Economic Note

November 2020 RBNZ Financial Stability Report

25 November 2020

Financial resilience a joint effort, but housing headaches to continue

- The NZ financial system remains sound and well placed to support NZ's economic recovery. Nonetheless, the RBNZ urges the need for continued vigilance.
- Housing market risks were acknowledged, with the RBNZ confirming its intention that the loan-to-value ratio (LVR) restrictions will be re-imposed in March (after consultation). We were a little surprised that no new initiatives were proposed to be added to the RBNZ policy toolkit.
- We doubt whether the LVRs on their own will be sufficient to bring the housing market to heel. A negative OCR remains off the drawing board for now but will likely remain an option in future if need be.

Summary and Implications

The NZ financial system has remained resilient and this looks to have been a team effort by NZ.INC despite being in the midst of a global pandemic. A strong starting point clearly helped, with the financial system entering the current downturn with strong buffers. The correct health policy response to tackle COVID-19, innovation, flexibility, adaptability by firms and households, as well as RBNZ and fiscal policy support have all played a role. The financial system has also benefitted and is well placed to play a key role in underpinning the post-COVID recovery.

However, the RBNZ urged the need for continued vigilance, noting the NZ economy is not out of the woods and that it is still climbing out of a deep hole. The impacts of the COVID-19 pandemic on the economy have been uneven, with the RBNZ concerned over weak business borrowing appetites which could have a bearing on medium-term growth prospects and broad financial stability.

There were generally few surprises from the RBNZ's commentary on housing. The RBNZ acknowledged that circumstances have changed in recent months and restated its previously announced intention to reimpose LVR restrictions at previous settings (20% deposit for owner occupiers, 30% for housing investors) from March 2021. In our view, more may have to be done and we were a little surprised the RBNZ did not provide a more thorough assessment of other policy options nor request that the policy toolkit be widened.

There was little new on the Funding for Lending Programme, although Governor Orr reiterated that the intent was not to impose restrictions on any form of lending. The onus will be on banks to play their part in underpinning what is hoped to be a durable upturn.

Governor Orr reiterated that the proposed changes to include house prices in the monetary policy remit will not change much in practice. That may be so, but the intent of the proposed changes is clear, and they will likely water down the notion of further OCR cuts when the housing market is booming. A housing crash may be a different matter.

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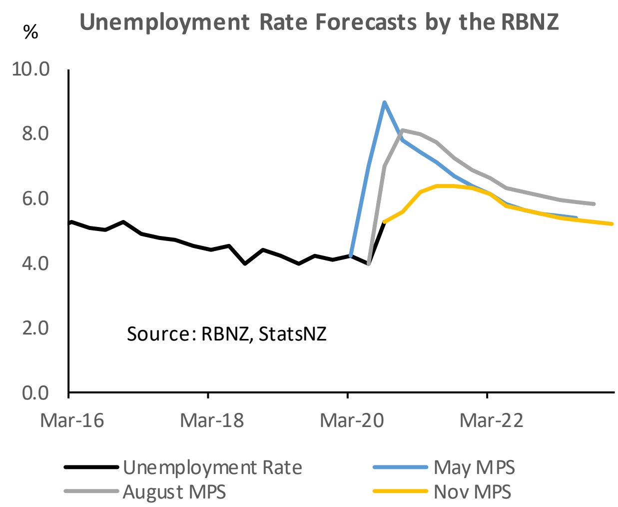
Resilience in financial system a joint effort

The key message of the November Financial Stability Report is that the financial sector is sound and that economic activity has been resilient. This looks to have been the result of a strong starting point for the economy (and wider financial system) and the subsequent joint efforts on the part of Government, the RBNZ and banks to cushion the economy from a sizeable COVID-19 hit.

A key component has been the Government's efforts at containing COVID-19, which have to date proved to be the correct strategy (sorry Sweden) and have played a key role in supporting NZ economic activity and bolstering financial system resilience. Domestic economic activity rebounded relatively quickly as the country moved to lower Alert Levels and this has supported financial stability. The RBNZ also lauded the innovation and flexibility being shown by businesses (and we would add households as well), via the adoption of technology and flexible operating practices. This has helped to reduce the fallout to the economy and financial system in general.

Policy support has also played a key role. The Government has used its strong fiscal position to support businesses and households, allowing the burden of the economic shock to be spread over the medium term. There has been a range of Government support measures for New Zealand businesses, and the wage subsidy has helped stabilised the labour market and household incomes. The better-than-expected outlook for the household sector has helped to mitigate risks to the wider economy and financial system.



