ANZ Research

NZ Insight: FLP to enter the toolkit

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FLP to enter the RBNZ toolkit – how does that change the outlook for policy?

Key points

Monetary stimulus from the RBNZ following the onset of the COVID-19 crisis has been significant – and it has had an impact. Wholesale and retail interest rates are lower, the NZGB curve is lower and flatter, and high-grade credit markets are functioning well. However, unconventional monetary policy has so far had less of an impact on retail mortgage rates, which have fallen by only around the same amount as the OCR. The RBNZ has indicated that a Funding for Lending Programme (FLP) is the next cab off the rank in terms of monetary stimulus, essentially providing cheap funding to the banks with the explicit focus of targeting lower retail interest rates.

We now expect the following:

- An FLP will be announced at the November MPS, along with details of the scheme, and the programme will come into effect soon after. The FLP will be aimed at lowering retail interest rates, and that will be its measure of success.
- The programme will need to be available up to a considerable amount to ensure maximum impact, though the size of the programme and take-up is uncertain. We don't expect it to be as large as the LSAP, but we do expect a meaningful programme, perhaps as large as $30-50bn.
- Banks will likely participate in the scheme and details will be designed to encourage take-up.
- However, effectiveness does not rely on banks going in boots and all, especially in the beginning. With the scheme providing a cheap funding backstop, competitive pressure should provide a degree of downward impetus for retail rates, even in advance of banks taking the funds.
- The LSAP will remain part of the monetary policy landscape for a long time and we do not expect that the RBNZ will back away from it in any meaningful way. Continued purchases under the LSAP will remain a cornerstone for wholesale markets.
- The FLP and LSAP will be complementary. With an FLP of significant magnitude now expected and forecast bond supply reduced at the PREFU, pressure to expand the LSAP is reduced. We therefore now think that the LSAP cap will remain at $100bn, rather than be increased further.
- Retail mortgage and deposit rates look set to go meaningfully lower – the question is what combination of policies is necessary to achieve it. If the FLP is effective, that could reduce pressure on the RBNZ to take the OCR lower.

On balance, we still expect a negative OCR to enter the toolkit next year, given the very challenging outlook for both the labour market and inflation. However, the implementation of a FLP may take the pressure off in the short term, increasing the odds of a slightly later or more gradual implementation.

From LSAP to FLP

The RBNZ has signalled that a Funding for Lending Programme (FLP) is the next cab off the rank for monetary stimulus and we expect that one will be announced (along with all relevant details) at the November Monetary Policy Statement (MPS), with implementation soon after. See our previous FAQ on a negative OCR and FLP for more on how this might work.

The introduction of an FLP represents a concerted effort by the RBNZ to have a more targeted impact on retail rates with additional stimulus, complementing the continuing Large-Scale Asset Purchases (LSAP) programme that has seen a significant easing in wholesale markets (see our FAQs here and here). It is fair to say that the easing seen in wholesale markets has not generated the same impact in retail interest rates. To illustrate, the OCR is 150bps lower than it was two years ago, and in that time, the lowest new mortgage rate is 160bps lower. But over the same period, 3-year and 10-year NZGB yields are around 200bps lower. This is because the LSAP has a direct effect on bond yields, but has less of an impact on retail interest rates, the determinants of which are more complex. But retail rates are where the rubber hits the road in terms of stimulus, so the RBNZ has decided to target them more directly.

At a high level, the LSAP and FLP would be very similar. Both are funded by central bank money ("printed money") and thus both schemes drive up the supply of cash. But whereas the LSAP drives bond yields down with follow-on impacts on broader market rates, the FLP is expected to drive mortgage rates down directly by providing cheap funds straight to the banks.

If there were an openly traded market for mortgages, SME and corporate loans (as there is for government bonds), the RBNZ could simply tilt the LSAP away from NZGBs and instead target those assets, lowering interest rates on these products directly. But the RBNZ can't do that without undermining bank intermediation (which plays a crucial role in the credit aggregation and creation process and the functioning of the financial system), and nor would it want to, since that would come with credit risk and could result in the RBNZ effectively becoming a retail bank. But by lending funds to banks though the FLP, banks are then able to on-lend these funds and the RBNZ is able to broadly achieve the same result.

