ASB

Economic Note

Adding a Funding for Lending Programme to the toolkit

5 November 2020

Funding for lending programme ready to launch

- The RBNZ looks set to deploy a funding for lending programme (FLP) before the end of the year. Details of the scheme are set to be announced in the November Monetary Policy Statement, at which stage we expect the RBNZ to unveil its timetable for FLP implementation.
- We expect a sizeable scheme (in the region of $30bn), over a 3 to 5-year term and 12-month implementation window, with the RBNZ potentially offering a floating and capped interest rate to banks at around the OCR that would fall if the OCR were to be cut. The RBNZ will want to keep the scheme simple so as encourage strong take-up and may offer incentives to promote more lending in some key pockets.
- We expect the FLP to have only a modest impact on the composition of bank funding and customer interest rates, and hence on prospective OCR settings. If the FLP has a strong take-up and proves highly effective in further lowering customer interest rates and boosting economic activity, it will reduce the need for more policy support via other means.

Summary and implications

The RBNZ has signalled they will provide further details on a Funding for Lending Programme (FLP) in the November MPS. By offering banks stable and cheap lending (at or near the policy rate), the intent of the policy would be to lower bank funding costs and lending interest rates, increase the supply of credit and provide additional stimulus to the economy. FLPs are used in both negative and positive interest rate environments overseas.

The FLP represents another welcome addition to the RBNZ policy toolkit, providing another means via which banks can obtain low-cost funds to lend throughout the economy. There are also some useful synergies with other policy tools (including the OCR and LSAP). The RBNZ will need to get the design details right and keep it simple so as to achieve a strong take-up of the programme, maximise its effectiveness and support business lending, whilst still ensuring that the FLP does not put a rocket under the housing market. This may prove to be a tricky balancing act and may prompt the RBNZ to tweak other policy settings, rather than create a system that is too complex and unwieldy. We also expect the RBNZ to introduce features in the FLP that enhance its effectiveness in a negative OCR environment.

We expect the FLP to have only a modest impact on the composition of bank funding and customer interest rates. The FLP will likely alter the composition of bank funding, but not as markedly as many would expect. Recent falls in customer interest rates were likely to be at least partly in anticipation of an FLP being introduced. While we see the possibility of a small 'announcement-type' effect, the overall impact on customer rates from here is modest (say a few tenths of a percentage point on overall lending and deposit interest rates).

Nonetheless, if the FLP has a strong take-up and proves effective in quickly lowering borrowing costs and stimulating economic activity, it will reduce the need for the RBNZ to provide as much stimulus through the LSAP programme and/or via pushing out and scaling back the amount of OCR cuts needed.

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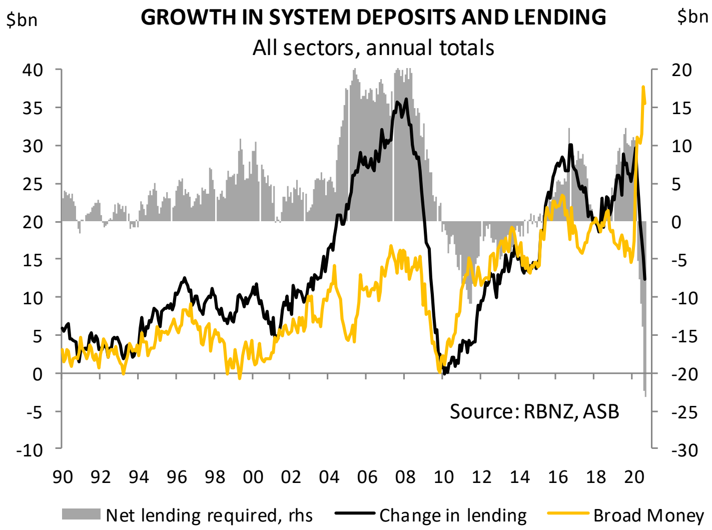
Why is the RBNZ going down the FLP route?

