Risks down but still up

- **Financial system sound, with continued watch on housing and dairy.**
- **Consultation on a Debt-to-Income macro-prudential measure forthcoming.**
- **No fresh implications for the OCR or the housing market.**

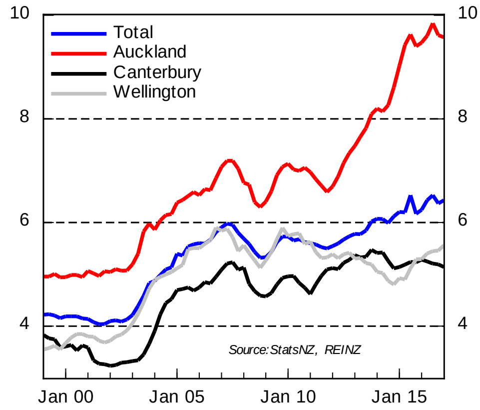
Summary
There was little new in the FSR. The RBNZ remains wary about housing, dairy, and the increased reliance of banks on foreign funding. Nevertheless, the RBNZ continues to note that the NZ financial system is sound.

There were **no new housing restrictions announced** – nor did we expect any, given the market has cooled off since late last year. Whether the market remains that way is another question, but our expectation is that future price growth will be constrained up and down the country. And that means little urgency for further macro-prudential action.

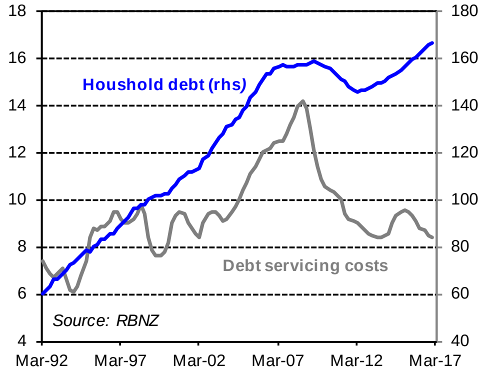
The RBNZ is still working towards getting a Debt-to-Income (DTI) restriction into its toolkit. Public consultation will start very soon, as hinted at when the Monetary Policy Statement was released earlier this month.

With no fresh macro-prudential action and creation of a DTI tool still some way off, **there are no fresh implications for the OCR or the housing market from the May FSR**.

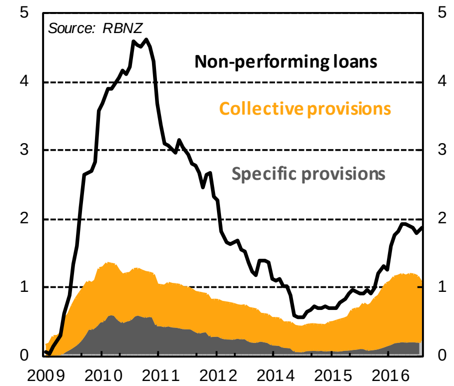
HOUSE PRICE TO INCOME



HOUSEHOLD DEBT
(% of disposable income)



DAIRY ASSET QUALITY
(% of dairy lending)



Housing: no new measures
As expected, **the RBNZ announced no new macro-prudential policies** in the May Financial Stability Report. And, while the RBNZ acknowledges that housing market vulnerabilities are one of the key main risks, it also noted that these risks have reduced in the past six months.

This is not to say that the RBNZ will stop monitoring housing-related developments. The RBNZ noted that house price growth and credit growth have fallen, but stated that household indebtedness, especially related to incomes, continues to rise. It is these households that would be particularly vulnerable to a lift in interest rates or a drop in incomes. The RBNZ also acknowledges that **the outlook for the housing market remains uncertain**, particularly as current rates of residential building are insufficient to meet population growth.

The RBNZ believes the Loan-to-Value Ratio policies are currently mitigating housing market risks, but are aware of the financial stability risks if house prices were to start growing quickly again. As a result, the RBNZ has announced that it will shortly be releasing a consultation paper on Debt-to-Income ratio restrictions. The RBNZ states that it has no desire to use the DTI tool just yet, but that this would offer them another alternative in the future, should house price growth return.

Still wary of dairy
An eye remains on dairy sector risks. The RBNZ has acknowledged that higher dairy prices mean the majority of dairy farmers should be profitable for the season just ending this month. But the RBNZ remains concerned that **part of the sector remains heavily indebted and vulnerable to financial shock**. If these borrowers came under stress, the RBNZ expects banks will respond quickly in their risk models and through loss provisioning.

