NOT OUT OF THE WOODS

BOTTOM LINE

In its May 2018 Financial Stability Report the RBNZ noted that financial stability risks have not changed materially over the past six months. The financial system is sound, but the culture and conduct of banks is in the spotlight – with findings from ongoing investigations to come. Risks related to the housing market have lessened, but house prices and debt remain high. High dairy debt and bank reliance on offshore funding also remain vulnerabilities. Loan-to-value ratio restrictions are unchanged and will only be eased once the RBNZ has sufficient confidence that risks have declined. Given high house prices and household debt, we think the RBNZ should tread carefully in easing restrictions further. Risks are likely to recede only slowly, short of a fundamental change in market conditions.

KEY POINTS

- **In its May Financial Stability Report, the RBNZ reiterated its views that the financial system is “resilient” and “broadly efficient”, while noting that vulnerabilities are “much the same” as in the last Report.**
  - Relative to 2016, risks related to the housing market have lessened, with housing price inflation and lending growth having slowed.
  - Dairy debt remains high and farms are facing a number of challenges (eg regulatory changes and Mycoplasma bovis).
  - Banks have reduced their reliance on external funding. However, market disruption and declines in asset prices remain risks, particularly with global liquidity tightening.

- **Bank conduct is in the spotlight**, with the RBNZ noting that good culture and conduct of banks affects public trust in the financial system. They note that the importance of this has been “dramatically illustrated” by the ongoing inquiries into financial services conduct in Australia. The RBNZ, along with other regulators, is examining bank conduct, and will report back over the coming months. This morning, the Minister of Finance and Minister of Commerce and Consumer Affairs said that they have seen "no evidence to date of the systemic problems that prompted the Australian inquiry but we are happy the FMA and RBNZ have a continuing programme of work”.

- **As expected, the RBNZ retained its calibration of loan-to-value ratio restrictions**, which were eased modestly from 1 January 2018. No more than 15% of each bank’s new mortgage lending to owner occupiers can be at LVRs of more than 80 percent, and no more than 5% of each bank’s new mortgage lending to residential property investors can be at LVRs of more than 65%.

- **Loan-to-value ratio restrictions will only be eased once the RBNZ has sufficient confidence that risks have declined.** The full effects of the easing in January are still working their way through, and the RBNZ will need to see house price and lending growth remain contained, with continued prudent lending standards, before further easing can be expected.
• We think the RBNZ will need to tread carefully in easing restrictions further, particularly given that investor loans can accentuate property cycles and exacerbate financial stability risks. And by not changing the measures today caution is clearly evident. The RBNZ found that tightening of restrictions on investor lending in 2016 was binding and thus very effective. Monthly mortgage lending to investors has been flat at levels that are 40% lower than those in late 2016. Government policy changes (eg extending the bright-line test) have been aimed at reducing the attractiveness of housing as an investment. But the possibility of pent-up demand after such a large fall means that an enthusiastic response by investors to any easing of restrictions cannot be ruled out.

• A number of factors could tip the demand-supply balance in the housing market. Proposed government policies have changed the calculus for property investment and crimped demand, while affordability constraints and credit headwinds have also weighed. But pent-up demand, strong population growth, and constrained supply are all supportive of continued housing demand. In the May Monetary Policy Statement, the RBNZ’s forecasts were based on a benign assumption for house price inflation – with annual house price inflation expected to ease to 1% from 2019 onwards. In our view, house price inflation will moderate – a welcome development – but be stronger than this.

• House prices and household debt remain very elevated, making New Zealand vulnerable to a disorderly correction. Any improvement in vulnerability metrics will be a slow grind, short of a fundamental change in market conditions (like a shake-up of land availability and land use regulation, or a significant shift in migration policy). We estimate that if house price inflation grew at very low rates of 1% per year and average household income grew 3% per year, it would take eight years for house prices to fall from 6 times income to 5 times income – to what is still an elevated level. For Auckland, this would imply a fall from 8.5 times income to 7 times over the same period.

• During the second half of this year, phase two of the review of the Reserve Bank Act will be conducted. The scope for this review will be announced in coming months, but will include a review of macro-prudential policy. The RBNZ are keen for debt-to-income limits to be added to their toolkit, but we think they will be met with resistance on that front – debt-to-income limits are not politically palatable because they make it more difficult for first home buyers to enter the market. And loan-to-value ratios have proven effective at improving resilience of the financial system, with lending on less risky terms and the housing market having cooled.

• Today’s Report does not have implications for the OCR outlook. We are pencilling in a hike in August 2019, but a lot can happen between now and then.
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