ASB

Economic Note

May 2019 Financial Stability Report

29 May 2019

Ongoing vigilance

- The RBNZ chose not to change the owner-occupier and investor loan-to-value ratio restrictions (LVRs), that were last relaxed in January. This looks to be a prudent move.
- The RBNZ remain wary to financial stability risks in the housing and dairy sectors. Global risks remain.
- The RBNZ also tried to make the case for significantly higher bank capital requirements. We believe they have overstated the potential benefits and understated the potential costs.

Summary

The RBNZ assessment is that that New Zealand financial system remains resilient to a broad range of economic risks. However, financial system risks remain. High debt levels in both the household and dairy sectors remain key vulnerabilities. Other risks include the potential impacts of weaker Chinese growth and risks in the Australian housing market. All require ongoing vigilance.

As we had expected, the RBNZ chose not to change owner-occupier and investor loan-to-value ratio restrictions (LVRs) for residential lending. Given that the LVR restrictions were last trimmed at the start of the year and the OCR was also cut to a new record low of 1.50% in May, and looks set to fall further, this looks sensible.

The RBNZ adjudged that the LVR restrictions had been successful in reducing some of the risk associated with high household indebtedness. However, their imposition has not been without costs. The RBNZ still intend to further relax the LVR restrictions, noting current LVR settings remain appropriate "for now". They have outlined what they would need to see before relaxing the LVR restrictions in future. This includes continuing subdued growth in credit and house prices and banks maintaining prudent lending standards. **Over the next two to three years we would expect the RBNZ to gradually move the restrictions to a point at which they are no longer a binding constraint on credit availability** – as long as low financial stability risks warrant further relaxation.

The RBNZ's view is that higher capital requirements are necessary, so that the banking system can be sufficiently resilient whilst remaining efficient. Our view is that the RBNZ's proposed increased in capital requirements for locally-incorporated banks are likely to lead to higher costs and lower potential benefits than what the RBNZ assert. The RBNZ have also signalled the need for insurers and non-bank deposit takers to improve their capital buffers. This will likely level the playing field but it could potentially impose higher costs on the NZ economy in relation to the potential benefits. We will have to wait for the scheduled November announcement to see if the RBNZ has heeded this message.

NZ remains vulnerable to adverse global shocks. The RBNZ cites negative developments in China and risks posed by the Australian housing market. The RBNZ cites evidence that down-side risks for house prices become more synchronised across advanced economies immediately before global recessions.

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Financial System sound but risks remain

The RBNZ's assessment is that New Zealand's financial system remains resilient to a broad range of economic risks. They remain cognisant that high debt levels for some household and farms keep the system vulnerable to risks.

Current LVR restrictions approprirate for now

The current the loan-to-value ratio (LVR) restrictions on housing lending were maintained. At present, most owner-occupier purchasers will still require a 20% deposit and the speed-limit (or proportion of new lending with high LVR) was raised to 20% from 15% at the start of the year. Investor deposit/equity requirements remained at 30%, with the speed-limit unchanged at 5%. The LVR restrictions were last relaxed at the start of this year, which followed a relaxation at the start of 2018.

The view of the RBNZ is that the loan-to-value ratio (LVR) restrictions on housing lending have been successful in reducing some of the risk associated with high household indebtedness. With the RBNZ still wary of the vulnerability to the financial system caused by high household debt, there was a strong case to maintain the LVRs.

This seems to be a prudent move in our view, given that the buoyancy in some provincial markets, the fact that the OCR was cut to a record low earlier this month (and mortgage interest rates have eased), and government decisions to shelve the Capital Gains tax may help support investor demand. Many regional housing markets outside of Auckland remain robust and in no need of further support. We expect the OCR (and potentially mortgage interest rates) to head lower over 2019. Moreover, the RBNZ are alert to the risk that housing market risks could quickly re-emerge.

The LVR restrictions have been very effective in the RBNZ's view. Despite the LVR restrictions having eased in recent years, the view of the RBNZ is that current policy settings are continuing to improve the resilience of households and banks, and help limit the likelihood and severity of a severe downturn in the housing market. By mitigating the scale of house price falls during a potential downturn, and limiting the indebtedness of households, the LVR restrictions have made the financial system more resilient to a housing-led downturn.

While the LVR's have been effective in helping to cool the nationwide housing market and in improving financial stability, this has come at a cost. The recent evaluation of the LVR's by the RBNZ, suggests that the first iteration of the restrictions in 2013 "disproportionately restricted" purchases of houses by first home buyers, favouring purchasers with housing equity, creating a tension with the public policy goal of housing affordability. Moreover, the Auckland regional LVR policy (applied for about a year starting in late 2015) contributed to a spillover of housing demand from Auckland to other regions, despite being effective at addressing risks in Auckland itself. Subsequent iterations of the LVR restrictions and related government policy changes have been more targeted at slowing demand from property investors.