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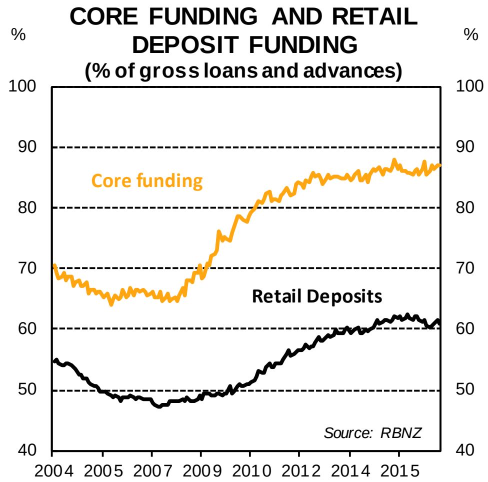

Bank funding in the spotlight

The RBNZ also discussed offshore funding exposure. **Given the slowdown in deposit growth and higher credit growth, banks have increased their offshore funding to fill the resultant gap**. The RBNZ notes that doing so increases banks' vulnerability to international risks on funding costs and availability. But the RBNZ also notes that banks are competing more aggressively for deposits and tightening credit availability, which will help to contain the funding gap. And banks have a high degree of stable and diversified funding sources, and have seen their Core Funding Ratios rise over the past year despite the slower deposit growth.

The slowdown in deposit growth over the last year has occurred in the household and business sectors, with the weightiest impact coming from households. The RBNZ notes potential deposit growth influences as: the winding down of Canterbury earthquake insurance inflows; asset reallocation towards equities; strong consumer spending. Our own analysis puts weight on the sharp lift in consumer spending over 2016 as a driver. We also ascribe part of the shift to a search for yield, particularly after the OCR dropped to fresh record lows from March 2016 onwards.

Household deposit growth appears to have stabilised – for now - around 7% yoy, having been as high as 11-12% in 2015. As housing credit continues to slow in line with softer house price growth, the deposit funding shortfall should gradually moderate.

RBNZ media release

New Zealand's financial system remains sound and the risks facing the system have reduced in the past six months, Reserve Bank Governor Graeme Wheeler said today when releasing the Bank's May Financial Stability Report.

"The outlook for the global economy has been improving but global political and policy uncertainty remains elevated and debt burdens are high in a number of countries. A sharp reversal in risk sentiment could lead to higher funding costs for New Zealand banks and an increase in domestic borrowing costs. New Zealand's banks are vulnerable to these risks because of their increasing reliance on offshore funding for credit growth," Mr Wheeler said.

"House price growth has slowed in the past eight months, in response to tighter loan-to-value ratio (LVR) restrictions, and a more general tightening in credit and affordability pressures in parts of the country. While residential building activity has continued to increase, the rate of house building remains insufficient to meet rapid population growth and the existing housing shortage. House prices remain elevated relative to incomes and rents, and any resurgence would be of concern.

"Dairy prices have recovered significantly in the past 12 months, and the majority of dairy farms are likely to have returned to profitability in the 2016/17 season. However, parts of the dairy sector are carrying excessive debt burdens, and remain vulnerable to a fall in income or an increase in costs. Banks should continue to closely monitor and maintain full provisioning against lending to high risk farms," he said.

Deputy Governor Grant Spencer said "The banking system maintains strong capital and funding buffers, and profitability remains robust. The banking system appears to be operating efficiently when compared with other OECD countries, based on metrics such as cost-to-income ratios, non-performing loans and interest rate spreads.

"Banks have generally tightened credit conditions in light of funding constraints and the increasing risks around housing. Banks are seeking to reduce their reliance on offshore funding and have raised deposit rates. The Reserve Bank supports a cautious approach to managing foreign debt, in light of lessons learned in the GFC.

"While the LVR restrictions have increased the banks' resilience to any fall in house prices, a significant share of housing loans are being made at high debt-to-income (DTI) ratios. Such borrowers tend to be more vulnerable to any increase in interest rates or declines in income. The Reserve Bank will soon release a consultation paper proposing the addition of DTI restrictions to our macro-prudential toolkit.

"The Reserve Bank is making progress on a number of other initiatives. A review of bank capital requirements is underway and we recently released an issues paper on the intended scope of the review. We recently concluded a review of the outsourcing policy for registered banks, and the Bank and other agencies are assessing the recommendations from the International Monetary Fund's recent (FSAP) review of New Zealand's financial system."

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