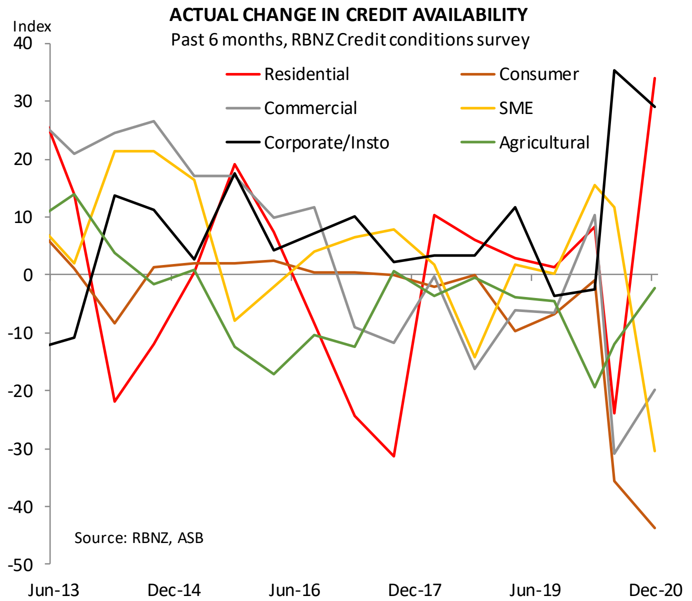
An important part of monetary policy transmission is via impacting interest rates faced by borrowers and savers to spur increased economic activity via increasing bank lending and/or reducing bank deposit growth.

This is yet to happen. Borrowing within the NZ economy has been weak with annual resident private sector credit growth at just 2.6% in September, about 40% of the rate back in March. What's more, bank deposit growth has remained robust at 9.8% yoy in September, in part due to the impact of the LSAP programme, which has boosted exchange settlement account system balances (ESAS) of financial institutions. Household deposit growth has actually accelerated to 9.4% yoy, cracking the $200bn mark.



Credit growth has also been uneven, with the 6.7% yoy growth in housing credit in September contrasting with the 3.5% yoy contraction in other forms of bank lending. The housing market is currently going great guns, with record-low mortgage interest rates and the RBNZ disposing of the Loan-to-Value Restrictions (LVR) prompting strong mortgage lending.

However, subdued business confidence has dampened investment intentions and credit demand. What's more, the latest RBNZ credit conditions survey shows markedly differing credit conditions across different sectors. The most hard-hit sectors appear to be Small and Medium-sized firms (SMEs), consumer lending and commercial property lending.

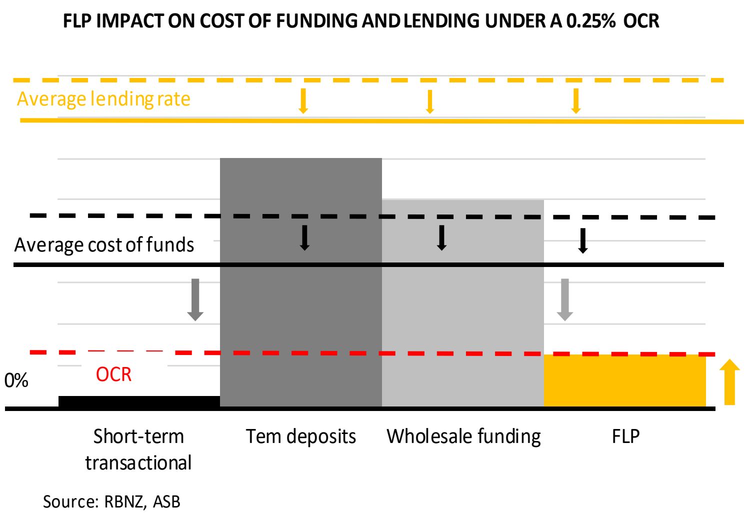


Moreover, banks have understandably been more cautious given the highly uncertain outlook, with more scrutiny of the income and employment status of borrowers. Credit availability looks to have tightened as banks adopt more sectoral and institution-specific approaches, with greater focus on high-risk sectors exposed to discretionary spending.

In its recent commentary, the RBNZ has reaffirmed the need for more monetary stimulus. In the September Monetary Policy Review, the RBNZ signalled that a Funding for Lending Programme (FLP) would be ready before the end of this calendar year, an explicit signal to banks to get things ready now. In subsequent comments the RBNZ have signalled that the November Monetary Policy Statement (11 November) will be when further details of the programme will be released. At that time, we also expect the RBNZ to also announce when the FLP is due to be launched.

