook of the future economic conditions rather than the actual deterioration of credit quality or the quantum of delinquent customers. The real challenge is the diversity and rapid change in the expectation of the various economic forecasts and its potential impact on credit portfolios.

Based on the latest RBNZ Dashboard[21], we can observe a significant increase in impairment expense compared to previous years as management attempts to quantify the impacts of the Covid-19 pandemic together with unknown future economic conditions on their loan portfolios and consequently the level of provisions held. In the first quarterly Dashboard results (March 2020) since the start of the pandemic, financial institutions have significantly raised the level of provisions. Despite the hard start, these institutions have continued to increase the level of provisions reflecting the uncertainties ahead of them. The table below shows the total impaired asset expenses recorded in the most recent quarter results in comparison with prior quarters' average for all New Zealand registered banks.

IMPAIRED ASSET EXPENSES BY QUARTERLY RESULTS

June 2020	$472.4 million	5.6x increase from 2018-19 quarterly average
March 2020	$769.2 million	9.1x increase from 2018-19 quarterly average
2018-2019	$84.7 million Quarterly average	

An analysis of the quarterly coverage ratio[22] equally shows an upward trend of provisions for the majority of New Zealand registered banks. In a benign environment (such as pre-Covid-19), the expectation is that the coverage ratio movement between quarters would be very minimal or similar to the previous quarter. Even irregular movements can usually be explained and often relate to either expedited portfolio growth or release of large troublesome exposures. Conversely, in this new environment where decisions are changing and evolving rapidly, ECLs (or loan loss provisions) become more and more point-in-time to reflect the outlook of the future economic conditions. In an unexpected manner, this aligns somewhat seamlessly with the underlying principles of the NZ IFRS 9 accounting standard which requires ECL to be an unbiased probability-weighted amount by analysing a range of outcomes using past events, current conditions and a forecast of future economic conditions.

INCREASE IN COVERAGE RATIO BY QUARTERLY RESULTS

June 2020	0.73%	35% increase from 2018-19 quarterly average
March 2020	0.69%	28% increase from 2018-19 quarterly average
2018-2019	0.54% Quarterly average	

The coverage ratio of the retail portfolios (comprising of Housing Loans and Consumer Loans) in the recent quarter results have not increased as much as the Wholesale portfolio, largely due to the wage subsidies and various deferral programmes, which have kept retail delinquency levels relatively stable. For Wholesale exposures (Business,

Agri and Other Loans), typically there is more information in relation to the borrower, such as industry sector or financial performance, which would refresh the credit worthiness of the borrowers in a pandemic environment and eventually resulting in an increased provision amount.

Whilst movements of average coverage ratios can be seen to be intuitively driven by the impacts of the pandemic, some individual bank's provisioning levels appear to fail to reflect the true effects of the pandemic. This may be partly due to some financial institutions' internal processes and effort focused on the precision of the associated quarterly reporting metrics. Financial institutions typically give more attention to year-end and half-year financial reporting compared to other quarterly reporting periods (i.e. Q1 and Q3) so we would expect information coinciding with these half-year and year-end reporting periods to be more accurate compared to the other quarters. Given the rapidly changing economic environment and resulting impact on credit exposures, there is an increased expectation to provide up to date information for the RBNZ quarterly Dashboard. Banks may need to enhance their quarter-end reporting with respect to provisioning, particularly for Q1 and Q3.

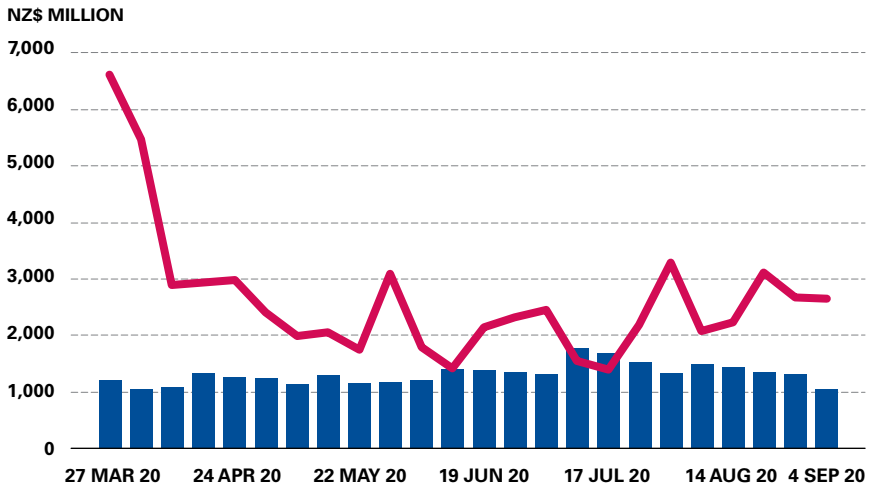
Government's response to the pandemic

From the onset, the New Zealand Government played an instrumental role in supporting the stability of the wider economy by introducing the mortgage deferral scheme to release some pressure from mortgage borrowers. The financial institutions have agreed to an initial six-month moratorium period of both, principal and interest, for mortgage borrowers to aid customers who have been financially affected by the Covid-19 pandemic. This has been extended to 31 March 2021. As a result of this arrangement, for capital purposes, financial institutions will not have to treat these borrowers as defaulted customers, which would usually entail harsher capital requirements.

The New Zealand Government played an instrumental role in supporting the stability of the wider economy by introducing the mortgage deferral scheme to release some pressure from mortgage borrowers.

Conversely, the implications of the mortgage deferral scheme require further considerations from a loan loss provision perspective. Financial institutions may have previously adopted an approach of classifying similar payment holidays and other factors (e.g. watchlist) as a qualitative indicator that automatically required an exposure be treated as Stage 2 (an exposure with significant increase in credit risk (SICR) since origination). However, as the International Accounting Standards Board (IASB)[23] has stated in the context of Covid-19, the extension of any payment holidays to all borrowers in specific portfolios should not automatically result in all exposures being considered to have suffered an SICR. Likewise, a financial institution cannot assume that all exposures subject to the deferral scheme should be treated as Stage 1 (performing loan or less than 30 days past due). Financial institutions have experienced that a number of these loan deferrals normalise since the original deferral was requested and should consider this as part of its assessment.

11 **BUSINESS RESTRUCTURED LOANS VS. BUSINESS MISSED PAYMENTS**



BUSINESS LOANS – MISSED PAYMENTS

BUSINESS LOANS – RESTRUCTURED LOAN FACILITIES

SOURCE: RBNZ BANK CUSTOMER LENDING FLOWS (C65)

Beyond the deferral schemes, financial institutions with exposures from certain types of customers, industries, or regions may also be an indicative of having a Stage 2 exposure. For example, it would be reasonable to assume that the borrowers from the hospitality, travel or the arts and recreation industries may be more severely affected during this pandemic and hence require lifetime provision calculations.

Figures 10 and 11 on pages 17 and 19 show that the effects of the various support packages from the Government and financial institutions have kept the quantum of missed payments for mortgage and business loans almost constant since the onset of the Covid-19 pandemic.

Separately, the Government had also introduced the Business Finance Guarantee Scheme (BFGS) to help small and medium enterprises (SMEs) whose business income have been affected by economic disruption and slowdown during the lockdown period to obtain additional credit. The initial BFGS scheme was expected to offer $6.25 billion loans to New Zealand SME businesses. Whilst the premise of the BFGS was appealing to the financial institutions (where the Government assumes 80% of the risk and participating banks[24] absorb the remaining 20%), the take up rate of these loans has been particularly slow after the first three months.