In essence then, the LSAP and FLP can be considered to be wholesale and retail "facets" of the same broad strategy. That doesn't mean that the RBNZ will look to phase out the LSAP in favour of the FLP though. The LSAP has played a key role in driving the NZGB curve lower and flatter, which has contributed to lower funding costs for the Crown (thereby facilitating fiscal expansion) and other high-grade borrowers.

The fact that the RBNZ has clearly signalled it will continue to provide stimulus through the LSAP is also contributing to keeping yields low, and moving away from that in any meaningful way would undermine that easing in financial conditions. At the margin, we do expect further mild reductions in the pace of LSAP purchases. This is likely to be a result of the time-frame for the LSAP being extended (implying a slower run rate), or because the RBNZ chooses to keep more firepower in store for tactical deployment later, or both. But either way, this should be viewed as a moderating tilt than a change of tack.

In short, we don't expect the RBNZ to walk away from the LSAP, which will remain a cornerstone of wholesale markets for some time to come. But as the RBNZ embarks on the FLP, this will take pressure off the LSAP, with less additional stimulus potentially needed through this channel. Ultimately, the schemes should be thought of as complementary tools.

The obvious implication of this is that the LSAP probably won't be increased further in November. Implementing the FLP to provide more stimulus makes more sense, given the traction it could get on retail interest rates. And there's still $63bn of capacity within the existing $100bn LSAP programme, meaning there's no pressure to expand the limit any time soon.

Bond supply also looks set to be a bit lower than previously expected. The RBNZ's current indemnity (to purchase 60% of outstanding NZGBs) would allow purchases of $100bn of bonds by June 2022, consistent with the current LSAP limit. But if the programme were expanded to $120bn (as we had previously forecast), the RBNZ would require a new indemnity and would need to be comfortable buying a little over 70% of NZGBs on issue. That seems unlikely.

Rather, we expect that the RBNZ will announce the FLP in November. The RBNZ has said in comments to the media that details of a FLP will be provided at the November MPS, so an announcement of when it will be deployed seems highly likely then too. So far, the RBNZ has been keen to provide stimulus pre-emptively, and the RBNZ's hiatus over the summer means that the November MPS is the RBNZ's last chance until February to generate a response in retail interest rates. The market has generally taken the view that three months is too long to wait.

Although we expect the FLP to be announced in November, deployment would not necessarily occur immediately. But it is likely to happen soon thereafter, consistent with recent RBNZ commentary. Specifically, the RBNZ have said "the Committee reached a consensus to … direct the Bank to prepare to have an FLP ready to deploy before the end of this calendar year. Details on the design of the programme would be agreed and published ahead of deployment".

How big might it be?

There are several ways the programme could be sized. One would be to simply specify a programme up to a certain limit, like the LSAP. Another would be to keep it open-ended, but limit it to a percentage of each bank's balance sheet. Or we could see a combination – say a programme up to a certain size, with each bank having a proportional limit.

How the programme will be announced and sized is unknown, but we think the scheme will be designed to generate bang for buck – and that means the volume of available funds needs to be significant. We expect that the size of the total programme could be comparable to a meaningful fraction of the LSAP. As a benchmark, we might see funds available of say $30-50bn.

The size of the programme is highly uncertain, though, and right-sizing it is more judgement than science. $30-50bn is our best educated guess, but should not be confused with us suggesting that there is a "right" size for the scheme. To put $30-50bn in perspective, that's 10-16% of GDP. International schemes we have looked at have been in the 11-17% of GDP range (with take-up to date only a portion of this).

There are arguments in favour of a large and bold scheme, consistent with the RBNZ's "go hard and go early" approach to date, which makes a scheme at the higher end of this range more plausible. Indeed, the LSAP limit is bigger as a share of GDP than similar QE schemes overseas (though not the actual bond purchases so far). That said, an FLP scheme in the range of $30-50bn would be equivalent to 5-8% of banking system assets, and a scheme at the smaller end of this range would be more in line with international norms when compared on this basis. Then again, it is hard to compare because schemes are often expressed relative to different bank balance sheet benchmarks.

