ASB

Economic Note

May 2020 RBNZ Financial Stability Report

27 May 2020

Financial system well placed to support recovery

- The financial system is in good shape, with extreme stress tests showing the limits of resilience.
- Banks' direct exposures to the most-affected sectors are small, according to the RBNZ.
- Nevertheless, the RBNZ expects that loan losses will increase.

Summary and Implications

The RBNZ sees the NZ financial system as well placed to support NZ's economic recovery, with good capital and liquidity buffers. But COVID-19 represents a significant challenge to the financial system. Even accounting for an expected economic recovery in the second half of the year, the RBNZ expects that its projected close-to-10% decline in annual GDP in 2020 will be the largest in at least 160 years. The associated losses in income will cause financial distress for a significant number of households and businesses.

Consequently, the RBNZ expects business failures and household income pressures to result in increased loan losses in the banking sector. Businesses in sectors directly exposed to COVID-19 have come in for closer scrutiny. The RBNZ notes that COVID-19 will have prolonged and sustained effects on some parts of the economy and it is inevitable that some firms will fail. Firms in the tourism, accommodation and hospitality sectors are particularly affected, and will face longer recoveries as border restrictions and social distancing measures affect sales and operating models. Compounding difficulties, firms in these sectors often hold relatively low financial buffers.

The RBNZ recently required banks to complete two stress tests, and notes banks are "resilient to all but the most severe scenarios". Under the most extreme scenario (18% unemployment rate, 48% decline in house prices) banks' capital levels fall below the minimum regulatory requirements if no mitigating actions were taken. By implication, under that economic outcome, banks would need to take some actions (e.g. capital raising) to maintain capital levels above the minimum requirements.

The RBNZ has already put into place a number of measures to ensure smooth functioning of financial markets, along with giving banks more headroom to lend by delaying its planned increases in bank capital requirements.

Solid outlook for the banking sector

The RBNZ have adjudged that the NZ financial system is in a solid position. The banking system had significant capital and liquidity buffers, built up due to both regulatory requirements and a general favourable climate. A multitude of recent policy actions by the RBNZ – including loans deferral schemes to households and small businesses, business financing guarantee schemes, bank liquidity and funding support measures, and regulatory relief - have been directed towards improving the provision and price of bank funding, that cash was plentiful and the financial system has kept ticking over. Banks will have a "critical role in supporting customers" and are well placed to play their part to support

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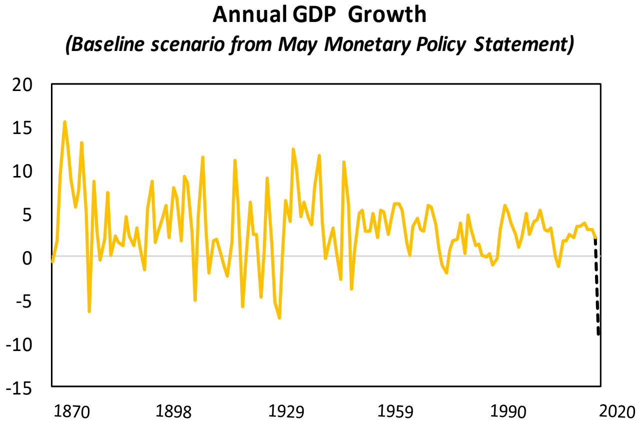
the economy as it rebuilds post COVID-19. The RBNZ are confident that the banking system can handle many of the challenges posed by COVID-19. Stress tests (see section at the end of this note) have shown that banks are well placed to accommodate significant shocks.



Source: Stats NZ, RBNZ

Nevertheless, banks have a balancing act to walk. Banks are providing huge support to businesses and households, with the RBNZ calling for banks to continue supporting the recovery and eat into their capital buffers in doing so. Banks will also need to make sure that they don't push too close to the regulatory limits and potentially erode the all-important confidence in their soundness. With that in mind, banks, the Government and the RBNZ have worked together on both ensuring that credit is readily available and that the banking system remains well backed-up.