Due to the slow take up of the initial BFGS scheme (approximately 2.4% of the expected $6.25 billion) the Government has now offered to relax and broaden the conditions imposed on prospective borrowers under the new scheme (BFGS 2.0). Some of them include, allowing restructured loans, larger businesses with annual revenue up to $5 million, increased limits of up to $5 million and loan purposes beyond normal business cash flows.

In addition, the Government through Callaghan Innovation[25] announced a Covid-19 $150 million Research and Development (R&D) loan scheme. This scheme is targeted at businesses with R&D funding impacted due to a shift of business focus for more critical, short-term needs. Unlike the BFGS, the R&D loan scheme is in high demand and is currently at capacity with some businesses placed on a wait-list.

In supporting the economy further, a recent announcement suggests that the current Government (through the Inland Revenue) is planning to extend the Covid-19 Small Business Cashflow (Loan) Scheme (SBCS) for another three years compared to the current deadline of 31 December 2023. This would allow eligible small to medium businesses going through financial difficulties to apply for unsecured loans under this scheme to dampen the impacts of the pandemic within their businesses.

A 'crystal ball' is what we need

The Covid-19 pandemic has also had a significant impact on the forward-looking aspects of the NZ IFRS 9 provision allowances requirements. A typical IFRS 9 forward-looking model employs simple statistical approaches (e.g. regression) to derive links between changes in economic conditions and historical customer behaviour through default experience or losses experienced. One of the fundamental problems faced by most New Zealand based financial institutions is that these models were built using historical internal data largely from a benign environment. As a result, this relationship is unlikely to read across a 'shock' environment such as Covid-19. Due to the volatile contraction and expansion of the economic conditions, these models could potentially produce erroneous or extreme outputs.

The Covid-19 pandemic has also had a significant impact on the forward-looking aspects of the NZ IFRS 9 provision allowances requirements.

For this reason, post-model adjustments become a necessary step to ensure a reasonable estimate of the loan loss provision is recorded. Many financial institutions have introduced the use of overlays (or underlays) which rely on expert judgement to appropriately reflect portfolio nuances and latest available information at the reporting date. This also resonates with the guidance published by the IASB suggesting overlays or adjustments to incorporate effects of the pandemic which cannot be reflected by the existing models.

In conjunction with the forward-looking aspects of provisions, the increased uncertainty around potential future economic scenarios may require financial institutions to explicitly consider additional economic scenarios and their associated weighting when measuring ECLs. In the past, most banks would have considered at least two to three scenarios with a balanced view resulting to a probability weighted ECL which is close to the central scenario. Given Covid-19, additional scenarios might be necessary considering the future uncertainties while also giving more thoughts on the weightings for the respective scenarios. One would expect that more weighting would be given to the downside or severe scenario compared to the upside scenario. In addition, these weightings will need to be updated more frequently given the rapidly changing economic environment. This means potentially moving from a bi-yearly macroeconomic forecast update to something more frequent, quarterly or even monthly.

Way forward

Most financial institutions have been monitoring and dealing with the immediate effects of the Covid-19 pandemic with respect to provisions. Whilst they have been working hard to understand these current challenges, there are future considerations that organisations will need to start thinking about and adapting to when looking into the medium to long-term effects of the pandemic.

Being prepared for the looming longer-term effects

The Government has played a critical role in supporting the financial services industry through its various support packages such as loan deferral programme and new loan schemes. These have helped keep the customer arrears and losses in a more controlled fashion. Financial institutions will need to be prepared when these 'shields' come off and the true effects of the pandemic starts to unfold.

These relief measures have had a significant impact on the financial institutions' provision estimation process, especially in the SICR element. Management will also need to form an expectation on the impact of the removal of these relief measure on their portfolios. The timing of these measures is important while also considering the possible scenarios such as contractual payments returning to pre-crisis behaviours or experiencing irregular payment patterns as the 'crutches' are removed.

Enhanced Board governance and oversight

The Covid-19 pandemic has highlighted certain improvement opportunities in the governance and controls around the IFRS 9 provision estimation process, particularly for smaller financial institutions. Financial institutions should consider implementing more robust frameworks for dealing with a 'shock' environment.

In situations like the Covid-19 pandemic, there is higher expectation for senior management involvement and increased Board oversight. Given that model outputs may not necessarily be providing a reasonable estimate, management will need to step in to provide additional insights and expert judgement as required. There is also an expectation from the regulator that models will be made or repaired so that they do work. The sensitivity of the provisions on the overall financial institutions' profit or loss statements also mean that management and board committees need to be consulted and informed more frequently due to the wider implications for the financial institution.

Greater disclosures expectations

The disclosure requirements as per NZ IFRS 7[26] require organisations to disclose the nature and extent of risks arising from financial instruments and how it manages those risks. Accordingly, financial institutions will need to explain the significant impacts of the Covid-19 outbreak on the risks arising from financial instruments and how it is managing those risks. Banks will need to use judgement to determine the specific disclosures that are both relevant to their business and necessary to meet these disclosure objectives.

Some examples of specific disclosure include:

- Information about a company's credit risk management practices and how they relate to the recognition and measurement of ECLs which may have changed in response to the Covid-19 outbreak.
- Financial institutions may also need to explain how it has incorporated updated forward-looking information into measuring ECLs especially with determining the level of overlays and post-model adjustments. In addition, they should also consider disclosing the various forward-looking scenarios and its associated probability weightings.

The RBNZ is expected to watch this space closely and encourage as much quantitative and qualitative disclosures as possible.

Rethinking the overall credit risk strategy

New Zealand financial institutions entered the crisis in a strong financial position. Lessons learnt and changes following the Global Financial Crisis meant that banks are well-capitalised and prepared to weather this storm. The banking sector has an opportunity to play a crucial part in supporting New Zealand's economic recovery. How the banking sector chooses to respond to this crisis will have a major influence on how the financial system evolves over the next decade. Banks are expected to 'Reset their Credit Strategy' that provides them with the tools to maintain the flow of credit and contribute to the long-term stability of the banking system by lending to productive, job-rich sectors of the economy.

The standard origination process in banks is under scrutiny as a result of the pandemic, having to make an unprecedented number of credit decisions within a constricted timeframe. Many banks lack sufficiently robust operations and credit platforms to respond to such demand, where existing policies, decisioning platforms and credit guidance are no longer adequate to support the banks during this crisis.