What is a FLP?

At present, banks obtain funding from deposits (both retail and wholesale, which constitute about 70% of total funding) and from wholesale funding sources (roughly 30%). **A FLP is explicitly designed to provide another source of low-cost funding that would help replace some of the more expensive sources of funding.** This, in turn, would help lower bank funding costs, lower borrowing interest rates, boost the supply of lending and provide stimulus to the economy.



The accompanying chart provides a stylised example, whereby the imposition of the FLP at the 0.25% OCR would help lower overall bank funding costs and bank lending rates via banks substituting away from more expensive sources (i.e. term deposits and wholesale funding). The FLP would also reduce the reliance of banks on term deposit funding and would trigger further falls in term deposit interest rates.

Features of a FLP

What form will the FLP take? We will have to wait until the November MPS for the details, by the key features of the FLP include:

Size. To have maximum impact, the RBNZ would more likely go large. The programme will need to be available up to a considerable amount to ensure maximum impact. The size of the scheme would depend on the risk tolerance of the RBNZ (the Bank will be incurring additional credit risk), how much high-quality collateral is available to secure loans, the size of the overall lending market and how willing the RBNZ is to drive funding costs lower. In our view, the scheme would need to be big if the intent is to drive overall borrowing costs lower. Similar schemes overseas range from approximately 10-17% of GDP, which is roughly $30-50bn for NZ. We envisage the NZ scheme would be about $30bn. This might seem large, but it pales into comparison considering the approximate $478bn in NZ bank lending, $394bn banking system deposits (of which $178bn are term deposits), and the close to $630bn in assets for locally incorporated banks.

Window of scheme. The RBNZ will want to get runs on the board early but would also want sizeable take-up of the programme. A 12-month window – similar to that employed by the RBA (see Appendix 1 for details) – would likely strike the right balance.

Term of lending. Ideally this would be around the horizons that borrowers feel most confident about, so as to ensure greater take-up of the scheme. Schemes overseas tend to range anywhere from 2 to 6 years, with most schemes typically around 3 years. With the RBNZ's focus on capping longer-term yields via the LSAP, we would envisage that the RBNZ would opt for something like a 3 to 5-year horizon. This would help offer potential borrowers with more certainty during these very uncertain times.

Interest rates offered. There are a number of options here. The RBNZ could offer banks a fixed-rate loan, tied to the current OCR. The RBNZ could also offer a floating and capped rate to banks, which would decline if the OCR were to be cut but would not increase. This is more consistent with the European Central Bank's term lending facility. Additional sweeteners could also be added, with the rates on offer tied to the extent to which individual banks take up the programme. The BoE, ECB and Riksbank tie the rates on offer from the scheme to actual lending, with banks facing slightly higher borrowing costs if lending targets are not met.

Flexibility. The scheme should be able to operate in both positive and negative OCR environments. The FLP could be designed to encourage credit supply to flow when a negative OCR is employed. This could involve setting up a tiered system (as in the case for the ECB), with negative rates charged only on a portion of settlement cash. This would help work against some of the adverse impacts of negative rates on bank margins, and the supply of credit

Type of lending. Schemes overseas are tilted to incentivise more small business lending, with the RBA and BOE FLPs enabling much higher lending if it triggers an increase in SME borrowing. The RBNZ credit conditions survey indicated that NZ banks have become more cautious and more discerning in providing funding to perceived high-risk sectors. However, weak demand conditions for NZ firms and heightened uncertainty also look to have hampered the demand for credit.

Other conditions. Not everyone will be able to access funding, with the programme only available to eligible institutions (including locally incorporated banks). There would be caps on how much banks can borrow under the scheme. We expect the FLP would act like a repo transaction (i.e. an agreement between the FLP participant to purchase the funds from the RBNZ for a specified period), with a wide range of securities (including government and corporate bonds and mortgage-backed securities) used as collateral.