Keeping vigilant

The RBNZ is also keeping close tabs on the wider financial system. Some non-bank deposit takers (NBDTs) have low profitability and are operating with low financial buffers. Consolidation within this sector is expected to continue. COVID-19 is likely to affect insurers in a number of ways. A number of insurers are exposed to investment losses as a result of financial market movements. Further, some providers of credit insurance appear vulnerable to a significant increase in unemployment. In the past six months the Reserve Bank has applied licence conditions to raise capital buffers for life insurers to mitigate the adverse impacts on their solvency caused by lower interest rates.

Business sectors under the microscope

Businesses in sectors directly exposed to COVID-19 have come in for closer scrutiny. COVID-19 will have prolonged and sustained effects on some parts of the economy and it is inevitable that some firms will fail. Firms in the tourism, accommodation and hospitality sectors are particularly affected. The RBNZ presented some detailed sector analysis that showed the balance sheet and debt servicing exposures by major sector. The lending to these sectors affected most severely by the initial impacts of COVID-19 makes up a modest proportion of the banking system's total assets. As such, losses on loans to businesses in these sectors are unlikely to undermine the stability of the financial system as a whole. However, the more widespread impacts on economic activity from COVID-19 are expected to lead to a deterioration in broader economic conditions. Housing and personal consumer lending, general business lending, and lending for commercial property, are also expected to face stress from the broader downturn in conditions.

The FSR also highlighted the vulnerability of the commercial property sector to COVID-19. Commercial property, of which NZ banks have a $40bn exposure, has historically been a source of significant credit losses for banks. Commercial property that services sectors directly impacted by COVID-19 – accommodation, hospitality, retail, and some office properties – has been immediately affected by COVID-19. The RBNZ noted large volumes of retail and accommodation space is due to be delivered over the next 12 months in the Auckland and Queenstown markets. We and the RBNZ suspect that COVID-19 may accelerate some of the longer-term trends apparent in the commercial property sector, which will lower demand. This could impact the viability of some projects and lending that has been put in place to a highly pro-cyclical sector. Encouragingly, in recent years banks have tightened lending standards and have increased scrutiny, which should ensure problems in the commercial property sector are therefore unlikely to threaten financial stability on their own. The commercial property sector, however, will be one to watch.

Household headwinds

The financial risks facing households have clearly increased materially thanks to COVID-19, and this was duly acknowledged by the RBNZ. Households are facing income shocks from two key channels: rising unemployment from both redundancies and business closures, and wage reductions as firms slash costs.

These headwinds mean households will have more difficulty servicing mortgage loans, particularly those that were late to the housing party and are hence carrying higher debt burdens. Likely house price declines will add to the stress on household balance sheets with the Bank warning the economic downturn could bring a "significant correction".

We've noted in our housing commentary some offsets to these risks from government and bank support. These were also noted as important by the Bank in the FSR. The mortgage holiday scheme has seen a take-up of around 13% and is assisting those borrowers finding it difficult to make mortgage repayments. The government wage subsidy and temporary dropping of LVR restrictions were also flagged as supportive of household balance sheets.

The Bank also, rightly, poured cold water on the idea that the dropping of the LVR restrictions may inflame imbalances and ignite another housing bubble. We ran a similar line in our latest housing note. The Bank hinted that, should the housing market again turn higher in future, the restrictions would likely to returned.

Taking stress tests to the extreme

The RBNZ recently had the banks conduct two stress tests of economic outcomes that were extreme, even by the standards of past stress tests that banks have performed for regulators. Under the first scenario (13.4% unemployment rate, 36% fall in house prices), banks' capital levels held above the regulatory minimum. The second scenario (aptly named "very severe") entailed an 18% unemployment rate and a 48% decline in house prices. The outcome of this scenario showed that banks' capital ratios would fall below the regulatory minimum if banks did not take mitigating actions (such as capital raising) to keep capital within regulatory requirements.

The encouraging takeout from these high-level results is that it takes an awful lot to put the banking sector under a degree of strain. Even our more realistic downside scenario 'only' had an unemployment rate of 11-12% and a 17% decline in house prices. The RBNZ's modelled outcomes are extremely unlikely but illustrate the extremes that banks can cope with.

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