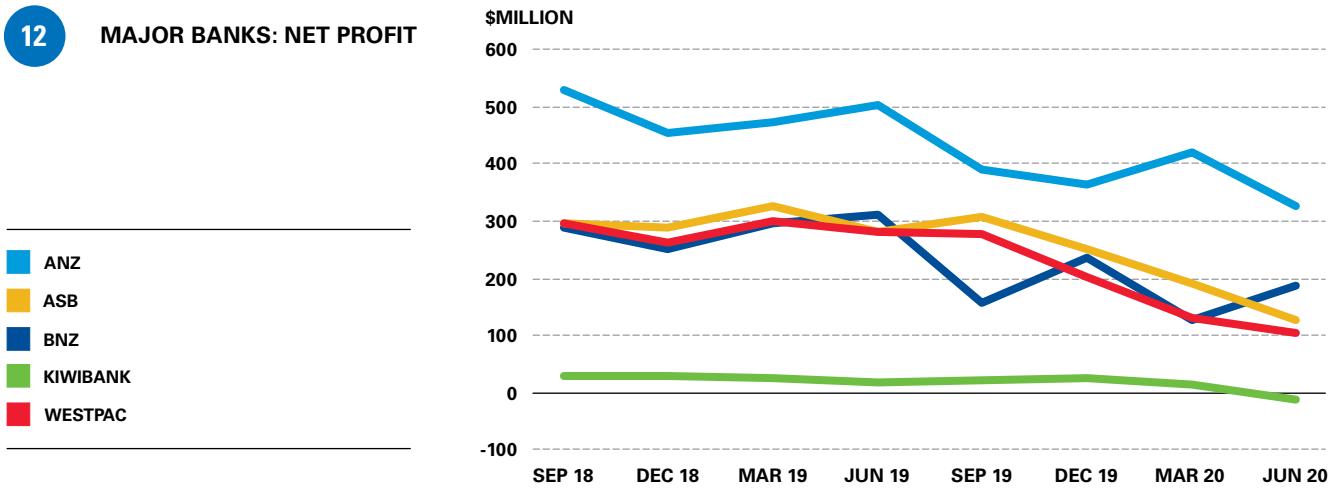
The effect of the pandemic can be observed in the increased requirement for financial assessment and impact analysis of the bank's current portfolio.

Major banks - Quarterly analysis

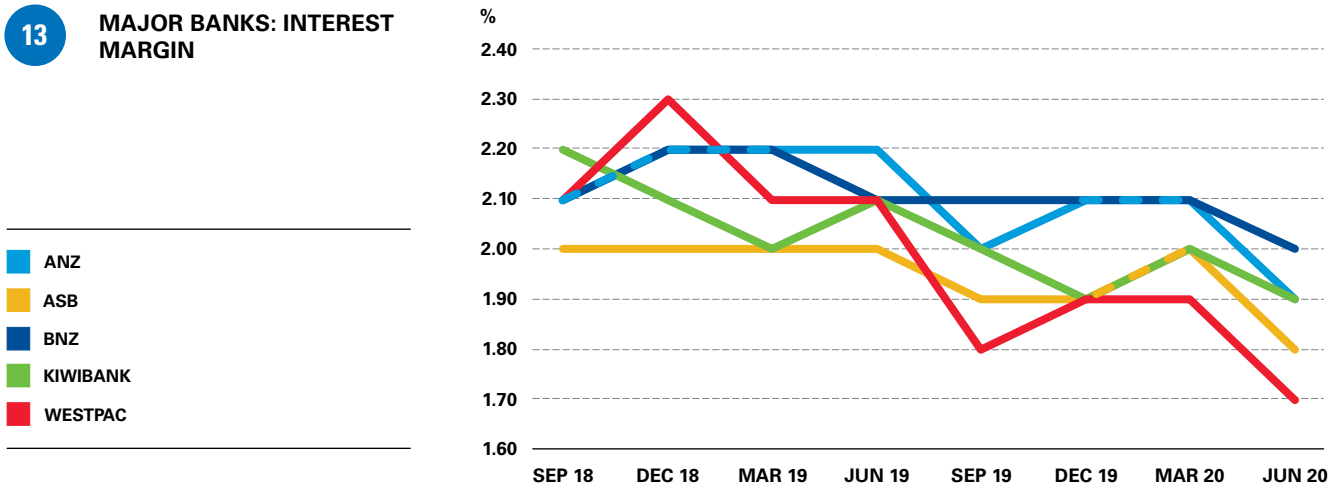
Entity	Size & strength measures							
	30 Sep 18	31 Dec 18	31 Mar 19	30 Jun 19	30 Sep 19	31 Dec 19	31 Mar 20	30 Jun 20
	Total assets[27] ($Million)							
ANZ	161,416	164,698	164,952	166,292	170,492	170,385	183,424	181,688
ASB	101,906	103,157	105,388	107,075	111,167	109,464	116,042	113,464
BNZ	99,991	102,536	103,758	105,313	109,111	108,289	118,501	114,452
Heartland Bank	4,596	4,018	4,054	4,139	4,206	4,262	4,315	4,322
Kiwibank	20,935	22,040	22,514	22,734	23,584	24,086	25,249	25,510
SBS Bank	4,574	4,660	4,755	4,791	4,863	4,948	4,942	4,836
TSB Bank	7,527	7,733	7,819	7,920	8,076	8,130	8,179	8,332
The Co-operative Bank	2,697	2,786	2,786	2,855	2,927	2,948	2,980	3,008
Westpac	96,656	98,537	100,180	101,464	106,762	107,111	120,525	114,223
Total	**500,298**	**510,164**	**516,204**	**522,582**	**541,188**	**539,622**	**584,157**	**569,834**
	Increase in gross loans and advances (%)							
ANZ	0.17	1.04	1.33	0.77	0.35	0.92	0.98	-0.02
ASB	1.11	1.76	1.68	0.91	1.40	0.83	1.03	0.09
BNZ	1.64	1.46	1.35	1.56	1.07	0.41	1.41	-1.36
Heartland Bank	3.12	-14.95	0.68	2.94	0.88	1.82	1.23	-1.98
Kiwibank	2.49	2.93	2.85	2.89	1.63	3.57	1.91	1.51
SBS Bank	0.37	2.20	1.11	1.24	1.05	1.63	0.58	-1.36
TSB Bank	1.88	1.88	2.40	3.77	2.72	-0.33	-0.16	-0.28
The Co-operative Bank	2.48	2.17	1.04	0.77	0.98	1.08	1.32	-0.31
Westpac	0.67	0.68	1.34	0.79	1.75	1.68	1.80	-0.29
Average	**0.93**	**1.16**	**1.48**	**1.13**	**1.10**	**1.07**	**1.27**	**-0.28**
	Capital adequacy (%)							
ANZ	14.40	15.20	14.60	13.50	13.60	13.60	13.90	14.00
ASB	13.90	14.80	14.30	14.00	13.50	14.20	13.60	14.00
BNZ	13.60	13.30	13.60	13.70	13.90	14.40	14.10	14.60
Heartland Bank	13.40	13.30	13.10	13.50	12.90	12.80	12.90	13.10
Kiwibank	15.70	15.30	14.90	14.50	13.50	13.20	13.00	12.60
SBS Bank	13.10	14.10	14.20	14.30	14.20	14.20	13.80	14.30
TSB Bank	14.50	14.80	14.60	14.50	14.60	14.60	14.30	14.90
The Co-operative Bank	17.20	17.20	17.10	16.60	16.70	16.40	16.30	16.90
Westpac	16.60	16.90	16.50	16.70	15.90	15.90	15.90	16.60
	Net profit ($Million)							
ANZ	530	456	473	504	392	367	422	327
ASB	297	292	329	282	310	252	192	130
BNZ	289	253	296	313	160	238	129	187
Heartland Bank	17	13	18	20	18	18	17	16
Kiwibank	32	30	25	20	25	27	17	-12
SBS Bank	8	8	6	8	8	6	-4	8
TSB Bank	13	13	5	14	14	12	-8	9
The Co-operative Bank	3	3	1	2	2	3	-1	3
Westpac	299	266	300	284	280	203	132	107
Total	**1,489**	**1,335**	**1,455**	**1,447**	**1,208**	**1,125**	**896**	**777**