The RBNZ believes it has played its part. The RBNZ has already put into place a number of measures to ensure the smooth functioning of financial markets, along with giving banks more headroom to lend by continuing dividend restrictions from the major NZ banks and delaying its planned increases in bank capital requirements. What's more, accommodative monetary policy settings have relaxed financial conditions and have eased debt-servicing burdens, supporting overall demand in the economy. The RBNZ's LSAP programme has boosted the level of deposits in the banking system and ensured sufficient liquidity remains in place. The banking system has maintained capital and liquidity buffers, and the insurance sector has also retained capital during this period.

Business failure rates have remained at very low levels to date, and unemployment has not risen to the extent initially feared. RBNZ policy easing has continued to support demand in the economy and alleviate financial pressures on businesses and households, and banks have been prudent. Moreover, economic stresses faced by businesses and households have yet to show up in banks' non-performing loan metrics. Business failure rates have remained at very low levels to date, and unemployment has not risen to the extent initially feared. Moreover, the agricultural sector has shown resilience, and although a number of highly indebted borrowers in the dairy sector remain vulnerable these risks are being appropriately managed.

However, the RBNZ remains wary and there is more work to do

The resilience shown by the economy and financial system in general will help sow the seeds for a strong (and let's hope durable) economic recovery. However, the RBNZ provided a reminder of the need for caution and for the financial system to remain vigilant. Let's not forget we are still in the midst of a global pandemic and while the vaccine news of late has provided light at the end of the tunnel, the NZ and global economies (and wider financial systems) still face a challenging period ahead. Circa 5% of the economy – inbound tourism and export education – is likely to remain offline until the border restrictions are lifted, and let's not forget the border restrictions will act to sharply slow net migration and overall population growth, for a while at least. It will take time for the global economy to come back online. Until then, there is still considerable uncertainty about the economic outlook, with NZ still vulnerable to the risk of further domestic outbreaks. The upshot from the RBNZ is that highly accommodative policy settings will need to be maintained for a while yet.

The severity of the initial fallout from COVID-19 has varied across industries, with the RBNZ highlighting potential vulnerabilities in retail properties, development lending and the wider commercial property sector, despite the recent resilience of the industrial and office sector thus far. Risks in tourism-centric retail and accommodation lending were also highlighted.

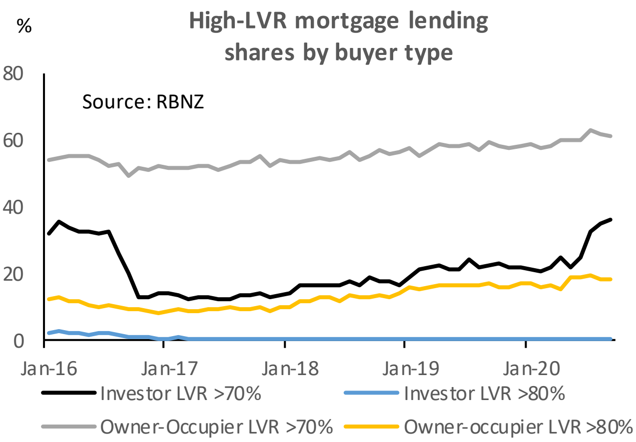
The RBNZ is also concerned over the uneven nature of lending growth, noting the persistent weakness of non-property related business lending. The latter could have sizeable implications for growth prospects and financial system soundness over the medium term. There is also the risk that, as government support schemes wind down, banks are likely to see a deterioration in their loan books. As such, banks will need to keep close tabs on borrowing and to maintain prudent lending standards.

RBNZ single out housing investors and signal LVRs will be reimposed

The housing market has hogged the headlines and captured much of the narrative elsewhere. On the positive side, the RBNZ noted that the increase in house price inflation in recent months had likely helped to mitigate financial stability pressures in the near term. Household balance sheets are sounder overall and this likely has supported the economy.

The housing market is also causing the RBNZ a number of headaches. Circumstances have clearly changed since the RBNZ removed the LVR restrictions in April. In recent months the proportions of new mortgages originated to borrowers with high LVRs, and to those with higher debt to-income (DTI) ratios have increased, as has the proportion of lending to investors. Moreover, the RBNZ is concerned that the recent growth in house prices increases the risk of a sharp correction in the medium term if the current demand and supply imbalances quickly unwind. This is another way of saying the risk of a housing correction has clearly grown, with housing supply having ramped up of late and with net immigration (and population growth) having cooled. As such, there is the need for prompt action.

At today's FSR, the RBNZ signalled that it intended to re-impose LVR restrictions at their previous settings from March 2021, to guard against continued growth in high-risk lending so that banks remain resilient to a future housing market downturn. These require most owner-occupiers to have a 20% deposit and most investors to have a 30% deposit, with some exceptions allowed. The RBNZ signalled that in early December it will consult on re-imposing the previous LVR restrictions.



