Reserve Bank of New Zealand's financial stability report, May 2009

Report of the Finance and Expenditure Committee

Forty-ninth Parliament
(Craig Foss, Chairperson)
June 2009

Presented to the House of Representatives

Contents

Reserve Bank of New Zealand's financial stability report, May 2009

Recommendation

The Finance and Expenditure Committee has conducted an examination of the Reserve Bank of New Zealand's financial stability report released on 13 May 2009, and recommends that the House take note of its report.

Introduction

The Reserve Bank of New Zealand assesses and reports on financial stability every six months. Changes were made to the Reserve Bank of New Zealand Act in 2008 to encourage parliamentary scrutiny of these reports, which examine the soundness and efficiency of the financial system, and other matters associated with the Reserve Bank's statutory prudential purposes. They also contain information necessary for assessing the activities undertaken by the Reserve Bank to achieve these purposes.

The key points of the Reserve Bank of New Zealand's financial stability report of May 2009 are summarised as follows:

- Despite some recent stabilisation in world equity markets, a concerted recovery in world growth appears to be some way off.
- The global financial crisis continues to affect New Zealand because of weakening domestic demand, falling international demand, and a decline in commodity prices.
- The economy's net international liabilities had increased to more than 90 percent of GDP by the end of 2008. Funding such a debt burden is likely to become more challenging.
- While the overseas credit crisis appears to have stabilised, New Zealand banks remain vulnerable to external financial shocks because of their dependence on overseas borrowing (approximately 40 percent of their total funding requirement).
- Even though liquidity pressures on the non-bank lenders have decreased with the Government's guarantee schemes, many continued to experience deteriorating asset quality.
- Credit growth has slowed in recent months, as borrowing demand has slowed and lending criteria have been tightened.
- New Zealand banks' interest margins increased slightly in the fourth quarter of 2008.
- Australian banks and their New Zealand subsidiaries are amongst the most profitable in the world.
- While the overall asset quality of the banks in New Zealand remains strong, their impaired assets have increased sharply since late last year.

- Clear signs of financial strains are emerging in large parts of the business sector.
- A substantial minority of households are likely to experience more severe financial distress as unemployment rises.

The rest of this report details the main issues that we have considered.

Failure to pass on official cash rate cuts to floating mortgage rates

We are concerned that some banks have not passed on the latest 50-basis-point cut to the official cash rate (OCR) in their interest rates for floating mortgages. The Reserve Bank was disappointed at the response of the banks' floating mortgage rates to the latest OCR cut—only two major banks, Westpac and ANZ National, have reduced their floating mortgage interest rates significantly. However, the Reserve Bank noted that, since the last peak of the OCR in July 2008, a large proportion of the OCR cuts, which have totalled 575 basis points so far, were passed on to banks' floating mortgage rates. The Reserve Bank said that many households are yet to benefit from these rate reductions, as their fixed-rate mortgages are yet to roll over.

The Reserve Bank also informed us that bank bill rates have fallen as a result of the latest OCR cut. As interest rates for business lending are based primarily on bank bill rates, the Reserve Bank believes that business lending rates, which are not publicised, have also decreased.

In view of our concern that OCR cuts are not being passed on in their entirety, we asked why mortgage rates do not appear to reflect the price that the New Zealand banks are paying to fund their mortgage lending. The Reserve Bank commented that longer-term mortgage rates are influenced more by overseas term rates and deposit rates than by the OCR. However, the OCR has a significant effect on floating mortgage rates through its influence on short-term wholesale rates.

We are surprised and concerned that longer-term mortgage rates have risen recently, even though conditions in bank funding markets have started to ease. The Reserve Bank explained that international swap rates increased at the same time as many banks and Governments raised funds from the markets. As a result, longer-term rates remained high.

We asked for an assessment of the economic benefits of passing on the OCR cuts more completely. The Reserve Bank considered that this would have helped the economy recover by stimulating demand. The Reserve Bank told us that it modelled different interest-rate scenarios for its economic forecasts and sometimes published the modelling results in its monetary policy statements.

To maximise the positive effect of the OCR cuts on the economy, we urge banks to pass on OCR cuts to their interest rates to the maximum extent possible.

Banks' profit margins

We were very surprised to learn that despite the severe impact of the current recession on business and household liquidity, bank profits declined only marginally in the past year, and principally as a result of provisioning against future credit losses.

We would expect that the banking sector would take on a greater role in sharing the burden of the current recession. Reducing interest-rate margins can help relieve the burden on mortgage holders and corporate borrowers. We consider that banks could further reduce interest-rate margins whilst maintaining an acceptable level of profitability.