Entity	Profitability measures							
	30 Sep 18	31 Dec 18	31 Mar 19	30 Jun 19	30 Sep 19	31 Dec 19	31 Mar 20	30 Jun 20
	Interest margin[28] (%)							
ANZ	2.10	2.20	2.20	2.20	2.00	2.10	2.10	1.90
ASB	2.00	2.00	2.00	2.00	1.90	1.90	2.00	1.80
BNZ	2.10	2.20	2.20	2.10	2.10	2.10	2.10	2.00
Heartland Bank	4.40	4.30	4.70	4.50	4.60	4.50	4.50	4.60
Kiwibank	2.20	2.10	2.00	2.10	2.00	1.90	2.00	1.90
SBS Bank	2.60	2.50	2.50	2.50	2.50	2.50	2.50	2.40
TSB Bank	1.90	1.90	1.80	1.80	1.80	1.80	1.80	1.60
The Co-operative Bank	2.40	2.30	2.30	2.20	2.20	2.20	2.20	2.20
Westpac	2.10	2.30	2.10	2.10	1.80	1.90	1.90	1.70
	Non-interest income/Total assets[27] (%)							
ANZ	0.76	0.46	0.52	0.67	0.68	0.31	0.85	0.33
ASB	0.63	0.71	0.78	0.64	0.67	0.57	0.53	0.51
BNZ	0.64	0.36	0.67	0.79	0.45	0.30	0.65	0.40
Heartland Bank	0.27	0.23	0.32	0.44	0.42	0.46	0.32	0.38
Kiwibank	0.98	0.91	0.74	0.83	0.86	0.90	0.92	0.53
SBS Bank	0.88	0.92	0.81	0.75	0.78	0.82	0.70	0.68
TSB Bank	0.35	0.33	0.30	0.27	0.29	0.29	0.25	0.22
The Co-operative Bank	0.63	0.69	0.56	0.71	0.66	0.71	0.50	0.67
Westpac	0.60	0.43	0.69	0.59	0.70	0.37	0.59	0.32
Average	**0.68**	**0.50**	**0.64**	**0.67**	**0.63**	**0.41**	**0.68**	**0.39**
	Impaired asset expense/Average gross loans and advances (%)							
ANZ	-0.07	0.04	0.06	0.07	0.13	0.05	0.64	0.23
ASB	0.05	0.16	0.14	0.14	0.05	0.04	0.65	0.59
BNZ	0.03	0.06	0.13	0.12	0.18	0.14	0.53	0.46
Heartland Bank	0.61	0.79	0.45	0.38	0.50	0.47	0.69	0.43
Kiwibank	0.01	0.07	0.08	0.08	0.03	0.06	0.28	0.56
SBS Bank	0.40	0.38	0.40	0.29	0.35	0.48	2.44	0.39
TSB Bank	0.10	-0.16	0.36	-0.06	-0.02	0.03	1.29	-0.01
The Co-operative Bank	0.15	0.13	0.16	0.13	0.03	0.10	1.03	0.12
Westpac	-0.14	0.03	0.04	-0.03	-0.08	0.10	0.87	0.54
Average	**-0.02**	**0.08**	**0.10**	**0.08**	**0.08**	**0.08**	**0.67**	**0.43**
	Operating expenses/Operating income (%)							
ANZ	35.64	38.14	35.23	34.29	45.63	44.88	33.93	43.97
ASB	35.39	35.22	33.58	37.72	35.89	43.48	38.09	49.46
BNZ	37.85	40.42	35.66	35.47	61.11	40.38	58.00	41.97
Heartland Bank	41.60	47.60	39.96	40.16	42.77	44.23	40.78	47.82
Kiwibank	72.87	71.71	74.33	78.57	78.13	79.01	75.76	91.00
SBS Bank	60.91	62.97	65.97	62.14	64.21	65.58	56.07	59.78
TSB Bank	53.75	60.63	69.31	54.14	54.46	60.00	80.68	66.31
The Co-operative Bank	75.00	76.33	87.88	80.00	82.09	75.48	75.77	74.52
Westpac	38.26	39.89	37.45	39.91	41.82	47.07	42.68	50.79
Average	**39.15**	**40.91**	**38.27**	**39.21**	**47.89**	**46.59**	**44.25**	**48.94**