As such, the RBNZ have highlighted the transitory nature of the LVR settings - remain appropriate "for now" – and have spelt out the conditions under which they would further relaxed. According to the RBNZ policy assessment "any further easing subject to continuing subdued growth in credit and house prices and banks maintaining prudent lending standards". Our view is that over the next two to three years we would expect the RBNZ to gradually move the restrictions to a point at which they are no longer a binding constraint on credit availability – as long as low financial stability risks warrant further relaxation.

We note that there are limits to what prudential policy (and even the OCR) can do to address challenges posed by housing affordability. It entails a comprehensive policy response and some trade-offs will have to be made. Encouragingly, the construction of new dwellings has stepped up significantly in recent years, with annual residential consent issuance currently the highest since the mid-1970s.

RBNZ still wary on dairy

The RBNZ remain vigilant to risks in the agricultural sector. Strong prices and production have allowed many farms to make progress in repaying debt, and the proportion of dairy loans on principal and interest terms has continued to increase. However, the RBNZ are concerned over the “slow rate of recovery” of some farms in the dairy sector, and many highly indebted farms have struggled to repay debt. The dairy sector remained “susceptible to higher interest costs or working expenses, and to changes in banks’ business practices”. The RBNZ’s view, “vulnerable farms must reduce their debt to improve their resilience to future downturns”. It notes, however, “options for addressing problems at financially stressed farms appear constrained at the moment”, given low demand for dairy farm land.

Banks have so far taken a long-term view in supporting stressed dairy farms and working with them to strengthen their financial positions, and have increasingly diversified their agriculture lending. Future investment needs for farms to address biosecurity and environmental challenges were identified by the RBNZ. **There is another headwind facing the rural sector.** We note that proposed increases to bank capital requirements would likely have a more significant impact on capital-intensive lending, including rural lending. Our view is the proposed capital requirements will significantly impact the cost of funding and the supply of credit for the rural sector.

Bank capital requirements

The Reserve Bank is also reviewing its baseline policies to ensure that they are up to date and the financial system can withstand severe shocks.

The RBNZ’s preliminary view is that higher capital requirements are necessary, so that the banking system can be sufficiently resilient whilst remaining efficient. The May FSR provided another plug for the RBNZ’s proposed increases in bank capital requirements for locally-incorporated NZ banks. Recall, that the RBNZ proposed that after a 5 year transition period that Tier 1 capital for the “Big-4” domestic systematically important banks (D-SIB), be increased from 8.5% to 16% of risk-weighted assets (RWA), with capital for smaller banks to be raised to 15% of RWA. This, as well as proposed changes to more closely standardize capital requirements for both the small and large banks represents a significant increase in capital that the banks will need to hold.

Our view is that the RBNZ analysis has overstated the potential benefits of the higher capital requirements, while the RBNZ has understated the potential costs of the banks holding higher capital. We expect that customer borrowing rates will be 50-75bps higher at the end of the transition period (versus the RBNZ’s estimate of 20-40bps), with bank deposit interest rates likely lower. The requirements are also expected to dampen the supply of credit to sectors with higher capital requirements, particularly if the transition period is too short. We note that the cost of funds for local-incorporated NZ banks are not much higher than for their (more highly rates) parents. Indeed, Standard & Poor’s have noted that New Zealand’s largest banks are unlikely to experience a lower cost of funds or a credit rating upgrade as a result of the capital requirements. The RBNZ is due to report back by the end of November (likely the November Financial Stability Report), with the new requirements set to be gradually phased in from April 2020. Watch this space.

The RBNZ have also signalled they will be casting the net wider. The FSR policy assessment cited the need for some insurers and non-bank deposit takers to improve their capital buffers. As, such, the RBNZ have said it will be reviewing insurer solvency standards in the months ahead.

The environment and climate change pose challenges

The Reserve Bank is engaging with insurers and banks in New Zealand and with international agencies as part of its climate change strategy. Climate change is widely expected to impact the financial system; the majority of banks and insurers believe climate change will impact their business. The FSR notes that “all banks and 90 percent of non-life insurers thought climate change is a risk to their businesses”. The FSR also notes “around 60 percent of life insurers recognised climate change as a risk to their businesses”, the lower result reflecting life insurers having less direct exposure to climate change risks.

Global risks of concern

The usual global risks remain. International risks include high global debt levels and elevated asset prices. The FSR notes that persistently low global interest rates "have allowed a significant build-up in global debt levels and asset values". In turn, this has increased the vulnerability of borrowers to funding and equity market shocks. The risk remains that global shocks can cause a significant increase in funding costs in New Zealand.

Moreover, policymakers in advanced economies are noted to have "less headroom for fiscal and monetary policy to respond to a significant economic downturn" than before the Global Financial Crisis. This is a reflection of already-low monetary policy settings and government debt levels that are much higher than pre-GFC levels in many advanced economies.

Risks in China and the Australian economy are also identified within the FSR. Negative developments in China have the potential to weaken global growth and impact New Zealand directly, as well as via Australia. The performance of the Australian economy and its financial system is important, given it is major trading partner, and New Zealand's largest banks and insurers are Australian owned. Risks from the weaker Australian housing market were examined. The RBNZ cites evidence that down-side risks for house prices become more synchronised across advanced economies immediately before global recessions. We have been warned.

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