8 May 2013

Westpac Institutional Bank

Nothing lasts forever

RBNZ Financial Stability Report May 2013

- **The Reserve Bank's six-monthly *Financial Stability Report (FSR)* revealed a growing degree of concern about the effect that low interest rates are having on the housing market and household indebtedness.**
- **As interest rates rise over time, this could place a significant amount of strain on borrowers and lenders, particularly for mortgages with high loan-to-value ratios.**
- **To that end, the RBNZ will require banks to hold a greater level of capital against these loans, increasing their safety buffer in the event of a major downturn.**

While the Reserve Bank's latest *Financial Stability Report* contained the by-now familiar refrains about high house prices and household debt, there was a stark warning underlying it: interest rates are unsustainably low. The booming housing market is predicated on those unsustainably low rates. And when interest rates inevitably rise, the actions of borrowers and lenders today could place the financial system under significant strain.

In fact, the RBNZ is so concerned about this risk that it's prepared to act now. The report was dominated by the announcement that the major banks will soon be required to hold a higher minimum level of capital against mortgages with a loan-to-value ratio above 80%. As we detailed in our latest quarterly *Economic Overview,* this is not a substitute for using the OCR – the main impact will come in terms of the size of the safety buffer that banks hold, with only a marginal impact on the cost of borrowing. Consequently, we don't expect this to have a decisive impact on the housing market – and we don't think this is the last we'll be hearing about the need for higher interest rates.

Details

The *FSR's* assessment of the local economy was in line with the most recent *Monetary Policy Statement.* The Canterbury rebuild is becoming a major driver of growth, but there are also more signs of growth outside the construction sector, driven by recent growth in consumer demand and housing market activity. The impact of the recent drought will be partly offset by higher dairy prices, but it could place some agricultural loans under stress.

Global financial conditions have become much more hospitable, having averted two major risks – a breakup of the euro zone and the US fiscal cliff. Improved sentiment and unconventional monetary policy easing in many of the major economies have driven a significant fall in longer term interest rates around the world, including here.

The *FSR* noted that the credit cycle is turning upward, supported by low interest rates and an improvement in risk appetites. Household debt and house prices are rising again from levels that were already high relative to incomes. Credit growth may also outstrip deposit growth soon, which would leave banks increasingly reliant on international funding markets, which became a major source of risk during the Global Financial Crisis.

The concern from a financial stability point of view is that a future downturn in house prices could place a significant degree of strain on the financial system. The scope for losses would be exacerbated by the growing use of high loan-to-value ratio (LVR) mortgages, which are now estimated to account for 30% of new lending. Recent gains in house prices may be predicated on temporary factors – for instance, if housing construction picks up in response to higher prices, it could eventually alleviate shortages and drive prices down again – though perhaps with a lag of several years.

However, the major risk to house prices is that current interest rates are at unsustainably low levels. The FSR notes this at several points:

"Low mortgage rates are helping to keep household debt burdens manageable in the short term, but the increase in underlying indebtedness leaves households vulnerable to a reduction in incomes or a rise in interest rates."

"Given that interest rates are at historical lows and will likely rise in the future, lenders should ensure borrowers will be able to service loans even if interest rates rise substantially."

"In an environment of low mortgage rates, there is a danger that house price increases are exacerbated as households develop an expectation that rapid house price growth will persist."

Capital requirements for high-LVR lending

In keeping with these concerns, the RBNZ announced today that the four major banks will be required to hold a higher minimum level of capital against loans with an LVR greater than 80%. This will come into effect from September 30. While this is not strictly part of the RBNZ's suite of 'macroprudential' policy tools (in that it won't be adjusted over the cycle), it will operate in much the same way.

In our *Economic Overview* published last week, we gave a brief example of how an increase in capital requirements would transmit through the banking system. In short, these rules alter the mix of the funding side of a bank's balance sheet. Banks make loans and fund these through both debt and equity. Equity tends to be the more expensive source, since equity holders are more exposed to losses; it also tends to be a small fraction of the total – in the ballpark of about 5% of the balance sheet.

The RBNZ's new rule means that the minimum amount of capital that banks will have to hold against high-LVR loans will increase by about 35% on average. The total impact on the cost of funding high-LVR loans will depend on a range of assumptions; the RBNZ notes that:

"We expect lending rates could increase by approximately 4-6 basis points in the short-term to the extent banks allocate additional capital across the entire housing portfolio. If the additional risk is allocated only to high LVR loans, then we expect lending rates for these loans could increase by approximately 20-30 basis points."

Competitive pressures will limit the extent to which higher funding costs can be passed through to mortgage rates – this is particularly relevant given that at this stage the new requirement only applies to the four major banks (the other banks use a different, much simpler formula to calculate their capital requirements). The RBNZ assumes that the impact on lending rates will be temporary and fully competed away over time.