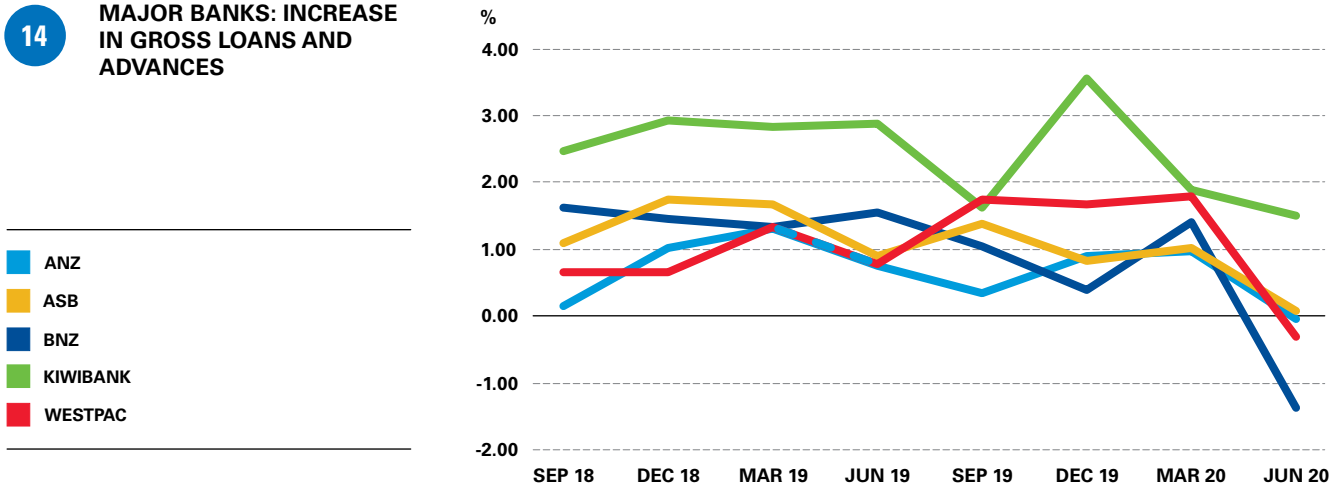
12 MAJOR BANKS: NET PROFIT



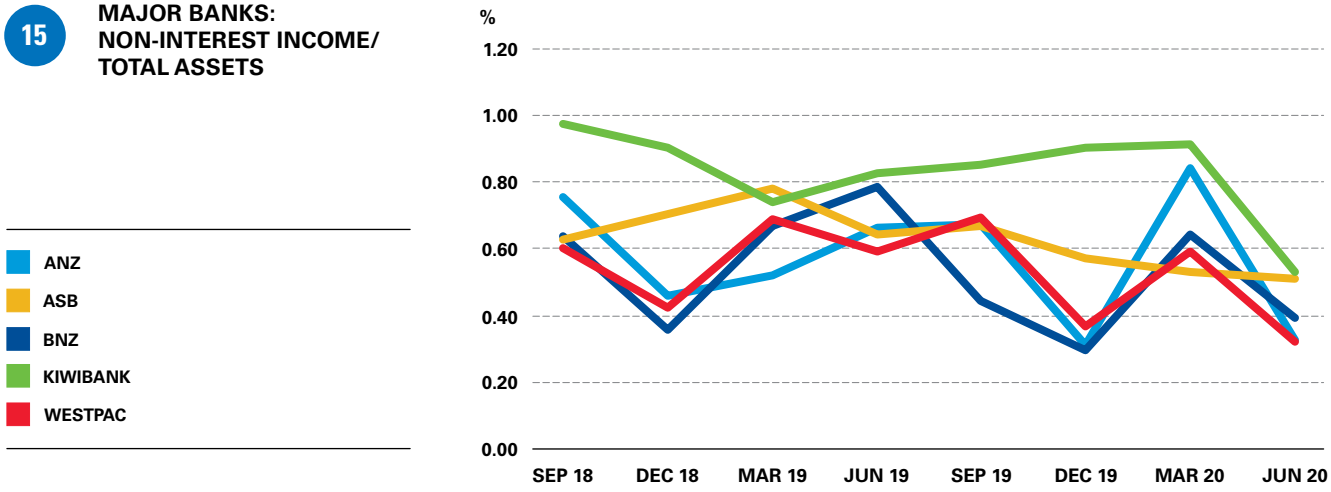
13 MAJOR BANKS: INTEREST MARGIN



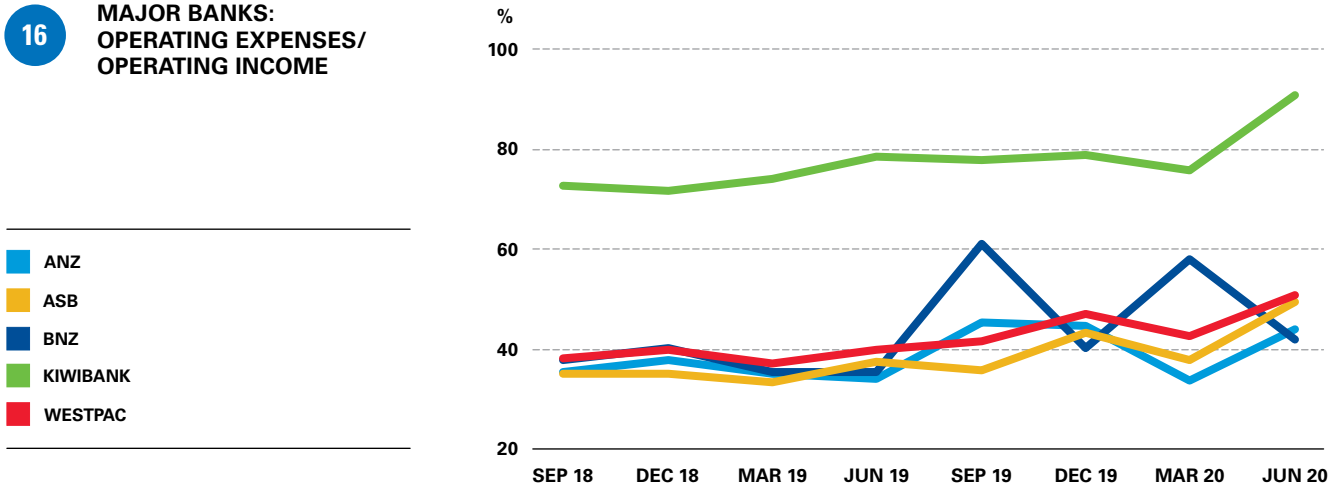
14 MAJOR BANKS: INCREASE IN GROSS LOANS AND ADVANCES



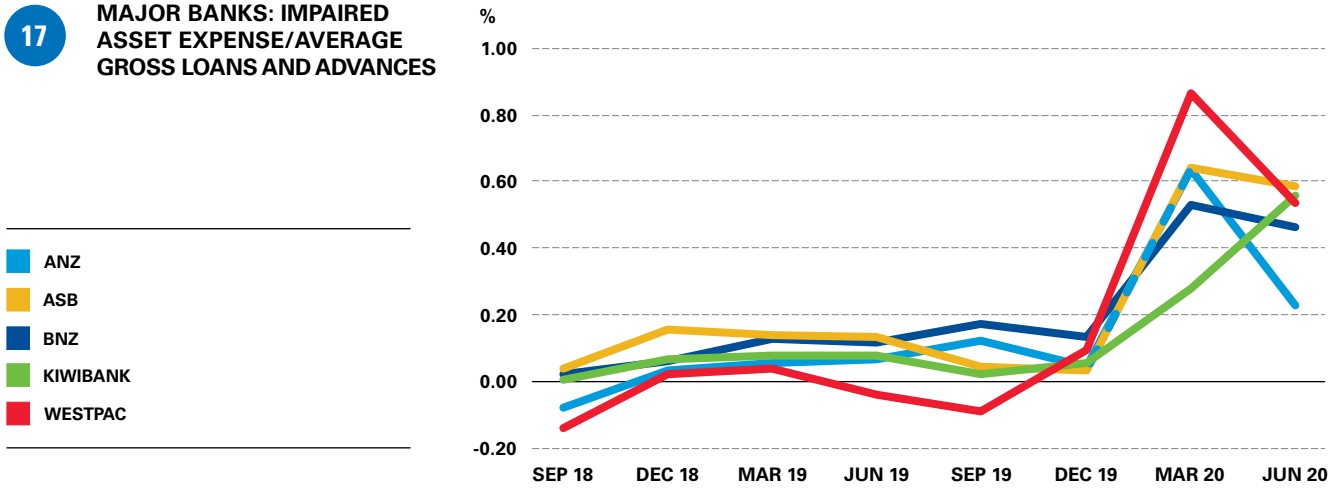
15 MAJOR BANKS: NON-INTEREST INCOME/ TOTAL ASSETS