In view of the relative resilience of profits in the banking sector, we are concerned that taxpayers are, in effect, subsidising banks through the Government's retail deposit guarantee scheme. The Reserve Bank agreed to a certain extent. In contrast, the Reserve Bank did not see the wholesale funding guarantee facility as an effective subsidy, because banks accessing funds from this facility have to pay "market rates".

Some of us consider it vital that banks neither insulate their profit margins nor charge excessively high interest rates at the expense of the real economy and the taxpayers, because of the potential adverse consequences for businesses and households. The Reserve Bank noted that banks' behaviour tends to be pro-cyclical—providing easy access to credit in booms, tightening credit supply in downturns. However, the Reserve Bank agreed that banks should carry on their normal business now rather than increasing their margins to the point of stunting growth in lending.

The Reserve Bank said that it has discussed interest rates and profit margins with the banks. We encourage the Reserve Bank to continue to work closely with the banks to help provide credit to the economy on reasonable commercial terms that reflect monetary policy settings and prevailing market conditions.

Relatively strong banking sector

We acknowledge that a strong and stable banking sector is crucial to economic recovery, and found it comforting to see that the banking sector in New Zealand remains relatively strong despite the global financial crisis. As noted by the Reserve Bank, four of the top 11 banks in the world in terms of credit ratings are based in Australasia. We note, however, that the strength of the New Zealand banking sector is partly due to increased funding from Australian banks to their subsidiaries in New Zealand.

We asked what banks need to do to stay in a strong position. The Reserve Bank considers that banks should make sure that their provisions and capital buffers are sufficient to absorb further unexpected losses. Banks need to be prepared for non-performing loans, which may continue to increase in the coming year. They should also secure longer-term funding arrangements, although the Reserve Bank recognised that it would be difficult to do so in the current economic climate.

While we understand that banks need to retain capital to remain in a strong position, we believe banks should not expect to maintain their usual rates of profitability in recessions, particularly when some sectors experience significant financial difficulties.

Lending terms to Australian and New Zealand firms

We consider it vital that Australasian banks treat Australian and New Zealand firms on an equal footing. The Reserve Bank commented that Australasian banks might offer different lending terms to Australian and New Zealand firms because the New Zealand subsidiaries of Australian banks operate separately from their parents. However, the Reserve Bank pointed out that both Australian firms and New Zealand firms face difficulty obtaining credit.

Asked how it assesses the fairness of the lending terms Australasian banks offer New Zealand firms, the Reserve Bank told us that it talked to a wide range of banks and business customers. The Reserve Bank is investigating whether banks have unreasonably withheld credit supply. It assured us that it is pressuring local banks to continue lending to creditworthy customers on reasonable terms.

We encourage the Reserve Bank to continue monitoring closely the lending terms offered by Australasian banks to New Zealand firms.

Measures for stabilising the economy

In view of the global financial crisis, we are interested in the measures taken to stabilise the economy, particularly as regards liquidity management. The Reserve Bank told us that its policies aimed to keep credit circulating in the economy. The Reserve Bank eased its monetary and liquidity policies, lent money to banks against collateral such as residential mortgage-backed securities, and improved banks' access to international credit markets through a wholesale funding guarantee facility. While the Reserve Bank considers that the measures have been effective so far, it is mindful of the possibility that the global financial crisis could worsen. It was of the view that the banking sector would have contracted further if these measures had not been implemented, bringing about a greater recession of the New Zealand economy.

We note that, through these measures in combination with expansionary fiscal policies, taxpayers are contributing indirectly to maintaining economic and financial stability in New Zealand. Moreover, some of the stabilising measures have increased significantly the risk exposure for the Crown and, ultimately, the taxpayer. We encourage the banking sector to consider carefully their corporate citizenship, especially when taxpayers are effectively providing the financial sector with large amounts of liquidity.

Term auction facility

We note that, as of 30 April 2009, the Reserve Bank has advanced $7.6 billion to the banking sector for up to 12 months through its term auction facility, which is intended to maintain the flow of funds through the banking system. The additional funds available under this facility are determined by the size of the available pool of mortgage-backed securities that are acceptable to the Reserve Bank as collateral. The Reserve Bank estimated that an extra $18 billion could be obtained under this facility if necessary.