We were disappointed that the RBNZ was not more thorough in discussing other policy options and in signalling that additional tools – including debt to income (DTI) limits – should be added to the toolkit. The FSR did include some material, which noted a recent uptick in the portion of new mortgage lending to borrowers with high debt-to-income (DTI) ratios, but these had coincided with the relaxation of the LVRs. The view seems to be that that the LVRs on their own would be sufficient and would help to constrain high DTI lending. Furthermore, it is the level of interest rates (as well as the level of debt) that impacts serviceability, something that a DTI on its own is not suited for.

These measures will help at the margin, but with NZ banks already reining in investor lending and also maintaining prudent lending standards for owner-occupiers, it is unclear whether this will be sufficient to slow the runaway housing market. Deteriorating housing affordability and the runaway housing market is a multi-faceted issue and will need to be tacked from a number of angles. There is not much that central bank policy can do to fix supply side issues in the housing market. The ball is back in the Government's court.

RBNZ provides view on proposal to include house prices in monetary policy remit

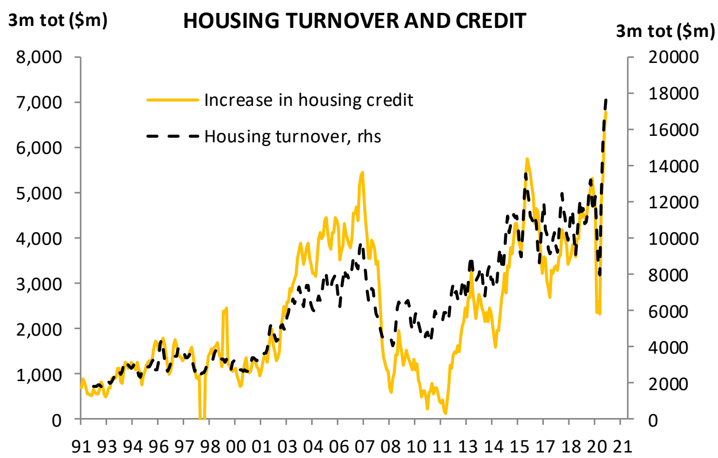
The RBNZ press conference at 11am give Governor Orr the opportunity to provide a view on how the RNZ should allow for the housing market in its housing deliberations. Recall, yesterday's letter from Finance Minister Robertson proposed that the RBNZ remit be tweaked, to include avoiding unnecessary instability in house prices (as well as for output, interest rates and the NZD) in clause 2b) in the RBNZ Monetary Policy Committee remit.

Orr reiterated what was said in yesterday's RBNZ's letter to the Minister of Finance. In short, he signalled that the proposed changes would not alter much in practice, with the housing market already playing a key role in policy deliberations, that policy support is needed considering we are still in a global pandemic and also there were limits to what RBNZ policy on its own could do. We concur.

To us, the intent of the proposed changes by the Finance Minister was clear, and it significantly reduces the odds of OCR cuts in the current climate. It does, not, however, rule out the OCR heading below zero in future if the circumstances change. There are some practical issues that will need to be worked through if house prices are to be added to clause 2b. What, for example, does "unnecessary instability" mean and over which horizon will the RBNZ look? How will the RBNZ deal with regional discrepancies? What is the pecking order if trade-offs need to be made between the housing market, employment and inflation objectives?

Few Details on the Funding for Lending Programme

Short of a high-level box on page 24, the FSR did not provide further details on the circa $30bn RBNZ Funding for Lending Programme (FLP), which is due to be rolled out next month. It reaffirmed that the intent of the FLP was to lower borrowing costs for firms and businesses within the economy and to boost demand pressure. From what we know so far, the scheme did not provide restrictions on what the funds could be used for. The risk is that the funds end up being used to subsidise lending on housing borrowing, while having little tangible impact on promoting business borrowing that can be used to fund productive investment and to grow the economy. It is little co-incidence that the recent exuberance in the housing market has coincided with a sizeable tick-up in housing lending (see chart).



Source: ASB, RBNZ, REINZ

At the Press Conference Governor Orr pledged that the RBNZ would not impose restrictions on types of lending so as to maximise the take-up of the programme and lower borrowing costs within the economy. This could be risky given the current state of the housing market. Either the RBNZ needs to put conditions around the FLP to promote business lending, as is the case with FLPs overseas, or it looks at trying to restrict housing lending by other means, including debt to income limits and other tools, as well as the LVRs. Both options will not be without cost. Stricter criteria on housing lending may well lock more first-home buyers out of the housing market. Some small business borrowing secured on the home will be not be eligible for the FLP. However, there is a balance to be struck between keeping the scheme flexible so as to encourage more take-up versus further igniting an already inflamed housing market and running the risk of a sizeable house price correction and a larger economic mess to clean up further down the track. Striking the right balance will not be easy, but the RBNZ has the option of adding more tools to its already expanded toolkit.

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