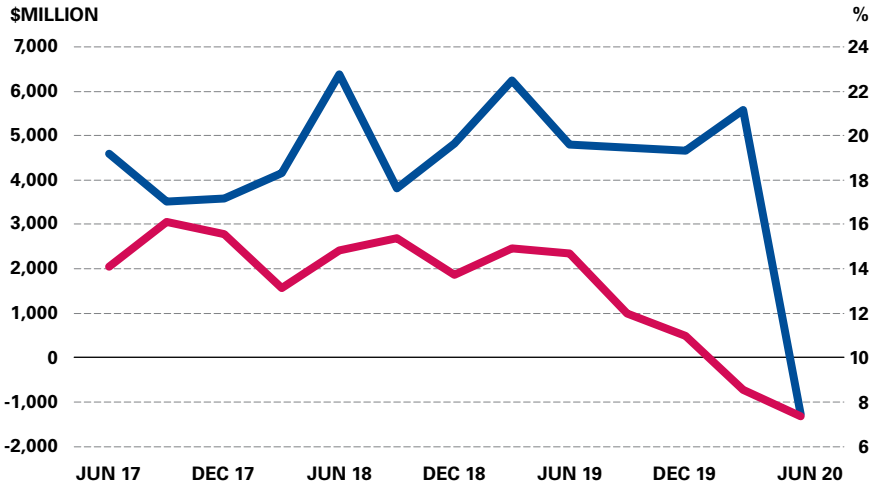
16 MAJOR BANKS: OPERATING EXPENSES/ OPERATING INCOME



17 MAJOR BANKS: IMPAIRED ASSET EXPENSE/AVERAGE GROSS LOANS AND ADVANCES



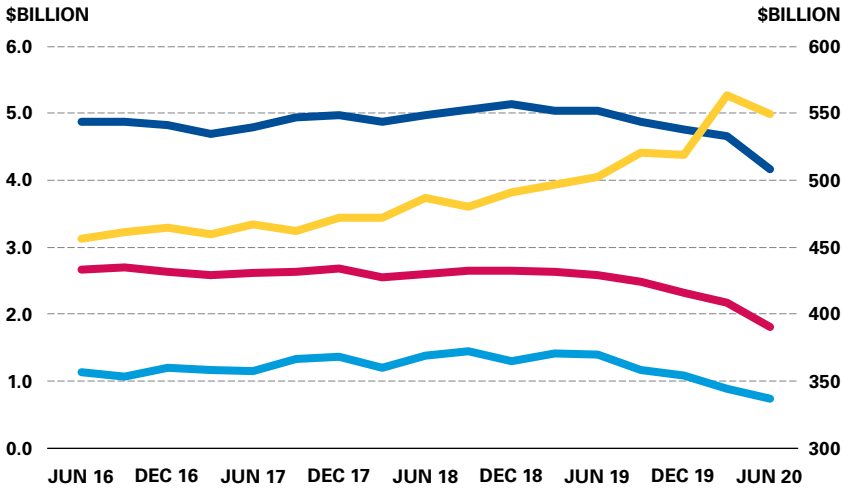
18 GROWTH IN GROSS LOANS AND ADVANCES VS. RETURN ON EQUITY



GROWTH IN GROSS LOANS AND ADVANCES (LHS)

RETURN ON EQUITY (RHS)

19 MAJOR BANKS: INTEREST EARNING ASSETS COMPARED TO INTEREST INCOME AND EXPENSE



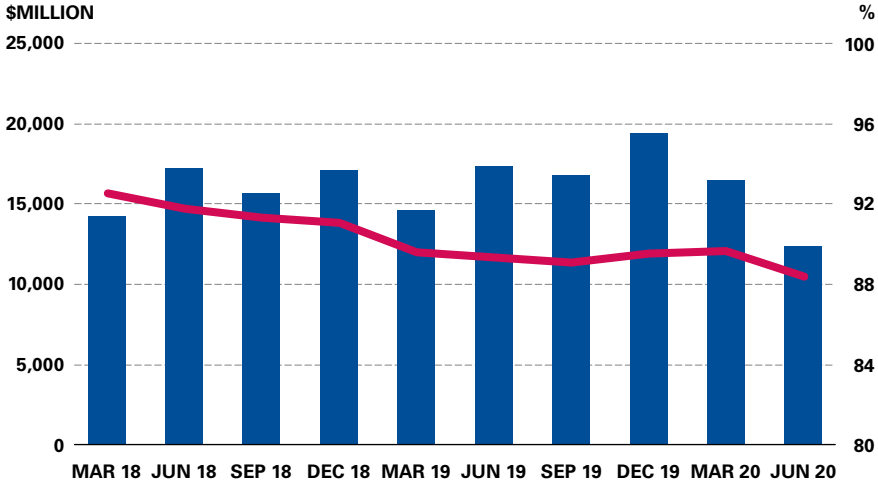
INTEREST INCOME (LHS)

INTEREST EXPENSE (LHS)

NET PROFIT (LHS)

TOTAL ASSETS (RHS)

20 LVR ANALYSIS OF RESIDENTIAL MORTGAGES



NEW MORTGAGES (LHS)

PROPORTION OF NEW MORTGAGES WITH LVR OF 80% OR BELOW (RHS)

SOURCE: RESERVE BANK OF NEW ZEALAND STATISTICS

Customer vulnerability

Brett Huntley
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KPMG Risk Consulting

Brett joined KPMG in June 2019 from the UK has 18 years' banking and financial services experience holding roles in wealth management, remediation, 1st and 2nd line risk.

Covid-19 has brought about a lot of unwelcome change in New Zealand including the significant increase of individual customer and business vulnerability.

Customer vulnerability is about the potential for detriment, particularly where customers are not able to represent their own interests appropriately and especially where firms are not acting fairly. The 2018 *Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* report uncovered many examples of poor conduct which led to severe customer detriment and reputational damage and no New Zealand business wants to be highlighted for the same issues. Examples included the sale of an accidental death, injury and funeral plan to an intellectually disabled person; exploiting the cultural significance of funerals when selling funeral products door-to-door to those living in Aboriginal and Torres Strait Islander communities as well as selling policies for children; and lack of effective and compassionate communication processes for dealing with vulnerable customers making insurance claims.

Customer vulnerability is about the potential for detriment, particularly where customers are not able to represent their own interests appropriately and especially where firms are not acting fairly.

Here in New Zealand, the 2018 Government census shows us how broad vulnerability is; 1 in 5 people have been diagnosed with a mental health disorder, 18% have no formal education and 30-40% of disabled customers are considered to be digitally disadvantaged. Put this into context and you start to understand the challenges vulnerable customers face with complex terms, marketing slogans and unclear communications. Now add to this the statistics from the recent *Commission For Financial Capability* review in June[29] showing that 40% of households received a Covid-19 wage subsidy and 1 in 4 were in financial arrears and you start to understand the scale of the problem that needs to be addressed.

Identifying vulnerability is critically important in this Covid-19 environment and we are seeing the warning signs of financial difficulty, stress and mental health issues emerging as a result of two periods of lockdown. To address this, financial institutions should be building suitable frameworks with senior executive ownership for delivery, in addition to existing conduct programmes that are starting to move into 'business as usual'.

Before every debt goes into deferral or arrears there will be a customer, family or business that is suffering financial hardship and stress.