There are two points to take out of this. The first is that the impact on lending rates is proportionately small – probably less than a single incremental change in the OCR. And if the price of loans doesn't change significantly, we shouldn't expect a significant change in the behaviour of borrowers and lenders, and therefore on the housing market. The second point is that the impact on the size of the banks' equity buffer is proportionately large – a 35% increase in the case of high-LVR loans. Put these two together, and it's apparent that this restriction is much more effective at making banks safer during a downturn than at leaning against the housing cycle.

Macroprudential tools

The RBNZ notes that its four 'macroprudential' policy tools remain a work in progress. The first round of public consultation ended in April, and the RBNZ is currently working through the responses. The next milestone will be the Memorandum of Understanding between the RBNZ and the Minister of Finance, which will set out the objectives and accountability arrangements for macroprudential policy; this is expected to be signed around mid-year. From there, there is still a substantial amount of work to be done on the technical details of the tools, and further consultation is likely. We remain of the view that these tools will probably be enacted next year.

Market implications

There was no substantial market response to the *FSR.* We saw a risk that interest rates could fall if the market viewed the increase in bank capital as a substitute for OCR hikes. However, the move needs to be balanced against the fact that the RBNZ is increasingly alarmed about the effects of low interest rates.

That might seem to contradict the RBNZ's stance in monetary policy reviews, where it has signalled that the OCR will remain on hold this year and be raised only gradually from next year. We suspect that it comes down to timeframes. Right now, it's appropriate for the cash rate to remain low, as inflation remains below the target range and is forecast to rise only gradually. But over time, the OCR will need to return to a more normal level.

The longer that interest rates remain low, the more that borrowers (and lenders) will behave as though low interest rates are permanent, and the more vulnerable they could be when interest rates rise in later years. Changing the 'macroprudential' settings can reduce lenders' vulnerability, but they are unlikely to have a major impact on interest rates – and hence on borrowers' behaviour.

Michael Gordon
Senior Economist

Westpac Economics Team Contact Details

Dominick Stephens, Chief Economist	Ph: (64-9) 336 5671	dominick_stephens@westpac.co.nz
Michael Gordon, Senior Economist	Ph: (64-9) 336 5670	michael_gordon@westpac.co.nz
Felix Delbrück, Senior Economist	Ph: (64-9) 336 5668	felix_delbruck@westpac.co.nz
Nathan Penny, Economist	Ph: (64-9) 336 5669	nathan_penny@westpac.co.nz

Disclaimer

This information has been prepared by Westpac Institutional Bank, a division of Westpac Banking Corporation, ABN 33 007 457 141 incorporated in Australia ("Westpac") and is current as at 8 May 2013. It is subject to change without notice but Westpac is not obliged to update or correct it. Recipients should not forward or reproduce (in whole or part) this information unless Westpac consents however Westpac accepts no liability for the actions of third parties in this respect. This information does not constitute investment advice or an offer to subscribe for any financial instrument or to enter into a legally binding contract. It has been prepared without taking account of your personal objectives, financial situation or needs. You should seek your own independent legal and/or financial advice before proceeding with any investment decision. Any forecasts given are predictive only and past performance is not a reliable indicator of future performance and may be affected by known or unknown risks and uncertainties. Except to the extent that such liability under any law cannot be excluded, Westpac makes no representation or warranty, express or implied, and does not assume any responsibility or liability for this information or any errors or omissions to it.

The distribution and use of this information may be restricted by law in certain jurisdictions. Persons who receive this information should inform themselves about them and observe any such restrictions:

If you are reading this in New Zealand: Westpac's current disclosure statement for the New Zealand division of Westpac Banking Corporation ABN 33 007 457 141 or Westpac New Zealand Limited can be obtained from any branch of Westpac New Zealand Limited or free of charge, at the internet address www.westpac.co.nz. Westpac Institutional Bank products and services are provided by either Westpac Banking Corporation ABN 33 007 457 141 incorporated in Australia (New Zealand division) or Westpac New Zealand Limited. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement.

If you are reading this in the United Kingdom: Westpac Banking Corporation is registered in England as a branch (branch number BR000106) and is authorised and regulated by The Financial Services Authority. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised and regulated by The Financial Services Authority. This communication is directed at a) persons who have professional experience in matters relating to investments falling within Article 19(1) of the Financial Services Act 2000 (Financial Promotion) Order 2005 or (b) high net worth entities, and other persons to whom it may otherwise be lawfully communicated, falling within Article 49(1) of the Order (all such persons together being referred to as "relevant persons"). The investments to which this document relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this document or any of its contents. In the same way, the information contained in this document is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Services Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on this document to any third party. In particular this communication and any copy of it may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. If you are reading this in Australia: This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac. Australian customers can obtain Westpac's financial services guide by calling 132 032, visiting www.westpac.com.au or visiting any Westpac Branch.

If you are reading this in Singapore: This document is provided to you solely for your own use and in your capacity as a wholesale client of Westpac. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Regulatory Banking Commission.

If you are reading this in the United States: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM') , a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). If this report is distributed in the United States, such distribution is done under Rule 15a-6 of the Exchange Act by WCM, which accepts responsibility for its content. All disclaimers set out with respect to Westpac apply equally to WCM.