FLPs Overseas

A range of countries have used FLP-type schemes in crisis situations where market dysfunction has been evident, to ensure there is sufficient liquidity available in the financial system. Similar schemes are in operation in a number of OECD economies, including Australia, Japan, the UK, the Eurozone and Sweden. While the amounts on offer from similar schemes are large (in the 10-17% of GDP range), the actual take-up to date has been more modest (less than 5% on average).

The UK and Australia have two very similar schemes (see Appendix 1 for further details). These schemes consist of longer-term loans at the prevailing (and mildly positive) policy rate with incentives to expand lending to small businesses.

There are also schemes in negative policy interest rate economies. The ECB, for example, offers banks a -0.75% fixed 3-year lending rate. The system is tiered, where only a portion of banks' settlement cash is charged at a negative rate, reducing the adverse impact of the policy on credit provision and bank profitability. Moreover, the ECB scheme carries the stick of slightly higher borrowing rates for banks (-0.50 instead of -0.75%) if their lending growth contracts.

Sweden did not implement a FLP when its repo policy rate was negative (2015-19), but in March this year the Riksbank instigated an FLP programme in response to the COVID-19 crisis. It offers banks up to SEK500bn (slightly more than 10% of GDP) in low cost funding at around the repo rate (currently 0.0%) to spur lending. With inflation in Sweden still dangerously low and the economy slowing, rate cuts in Sweden (where the repo rate is currently 0.0%) are back on the agenda.

FLP impacts on the NZ economy

The design aspects of the scheme will play a role in determining how effective a FLP scheme is likely to be and we await the release of the details in the November MPS. Before then, we highlight what some of the potential impacts of a FLP are likely to be.

Impacts on the composition of bank funding:

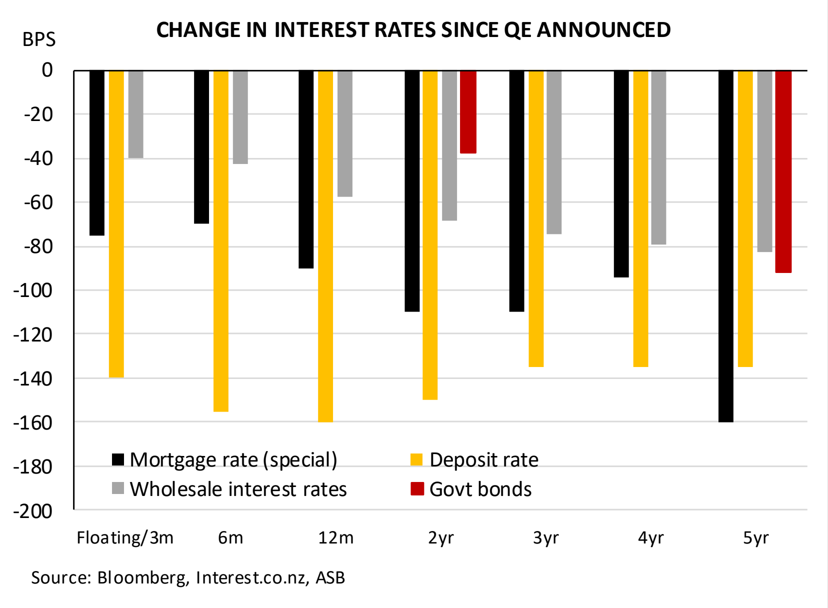
Having another source of funding for banks is another key positive and will bolster the resilience of the banking system. However, we don't expect that the FLP will prove to be the absolute gamechanger that many analysts believe it to be. First, even if a sizeable FLP is launched – say of $30bn – this would only constitute a reasonably modest portion (around 6%) of total bank lending and less than 20% of the $178bn in bank term deposits. Second, the impact of the scheme will also depend on the degree of take-up. Evidence overseas suggests this has been mixed, although this could reflect the lags in the system. If the RBNZ wants to attract strong take-up of the FLP it may have to offer a few sweeteners. They may also think carefully about making access to the FLP contingent on new lending if low credit demand is reflective of the general environment and not the lack of low-cost funding to borrowers. Third, it may also take time for banks to substitute away from term deposit and wholesale funding. According to the May RBNZ Financial Stability Report, more than half of NZ bank wholesale funding (57% of $135bn in March 2020) had a residual maturity for longer than 12-months). Furthermore, bank term deposits were approximately $178bn according to recent RBNZ figures.