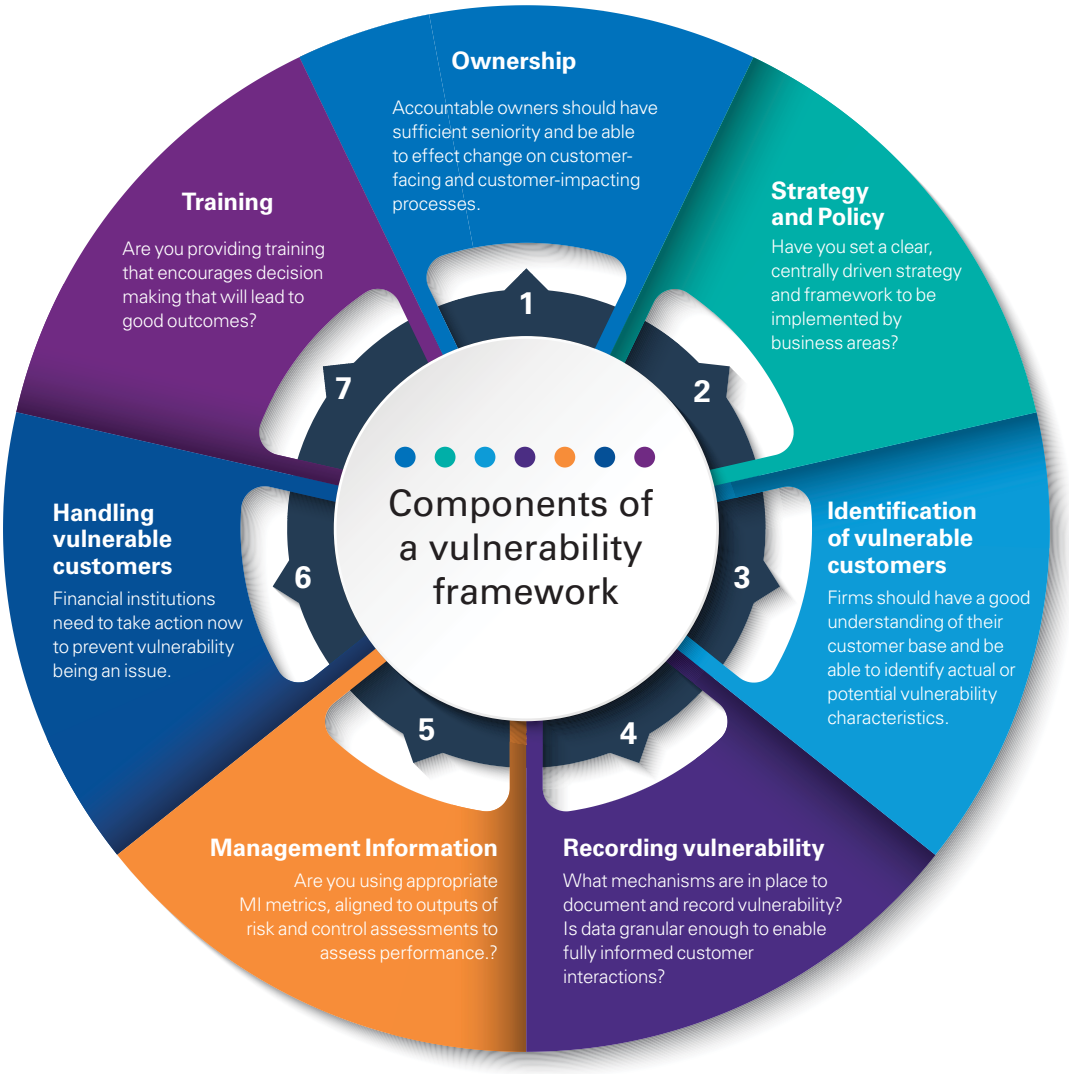
Current statistics from the New Zealand Bankers Association (NZBA) suggest there are around 95,000 customers on reduced loan repayments and around 62,000 with all loans being deferred, to a value of approximately $50 billion[30] and we are starting to see financial institutions provisioning for this debt. This highlights that before doing this, banks also need to consider the extent of vulnerability that sits behind this. Before every debt goes into deferral or arrears there will be a customer, family or business that is suffering financial hardship and stress. Squeezed or non-existent cash flow, wage subsidy, losses, missed payments, fees and charges are all critical indicators of hardship and vulnerability.

KPMG published a paper in July *Addressing vulnerability in New Zealand*[31], which set out the Financial Markets Authority's (FMA) expectations and provided a starting point for an effective operating model in these times. We have seen organisations take positive steps in identifying and working with vulnerable customers, but there is still more that financial institutions can do. Customers want to be proactively recognised as vulnerable and listened to; they want communications to clearly tell them when action is required, and products to say what they are, without using fancy marketing terms. Customers want to trust their providers and disclose their personal circumstances, but may hold back if they do not believe that the organisation is acting in their best interests and this will only exacerbate the problem.

Customers need to be, and should be, protected from harm, but customers do not want to be seen as a charity case or prevented from transacting. Customers want to be treated as valued and loyal customers, supported and encouraged to make their own decisions, and therefore striking a dignified balance will be critical.

Such balance is important to consider as financial institutions move more customers onto digital platforms to access products and services easier.

21 **COMPONENTS OF A VULNERABILITY FRAMEWORK**



Equal effort should be applied to offering protection against fraud and phishing scams, especially for those customers who may be new to digital technologies and do not understand the risks.

We recommend that financial institutions review their current suite of customer collateral and ask themselves if it is supportive of meeting the needs of vulnerable customers and is it clear, fair and not misleading. Do your customer-facing teams make decisions in the best interest of customers without being driven to focus on meeting a 'metric', and can you evidence this is working?

Regulations of course have a role to play and there is no doubt that supervision and expectations will increase, but it is important to ensure that any regulations both encourage innovation and provide a safe space for financial institutions to test this innovation with real customers. Professional industry associations and forums should be encouraging their members to support the balance of innovation and protection.

Vulnerability is about the potential for detriment.

To summarise, vulnerability is about the potential for detriment. Financial institutions will need to understand the critical path of warnings signs and put in place appropriate mechanisms to deal with this, which will only work if driven and supported by senior management and their boards. This will enable firms to have long term valuable and supportive relationships with their clients that will be beneficial for all.

Now is an appropriate time for financial institutions to compare their own framework models against the vulnerability framework and identify where any gaps may exist.

Considerations for setting out a firm-wide strategy

1. **OWNERSHIP**
   Identify a suitable owner for a vulnerability programme including governance frameworks to effect positive change on customer outcomes.

2. **STRATEGY AND POLICY**
   Map your end-to-end customer journeys, identify areas of weakness and design appropriate controls to reduce the risk of customers receiving poor outcomes.

3. **IDENTIFICATION OF VULNERABLE CUSTOMERS**
   Understand the risk factors of vulnerability. Use specific data points to understand the customer base and be able to identify actual or potential vulnerability characteristics.

4. **RECORDING OF VULNERABILITY**
   Put mechanisms in place to document and record vulnerability or find solutions where consent is withheld.

5. **MANAGEMENT INFORMATION**
   Design a reporting suite of quantitative and qualitative metrics to demonstrate trends, the nature and extent of vulnerability and indicators of potential issues.

6. **HANDLING VULNERABLE CUSTOMERS**
   Develop treatment and handling strategies for dealing with the wide range of vulnerabilities that may lie within your customer base.

7. **TRAINING**
   Identify the role and responsibilities within a customer journey that require specific or bespoke training and support.

Current state of play in the residential property market

Kelvin Davidson
Senior Property Economist
CoreLogic

Kelvin is a Senior Property Economist at CoreLogic and has a wealth of experience after spending more than 15 years working largely in private sector economic consultancies in both New Zealand and the UK. Kelvin applies macroeconomic trends and data to the property market, both residential and commercial to provide key insights and tell a compelling story.

It goes without saying that the past few months have been tumultuous for the economy, mortgage market, and the residential property sector. After the lockdown for most of April and then the subsequent moves back down the Alert Levels there was evidence that by July property sales had returned to 'normal', up by an impressive 25% from a year earlier (albeit still down by about 20% year-on-year if you combine the period April to July).

Mortgage lending activity in July was also back to normal, with the new flow of $6.6 billion almost $700 million higher than a year earlier (for context, in both April and May, lending flows were more than $2 billion below a year earlier). After a surge in interest-only loans in April and May, as borrowers looked to reduce their household expenses, this type of lending has eased off again. In addition, even though the Reserve Bank of New Zealand (RBNZ) has (temporarily) removed the loan to value ratio (LVR) speed limits, banks are still generally requiring a 20% deposit and are looking closely at job security and the ability to service the loan even at higher interest rates than those prevailing in the market.

In terms of the mix of buyers active in the market, there have been some notable shifts since the end of March (see Figure 22 on page 31). According to the CoreLogic Buyer Classification series, movers' (i.e. existing owner-occupiers who are relocating) share of purchases dropped from 28% in Q1 2020 to 27% in Q2, and has started Q3 on an even softer note – down to just 24% in July. Due to factors such as already-high debt levels and/or fear about finding the ideal next property in a listings-constrained market, many would-be movers are sitting tight at present.