We were interested in the interest rates charged on the funds borrowed under the term auction facility. The Reserve Bank told us that, for a one-year loan, the interest rate is the sum of the one-year bank bill rate, the bank's margin, and "haircut"—the extent to which the value of the collateral has to exceed the borrowed amount. The Reserve Bank considers this total to be a "market rate". It acknowledged that the interest rates charged on the funds borrowed under the emergency term auction facility are lower than the mortgage rates charged by the banks, but pointed out that banks put interest-rate margins on any funds they borrow from other institutions.

We note the Reserve Bank's argument that the term auction facility should not be viewed as a subsidy because banks have to pay "market rates" for the funds in question. We also note the argument that banks tend to regard the Reserve Bank as the last resort for funding, using the term auction facility only when no other funding avenue is as readily available at the rate charged by the Reserve Bank.

We recognise that the term auction facility is a useful tool for maintaining liquidity in the banking sector, and has yet to reach its full capacity. However, since the facility is effectively funded by the taxpayers, we encourage the Reserve Bank to maintain a prudent approach when providing banks with loans through the facility.

Debt in certain sectors

The Reserve Bank commented that there has been a significant credit expansion in the dairy sector over the past year, but expects credit growth to slow down, as farmers start to reduce capital-intensive investment. We are concerned by downside pressures on the farming sector, particularly dairy, reflecting the exchange rate and commodity price variability.

Major banks have indicated that they intend to assist rural borrowers through a period of weaker returns and we support this approach. We expect that the banking sector will work constructively with the rural and productive sectors, taking a long-term view of sector risk and returns, to enable the clients to weather the recessionary conditions as far as possible.

We are also concerned that some households are struggling to meet their mortgage payments. We expect that the Reserve Bank will continue to closely monitor the debt levels in the dairy and household sectors.

Housing market

We are concerned that much of the increase in New Zealand's overseas debt was channelled through banks into the housing market, and asked the Reserve Bank's view of the trend in the housing market. The Reserve Bank believes that the recent slight recovery in the housing market is only temporary, although house prices may not fall again very quickly. The Reserve Bank is still assessing the implications of the recent recovery for the long-term trend in house prices.

The Reserve Bank considers that houses were overvalued by 20 percent at the top of the last housing boom, and are overvalued now by only 10 percent. While the Reserve Bank believes that people are making decisions about house-buying more rationally now than they did two years ago, it notes that the ratio of house prices to disposable incomes was still above the long-term average .

Effectiveness of monetary policy

We are concerned that the effectiveness of monetary policy may be undermined by the failure of some banks to pass on the latest OCR cuts to their lending interest rates. The Reserve Bank suggested that, in the globalised financial environment, domestic monetary policy might be more effective in the current economic downturn than it proved during the economic boom. Then it was difficult to control inflation by tightening monetary policy because easy access to overseas funds weakened the Reserve Bank's ability to restrain money supply. However, in the current downturn, it appears to be easier for the Reserve Bank to implement monetary policy effectively, as central banks around the world adopt similar policies simultaneously.

We urge the banking and finance sector to better reflect movements in the OCR in their lending rates.

Exchange rate

We invited the Reserve Bank to comment on the recent appreciation of the New Zealand dollar despite cuts to wholesale interest rates. The Reserve Bank was not surprised at this because the resurgence in share markets globally has boosted investors' appetite for risk. The Reserve Bank expects the rise in the New Zealand dollar to be temporary.

The Reserve Bank also told us that it has not intervened in the foreign exchange market in the past two months to counter the recent appreciation of the New Zealand dollar.

Conclusion

Overall, we share the Reserve Bank's concern about the role of the banking sector in responding to the current recession. While we recognise the need for a strong, stable and profitable banking sector, we stress the importance of responding appropriately to current conditions. This includes passing on reductions in the OCR; maintaining liquidity; ensuring liquidity is available on equal terms to comparable companies in Australia; and recognising current economic conditions.

Appendix

Committee procedure

We met on 13 and 27 May and 3 June 2009 to consider the Reserve Bank of New Zealand's financial stability report, released on 13 May 2009. We heard evidence from the Deputy Governor of the Reserve Bank, and received advice from our independent specialist adviser, Ulf Schoefisch.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Raymond Huo
Rahui Katene
Peseta Sam Lotu-Iiga
Stuart Nash
Dr Russel Norman
Chris Tremain

Evidence and advice received

Reserve Bank of New Zealand, *Financial Stability Report*, May 2009.

Briefing paper, prepared by specialist adviser, dated 13 May 2009.

Additional comments, prepared by specialist adviser, dated 18 May 2009.