An FLP of this size would be about half the size of the LSAP. But comparing the size of the LSAP and FLP is not apples-for-apples. That's largely because the RBNZ cannot control FLP take-up. Given uncertainty on this front, the RBNZ may well shy away from putting a dollar value on the size of the scheme entirely, though other central banks have tended to specify the upper limit of funding available in dollar terms, so we think on balance the RBNZ will do that too. At the very least, this will give a strong announcement effect that more stimulus is on the way, which would likely be accompanied by more signalling that retail interest rates are expected to move lower.

Take-up and impact

A key point to take away from the above discussion is that the transition to the FLP is likely to be bank-led, rather than RBNZ-led.

Initially at least, drawdowns from the FLP may be a bit limited, given deposit growth is already running well ahead of loan growth thanks to the LSAP. However, we do think that banks will take some of the funds at the outset. And over time, if credit growth is responsive to lower rates (and the FLP kicks off a round of retail interest rate reductions – see next point), the scheme could see much more take-up.

Offering cheaper funding to banks (to either generate new lending or to replace funding that is rolling off) will make it easier for banks to reduce their term deposit rates (knowing that they can access the FLP to replace any loss of funding or deposit market share). This will in turn allow banks to reduce mortgage rates.

Competitive pressures will speed the process (and FLP take-up), particularly as concern about maintaining market share of deposits becomes less important.

What is less clear is what term would see the most competition. At the moment, competition is the most intense at the 1-year part of the mortgage curve. Banks may be reticent to commit to a longer-term re-pricing profile of their assets (mortgages and other lending) than their liabilities (deposits) if the FLP is expected to fund only a marginal share of its traditional funding. But banks might be more comfortable competing more aggressively in the 2-3-year mortgage segment if they could lock in advantageous funding via the FLP for 2-3 years.

We expect the FLP to be a repo transaction, with banks pledging mortgage-backed securities (MBS) as collateral. There is an argument that the RBNZ could also accept NZGBs and other high-quality assets as collateral. However, most settlement banks will be holding these for liquidity reasons, or in trading books that facilitate issuance and the LSAP. It therefore makes less sense for these assets to be made eligible, since it could compromise liquidity ratios and primary market functioning.

To be clear, we don't envisage the lack of eligibility of NZGBs and the likes as a factor that will dent demand for them, at least initially. That's because as banks draw down against the FLP, they are likely to "park" funds in liquid assets before they are able to originate new retail assets. This is another reason why we expect NZGB yields to remain low despite the likely shift in focus from the LSAP to the FLP.

What does it mean for the odds of a negative OCR?

There are a number of considerations that the RBNZ will need to weigh up in the months following the introduction of a FLP.

- Does this buy the RBNZ time to wait and see how the economy is tracking, and potentially reduce the need for a negative OCR?

- Does it argue for a more gradual approach to future OCR cuts (and other stimulus)?

We are of the view that all else equal, the early launch of the FLP does buy the RBNZ time to pause and consider further actions. There is no way to measure this, especially since the effects are so uncertain. But if we observe that the lowest mortgage rate has fallen by around the same as the OCR over the past two years, and if we were to see mortgage rates fall by say another 50bps in the first few months after the FLP is launched, that's arguably 50bps less easing that needs to be delivered via other means (forward OCR expectations notwithstanding).

In the end, it's going to come down to two things: how much stimulus the Reserve Bank thinks it needs to deliver, which depends on how the economy evolves, and second, how much the FLP delivers in terms of the path of retail rates.

On the first point, the RBNZ has made it clear that they will look through the strength of the bounce out of the initial lockdown and focus squarely on the medium term, where they foresee inflation being too low and unemployment too high. Our forecasts are similar, though we've revised up our estimate of the bounce in activity in the second half of 2020 (see our Data Wrap). There has been nothing yet to suggest the RBNZ considers it anything other than pedal-to-the-metal time, with repeated commentary that if they are going to get it wrong, too much stimulus is better than too little.