In short, we expect that the FLP will likely alter the composition of bank funding, but not as markedly as many would expect. We envisage that NZ banks would want to keep all avenues for funding open and will aim to modestly scale back some of the more expensive sources of funding, including wholesale funding and term deposits.

Impact on NZ interest rates:

As the stylised diagram suggested the switch of banks to cheaper funding should help to lower the cost of funds for banks and lower customer interest rates. **The introduction of the FLP will undoubtedly heighten the focus on banks to drop customer interest rates**. We could well see a small 'announcement-type effect' on lowering carded lending and deposit interest rates. **Further falls in lending and deposit interest rates are possible but given the relatively small size of the FLP these falls may be modest and may not occur straightaway.** A $30bn FLP, for example, is just 6% of bank lending and less than 20% of term deposits**. All up, the FLP could reduce customer interest rates by a few tenths of a percentage point.** However, we could see more sizeable falls in some areas if banks decide to specifically target them.

We also need to recognise that we have already seen sizeable falls in customer interest rates since the start of the year (see chart). This has been partly related to the RBNZ announcing it would be launching a LSAP programme (from late March) and it continuing to flag the potential for a lower OCR. However, we also suspect that some of the falls we have also seen have been in anticipation that an FLP-type scheme will soon be launched in NZ given its earlier adoption in Australia and other OECD countries. Of note have been the more sizeable falls for carded mortgage and term deposit rates than for wholesale interest rates and NZ government bonds.

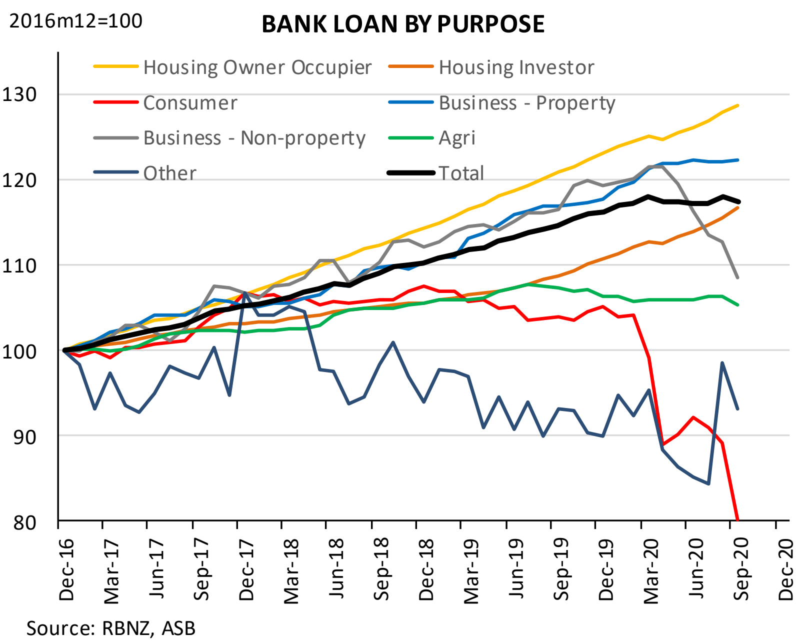


Also evident are the larger falls for bank term deposit interest rates than for carded mortgage interest rates across most tenors. Again, this is partly linked to the impacts of the LSAP in boosting ESAS balances in the system, with banks able to offer a lower deposit rate to attract the required funding. **However, we also suspect these falls are partly in anticipation of the FLP. Looking ahead, we would envisage that falls in term deposit interest rates could be more sizeable than falls for lending interest rates under the FLP.** The fall, however, could be tempered if the introduction of the FLP results in the RBNZ scaling back its LSAP programme.

Lower deposit interest rates would likely reinforce recent trends, which have seen the running down of term deposit balances as savers/investors look for other alternatives. More of the funds could be parked in transactional accounts, but some of it could be moved outside the banking system. This, in turn, could support the demand for banks for more FLP funding.

