Economic Note

November 2019 RBNZ Financial Stability Report

27 November 2019

Curtain raiser

- The RBNZ chose not to relax loan-to-value restrictions, as some had speculated
- Concern the low interest rate environment and loosening bank lending standards could further gee-up the housing market look to have been key considerations for holding the line
- As expected there was no sneak peek on next Thursday's bank capital decision

Summary & Implications

The RBNZ today added to its recent run of "no change" decisions, this time on the financial stability rather than monetary policy front.

There was no change to the Bank's loan-to-value (LVR) restrictions for mortgage lending, in what we thought would we be a finely balanced decision. There also wasn't too much change in the RBNZ's general assessment of financial stability risks. NZ's dairy and housing vulnerabilities remain on the RBNZ's watch list, and got another thorough airing.

The RBNZ's monetary and financial stability arms appear to be working together. The low-for-longer interest rate environment was frequently cited in the Financial Stability Report (FSR) as a possible risk to financial stability. Indeed, the decision not to relax LVRs was largely motivated by concerns low interest rates, and an expansion of riskier bank lending, could further gee-up the housing market.

In our view, the RBNZ's intention is to continue slowly relaxing the LVR restrictions to a point at which they are no longer a binding constraint on credit availability. But given they didn't move them today, and our view that the housing market upturn will continue to gather pace over the next year, it could be a while before they are relaxed again. It's worth noting that impacts on residential credit supply from the RBNZ's proposed increases in bank capital will be relatively modest compared to business and agricultural lending.

There was no sneak peek on next Thursday's much more highly anticipated announcement on the RBNZ's finalised bank capital proposals.

Nothing to see here – policy settings unchanged

There wasn't anything earth shatteringly new in today's FSR. The key 'new news' if you like was: 1) that the RBNZ is going to be even more vigilant on financial stability risks given we are in a lower-for-longer interest rate environment, and 2) the Bank is watching closely "early signs" that banks are easing mortgage lending standards.

The RBNZ has relaxed LVR restrictions four times since the scheme was introduced in 2013. In our view, the case to do so again today was evenly balanced. In the event the Bank chose to not to do so, not so much because of any clear and present danger, but more so with an eye to the future.

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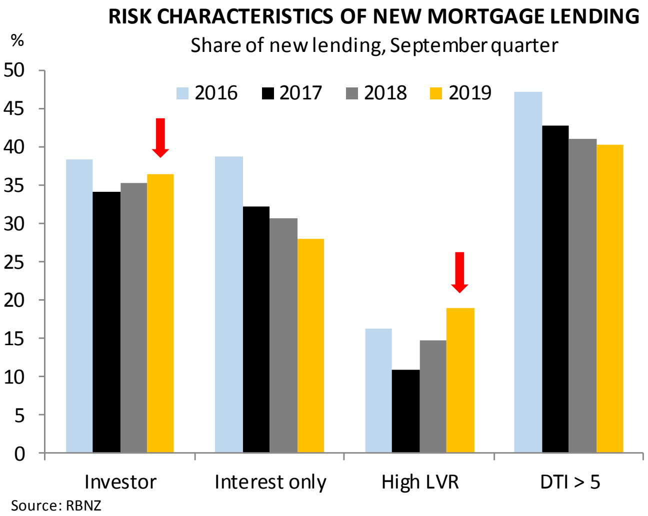
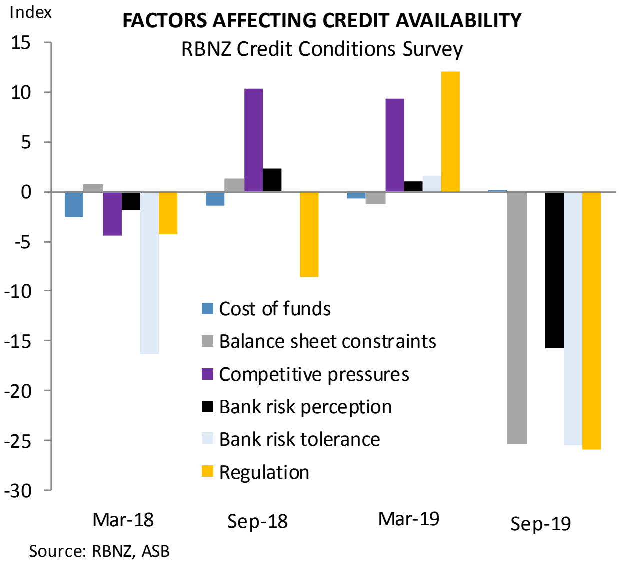
To be comfortable relaxing LVR restrictions the Bank has said it needs to see: 1) credit and house price growth remaining relatively well contained; and 2) banks maintaining prudent lending standards. On the first point, the Bank, like us, anticipates the lower interest rate environment will further stimulate a housing market that is already showing clear signs of momentum. But it was 2) that seemed to be the bigger sticking point.



In July, the Australian Prudential Regulation Authority (APRA) relaxed its rules on debt-servicing test rates which, coupled with rock-bottom interest rates, have contributed to a loosening of bank lending standards in New Zealand in the past few months (see chart). It's arguably marginal stuff but the Bank has opted to take the prudent approach and watch and wait to see if this trend continues. In their words "a significant resurgence in house prices would still be concerning given that they remain elevated relative to incomes and rents."

Bank capital – no sneak peak

The big 'reveal' for financial stability is next week on December 5 when the RBNZ announces its finalised bank capital proposals. On that front the RBNZ continued to make the case for improving NZ banks' resilience to withstand shocks and referenced its proposals for setting capital at a level intended to enable banks to withstand a 1 in 200 year crisis. There were no obvious signs in the FSR that the RBNZ has changed its stance on how much capital or what type of capital it will settle on for its new requirements - we'll have to wait until next week.



Our view remains that RBNZ analysis has overstated the potential benefits of the higher capital requirements, and understated the potential costs of banks holding higher capital.

The bank did tip it's hat to various reports and commentary about the fact credit conditions for certain sectors have begun to tighten *in advance* of the bank capital decision, noting "…credit conditions are expected to tighten for a number of sectors of the economy".

Housing and dairy vulnerabilities remain

Housing and dairy remain high up on the RBNZ's wall of worry, albeit we didn't detect any noticeable increase in the Bank's assessment of risks today.

According to the bank, "the high level and concentration of household sector debt remains the largest single vulnerability of New Zealand's financial system". Household vulnerably may also grow as a consequence of the current historically low interest rate environment. Admittedly, lower interest rates and hence debt servicing ratios were noted as buffers to the otherwise concerning build-up of debt.

On dairy, profitability has improved on the back of rising dairy prices but the RBNZ duly noted the laundry list of issues confronting the sector including: high and concentrated dairy debt, rising non-performing loans to the sector, impacts from environmental regulations, and significantly tighter lending standards blunting the stimulatory impact of materially lower wholesale interest rates. Banks were thus encouraged to "work constructively with farmers wherever possible."

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