But on the latter point, if the FLP is very effective, then this undeniably reduces the need to deploy a negative OCR urgently, all else equal. So could a FLP potentially slow the timing for future cuts? Yes, it could. Dangling the prospect of cuts 'out there' is useful to shape forward expectations (and should, all else equal, exert downward pressure on the exchange rate). But the outlook for monetary policy is starting to become more nuanced, and a negative OCR as soon as the RBNZ's forward guidance ends is not guaranteed, depending on how things are looking on the macroeconomic front.

Whereas an "all-in" approach to stimulus was the right approach at the advent of the COVID-19 crisis, the RBNZ now has the luxury of time to consider the net impacts of its policies (particularly monitoring the impact of the FLP on retail rates) and to think about trade-offs around the likes of a negative OCR, given uncertainties around its impacts, its risks, and the unknown point at which further rate cuts become counter-productive. We still think the RBNZ will remain dovish and aggressive in their approach to stimulus, but that doesn't necessarily mean it's a no-brainer that the best approach is to pull the trigger on its tools all at once.

We still expect that the OCR will be dropped by 50bps in April, all things considered. But the introduction of the FLP tilts risks towards a lower or negative OCR occurring slightly later (say at the MPS in May) or more gradually (perhaps in 25bps increments, or with a cut to just above zero before deciding whether to take the OCR even lower). Of course, a sudden turn south in the data would change the picture again – as always, this view is contingent on our economic forecasts being right, and as we've stressed many times, uncertainty is extreme at the moment, given the unprecedented nature of the closed border, fiscal stimulus, and other policies such as the mortgage deferment scheme. All of these are causing volatility and noise in the data and obscuring the true picture.

The Reserve Bank has one more conundrum on its hands. Apart from what it actually chooses to do with the OCR, more urgently it has to decide what to forecast for the OCR.

Since May, the RBNZ has dodged the issue by simply stopping its OCR forecast at the end of Q1, the end of its forward guidance that the OCR would be unchanged. No explicit justification was ever provided for this, but perhaps uncertainty about when the banking system would be technically able to cope with negative rates was a factor.

The omission is getting harder to justify. Banks have been instructed to be ready by 1 December. By the November MPS, the RBNZ will know with a high degree of certainty whether banks are on track. For a central bank that has always prided itself on its transparency, the omission is becoming awkward.

The Reserve Bank would probably prefer to wait and see what impact the FLP has before forecasting OCR cuts or not. But OCR forecasts have always been conditional, not a commitment. In practice, the RBNZ has deviated from its previous forecast OCR track more often than not, with each new set of forecasts explaining what developments have driven this. It’s always just a best guess, not a promise, and the market and commentators understand that. But even if zero is “just a number”, signalling that the OCR will go lower from here does feel more loaded in that it could risk being misinterpreted as a firm commitment. The RBNZ must be sorely tempted by the last of its three options: forecast OCR cuts, forecast no OCR cuts, or don’t forecast the OCR at all.

Previously we have said that the RBNZ would signal future OCR cuts in its November MPS, but the introduction of the FLP reduces the urgency to do so. The November MPS is intended be all about the FLP, and signalling a lower OCR would muddy the waters (not to mention steal the headlines and the market’s attention). On balance, therefore, signalling of future OCR cuts is more likely to come in February. This forecast would in itself deliver a slight further easing, and dovetail nicely with the RBNZ’s commitment to leave the OCR unchanged for 12 months, made in mid-March last year.

This later timing also reflects the RBNZ’s clarification about the ordering of deployment, with a FLP now planned before a negative OCR, rather than simultaneously. Given that there is considerable uncertainty about FLP impacts and reasons to be very considered when weighing up further policy options and how they might work in combination, it seems to us that preserving optionality around the OCR outlook in November is a good strategy, especially given that the probability of a negative OCR next year is already well priced into markets. However, communications would need to be managed to ensure the market didn’t conclude that not forecasting a negative OCR in November meant it was off the table, which would result in a tightening of monetary conditions on the day.

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