In terms of the mix of buyers active in the market, there have been some notable shifts since the end of March.

Meanwhile, mortgaged investors' share of purchases has continued to rise lately, reaching 27% in July, the highest figure since late 2016 – when the RBNZ imposed a 40% deposit requirement on investors. The low returns available on alternative assets, such as term deposits, is likely to have been a factor behind continued interest in property from investors. At the same time, first home buyers' (FHBs) share of purchases has also held up, edging higher to 24% in July. Anecdotally, some people who would otherwise have headed off on their overseas experience are now choosing to buy a house here instead.

The low returns available on alternative assets, such as term deposits, is likely to have been a factor behind continued interest in property from investors.

Those national patterns have been replicated in Auckland, with movers' market share dropping lately, but the figures for mortgaged investors and FHBs continuing to improve. In fact, the number of property purchases in Auckland by both mortgaged investors and FHBs in July was also higher than a year earlier.

It's also interesting to note that even though we do not have any international tourists for the time-being, the Airbnb sector seems to have held up on the back of domestic visitors. In turn, this means that early fears of a flood of holiday lets into the traditional long-term rental property sector, which would suppress rents and undermine investors' finances, have not been realised so far.

Of course, after a period where optimism had returned, the latest round of social restrictions means that we are obviously now in a new phase of heightened uncertainty with downside risks to residential property market activity and house prices. A key period to watch will be the first few weeks after the wage subsidy ends on 15 September, although at least there does not seem to be too much concern out in the property market that the delayed election will have much bearing either way.

On the plus side, the extension of the mortgage payment deferral scheme will help some households to negotiate the next few months, and of course the RBNZ stands ready to take further action if and when it is required. The Quantitative easing (QE) programme has already been extended to $100 billion, and the chances that we see a negative Official Cash Rate (alongside funding direct to banks to ensure they have the money to keep lending) by early 2021 are growing all the time. That points to further falls in mortgage interest rates, although unfortunately for savers, also lower deposit rates.

Overall, forecasting even the next few months ahead is difficult enough in the current environment, let alone trying to formulate a view about 2021. Even so, our central scenario is that sales volumes come in at about 70,000 for 2020 as a whole (compared to around 88,000 in 2019), with the risks to the downside the longer any partial lockdowns last. Provided that the current uncertainty reduces and economic growth can resume on a steadier path next year, sales volumes could improve to more than 75,000 in 2021.

Forecasting even the next few months ahead is difficult enough in the current environment, let alone trying to formulate a view about 2021.

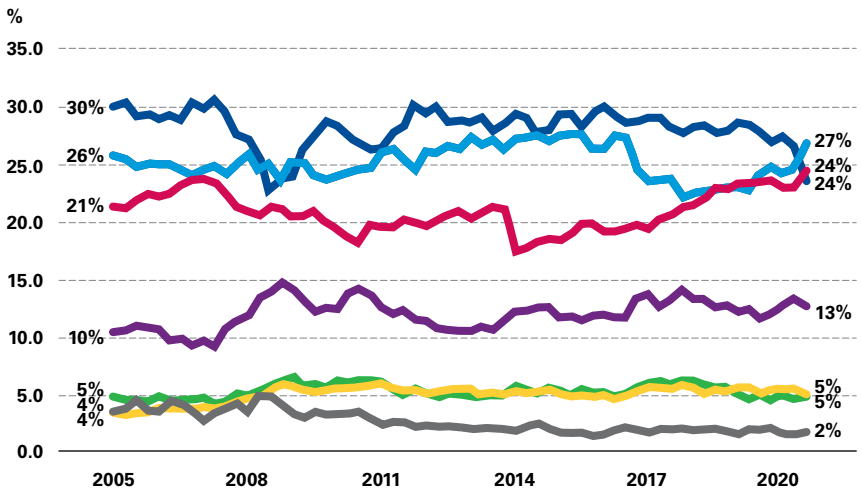
For the banking sector, in addition to lending activity related to those property sales, there is also a busy period looming in terms of refinancing existing fixed loans that are rolling over.

At present, 52% of the stock of mortgages (by value) is currently fixed for one year or less. For the borrowers, given that they can still meet the deposit and serviceability requirements, these roll-overs should be beneficial in terms of moving to a lower mortgage rate than they had been placed on a year ago.

In terms of house prices, we have always been at the less pessimistic end of the spectrum, with low mortgage rates, improved affordability, and housing shortages all supportive factors. Even so, prices seem unlikely to emerge from an economic recession unscathed, and our projection is that national average values could fall by 5-7% from peak to trough. This would be unwelcome for existing owners, but would at least be a smaller decline than the fall of 10% during the Global Financial Crisis.

Another key factor at present that points to minimal downside risk for house prices is the sheer shortage of listings on the market – put simply, there is just very little choice out there for buyers, and that means support for prices. As our just-released Housing Affordability Report[32] also highlights , property has generally become more affordable in recent years, on the back of falls in mortgage rates, and that too suggests only limited downside risk for house prices.

22 **MIX OF BUYERS ACTIVE IN THE MARKET**



Endnotes

1. Westpac Bank senior economist Satish Ranchhod: https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12339105
2. https://www.stuff.co.nz/business/opinion-analysis/300083034/ground-hog-day
3. https://www.stats.govt.nz/news/post-lockdown-retail-card-spending-picks-up#:~:text=Total%20retail%20spending,April%2C%E2%80%9D%20Ms%20Hicks%20said.
4. https://www.bbc.co.uk/news/resources/idt-dc2d6e2d-3ab4-42de-8d03-bb7eda5fff8e
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17. https://www.rbnz.govt.nz/statistics/c65-bank-customer-lending-flows
18. https://www.ird.govt.nz/about-us/tax-statistics/kiwisaver/withdrawals/number
19. https://bankomb.org.nz/complaints-dashboard/
20. https://www.rbnz.govt.nz/news/2020/04/the-financial-sector-and-responsible-behaviour
21. The RBNZ hosts the Banks' Financial Strength Dashboard (Dashboard) which is an online tool for sharing prudential and financial metrics on New Zealand registered banks. https://bankdashboard.rbnz.govt.nz/summary
22. Coverage Ratio is the total collective and individual provisions divided by the total loans.
23. The IASB published a document responding to the application of IFRS 9 during the Covid-19 pandemic.
24. Participating banks: ANZ, ASB, BNZ, Heartland Bank, Kiwibank, SBS Bank, TSB, Bank of China and Westpac.
25. Callaghan Innovation is a Crown entity of New Zealand and has the task of making New Zealand business more innovative.
26. NZ IFRS 7 is the accounting standard relating to Financial Instruments disclosure requirements.
27. For quarters ended 31 December 2017 and earlier, total assets excluded intangible assets. From 31 March 2018, intangible assets are no longer deducted as this information is not available in the RBNZ Dashboard.
28. In line with the information disclosed in the RBNZ Dashboard, the net interest margin is disclosed to 1 decimal place from 31 March 2018 onwards. As interest earning assets are not disclosed in the RBNZ Dashboard, average net interest margins cannot be calculated from 31 March 2018 onwards.
29. https://cffc-assets-prod.s3.ap-southeast-2.amazonaws.com/public/Uploads/Research-2020%2B/CFFC-Barometer-Jan-June-2020-Changes-in-financial-attitudes.pdf
30. https://www.nzba.org.nz/wp-content/uploads/2020/09/Consumer-lending-data-31-August-2020.pdf
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