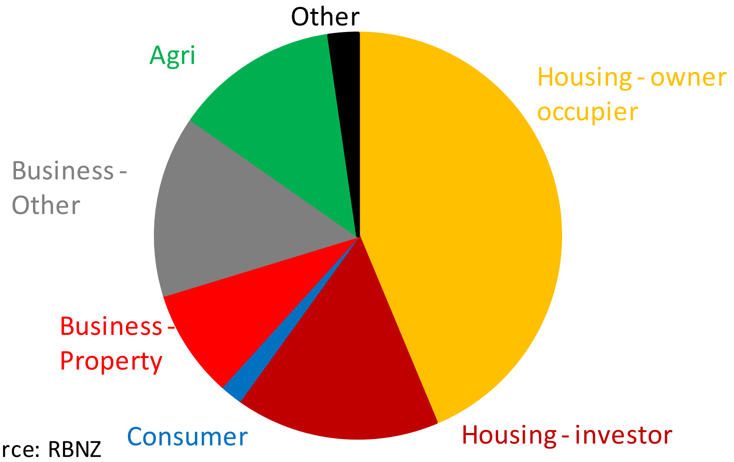
__Sector considerations:__

The latest credit figures from the RBNZ (September 2020) confirm a subdued overall credit environment, with bank lending slightly down from March levels. However, the accompanying chart shows the highly uneven nature of credit growth. The strongest performers were housing-related with strong growth in housing lending (+6.7% yoy), led by higher housing investor lending (+7.4% yoy), which has taken off following the relaxation of LVR restrictions. Of concern to the RBNZ has been subdued business lending, with non-property business lending more than 10% below March 2020 levels. This has been consistent with low (but improving) surveys of business confidence and investment intentions. Consumer lending has not been that flash either, but in large part this has been the result of households with the means retiring consumer debt (notably on credit cards), illustrating the uneven nature of the burgeoning recovery.



About 60% of bank credit is secured on housing, with about 80% of bank credit either used in some form of property transaction or used as security for a bank loan**.** Mortgage lending has been on a different trajectory to other forms of lending. While lower mortgage interest rates may help some SME borrowers, it will do little to quell concerns we have over the housing market overheating. **If the RBNZ was looking to bolster the provision of credit to where it was needed, some form of targeted scheme would be advisable.** The trade-off might be too complex and unwieldy a programme for banks to be able to utilise. An alternative might be the RBNZ instigating other measures – including jawboning banks into tightening their lending standards for residential borrowing or even re-imposing LVR restrictions for housing lending – to try and cool the housing market.

BANK LENDING BY PURPOSE
($478bn, September 2020)



Source: RBNZ

Co-ordination with other RBNZ tools, including a potentially negative OCR

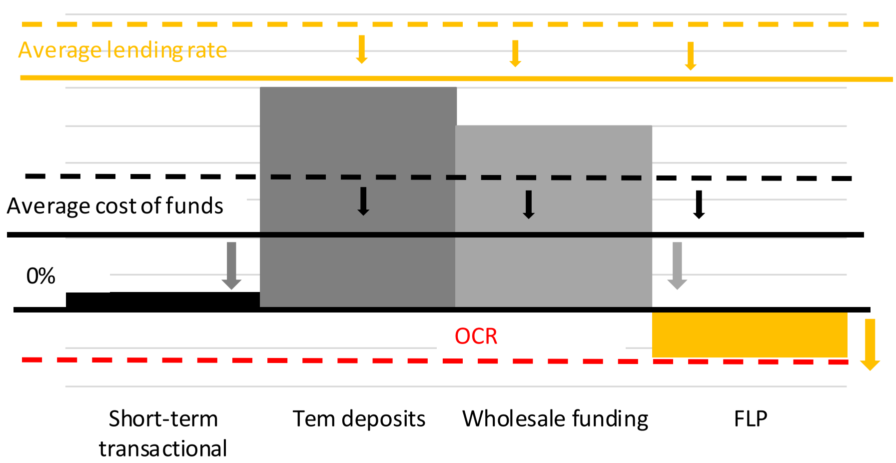
The FLP is a tool that can be used on its own, but the RBNZ will no doubt be considering how it would work with (and ideally complement) other policy measures that it already has in the kitbag or is intending to add.

