Westpac

Institutional Bank

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RBNZ Financial Stability Report review, November 2015

This morning the RBNZ released its latest Financial Stability Report. The RBNZ reiterated that the New Zealand financial system is generally sound, but that heightened risks were emerging in the Auckland housing market and the dairy sector. However, the RBNZ seemed to indicate that it would wait and see how its latest round of mortgage lending restrictions would affect Auckland housing, rather than introduce any new measures to cool the market.

This morning the Reserve Bank released its latest Financial Stability Report (FSR), a six-monthly assessment of the financial system's strengths and vulnerabilities. As expected, the RBNZ reiterated that the New Zealand financial system is generally sound, but that heightened risks were emerging in the Auckland housing market and the dairy sector. However, the RBNZ seemed to indicate that it would wait and see how its latest round of mortgage lending restrictions would affect Auckland housing, rather than introduce any new measures to cool the market. In particular, the RBNZ sounded rather cool on the idea of introducing loan-to-income restrictions on mortgage lending. Furthermore, the RBNZ seemed to view the dairy situation as manageable from a banking system perspective.

All in all, today's FSR contained no great surprises, nor any indication of impending changes to macroprudential policy.

Housing

The housing market remains a key concern. Nevertheless, the RBNZ is not looking at any policy changes, and instead is monitoring the effects of the recent changes to the LVR policy.

Housing market concerns continue to be centred on Auckland. The RBNZ again noted that prices in Auckland look stretched relative to incomes and that rental yields are low. The large role of investors in the Auckland market was highlighted. These conditions mean that the banking system is significantly exposed to developments in Auckland's market.

In response to such concerns, the RBNZ has tightened the restrictions on borrowing in Auckland (those policies came into effect 1 November), complementing changes in the taxation of investment properties. It's too early to say what impact these policies will have, and so the RBNZ is monitoring their impact. Early indicators are that these polices are dampening demand in Auckland, with the latest housing market figures showing a sharp pull back in sales in October.

The RBNZ noted that there has been a shift in housing demand to areas outside of Auckland, and that this could be positive for financial stability. However, they are continuing to monitor regional housing markets for signs that financial stability risks may be developing outside of Auckland.

Today's FSR did include a discussion on debt to income ratios (DTI) – a potential policy that has been bandied about in policy circles and discussion forums of late. However, while the RBNZ did note that around 40% of lending in NZ is at high DTI levels, today's report did not indicate that the RBNZ is currently planning to introduce restrictions on such lending. In New Zealand, high DTI lending has been concentrated among investors and those on higher incomes – both groups that tend to have bigger financial buffers. While the RBNZ is continuing to monitor DTI levels, at this stage they looking at how recent changes to the LVR policy are affecting the resilience of the banking system.

Dairy debt

The FSR also focused on the risks from high levels of debt in the dairying sector, and highlighted the challenges stemming from a second year of weak cash flow. However, the RNBZ concluded that such risks were manageable.

The RBNZ noted that many loans to indebted farmers could become non-performing if the payout is slow to recover, which is clearly a possibility given the increases in global production in recent months. The RBNZ also noted that there was downward pressure on farm prices that could exacerbate financial stress in the dairying sector. In response to financial pressures, farmers have been reducing expenditures (including staff numbers) which will affect associated industries.

Under the scenarios the RBNZ examined for the dairy sector, bank losses resulting from continued low dairy prices were expected to be around 2 to 18% of bank profits, levels that are manageable for the system as a whole.

Market liquidity

The RBNZ noted that some global financial markets had experienced a drop in liquidity, partly due to increased regulatory burden on market markers. This has sometimes resulted in increased volatility in financial market prices. One key consequence for New Zealand has been increased bank funding costs – markets are demanding due compensation for the risks they are taking in more volatile markets. Ultimately, this will result in higher retail interest rates than otherwise for New Zealanders. The RBNZ also noted that liquidity in the New Zealand Government Bond market has dropped – the ultimate consequence will be wider spreads for those trading NZ Government bonds (and we would add, slightly higher borrowing costs for the New Zealand Government).

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