There are already some synergies we can see with the FLP. It could work in tandem with the OCR to ensure official interest rate settings have a clearer pathway into bank funding costs and retail interest rates. The FLP and LSAP are also likely to be mutually reinforcing in that both act to boost liquidity and lower yields, although the focus of the LSAP is on government bond yields as opposed to customer interest rates under the FLP. As we saw earlier, however, the LSAP looks to have played a part in lowering interest rates more broadly.

Having the FLP in the policy toolkit may have implications for OCR settings. All else equal, if the FLP proves to be effective in quickly lowering retail interest rates, increasing liquidity and boosting economic activity, the likelihood is that the RBNZ may either delay or not instigate OCR cuts that would otherwise have happened. **Conversely, if the RBNZ still deems that a negative OCR is necessary, having an effective FLP in place would also help to mitigate some of the pitfalls of negative interest rates,** including the contractionary impacts on credit supply and bank profitability.

To ensure that the FLP put in place could work effectively alongside a negative OCR, a few system features would be needed. This would include designing a system that would encourage credit supply when a negative OCR is employed. Cash tier systems could be established where negative rates would be charged only on a portion of settlement cash. The ECB and Bank of Japan have similar schemes. This would lessen the impact on banks. This combination could be a net positive on the demand for credit, and it may also support the supply of credit.

FLP IMPACT ON COST OF FUNDING/LENDING UNDER A NEGATIVE OCR



Source: RBNZ, ASB

Appendix 1: Features of funding for lending schemes in Australia and the UK

Features	Australia Term Funding Facility	UK Term Funding Scheme
Established	March 2020 and subsequently extended on 1 September	From March 2020
Dates	From April 2020 until Sep 2020 for initial facility. From Oct to June 2021 for supplementary facility	Drawdowns under the scheme may be undertaken on each business day during the Drawdown Period which will open no later than 27 April 2020, and which will run until 30 April 2021.
Eligibility	Authorised deposit-taking institutions (ADIs) in Australia that extend credit (130+ in Australia)	Banks and building societies that are participants in the Bank of England's Sterling Monetary Framework (SMF) and that are signed up to access the Discount Window Facility (DWF).
Rate	0.25%. Payable on maturity of facility or when TFF is terminated	Bank Rate plus a Scheme fee. Borrowing rates up to 0.25% if lending falls more than 5%.
Term	3 years for each drawing by an ADI Participants may partly/fully reduce any usage of TFF in accordance with procedures	4 years from date of drawdown with option to extend to 6 years. Participants may terminate any transaction, in part or in full, before its maturity date.
Funding per institution	Initial allowance of 3% of participants total credit as at Sep 30 (AUD575bn in total). A supplementary allowance is set at 2% of total credit outstanding. Also added is an additional allowance based on a 1 for 1 increase in business credit, with heavier weighting (5:1) in favour of SME loans. Estimated to be at least 7% of total bank credit (up to AUD200bn out of roughly AUD3 trillion).	Initial allowance + additional allowance. Initial allowance of 10% of total loans at start of reference period (31 Dec 2019). Additional allowance is generated 1-for-1 for lending to households and large corporates; and 5-to-1 for lending to SMEs (i.e. SME lending attracts 5x the borrowing allowance). August 2020 Aggregate UK M4L credit in the UK economy was roughly £2,200bn, of which £1,680bn was lending to individuals, £207bn was lending to SMEs and £330bn was lending to large businesses
Collateral	ADI must nominate 'Eligible Securities' that it wishes to sell under repo. This consists of all securities currently eligible for domestic market operations.	Eligible collateral includes Level A, B and C collateral It includes tradable securities (Govt bonds), covered bonds, collateral securities (including mortgage-backed securities) and securitised loans.
Conditions	ADIs have access to additional low-cost funding if they expand their lending to businesses. The scheme encourages lending to all businesses, although the incentives are stronger for small and medium-sized enterprises (SMEs).	Scheme participants must submit necessary data to the Bank showing proof of lending. Reference period 2020 calendar year

Source: RBA, BOE, ASB

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