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Credit FAQ:

Why Economic Risks Are Rising For New Zealand's Financial Institutions

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New Zealand's rapidly rising house prices are cranking up the economic risks for the financial institutions operating in the country. S&P Global Ratings believes that if a sharp correction in property prices were to occur, the impact on financial institutions would be amplified by New Zealand's external weaknesses--i.e., its persistent current account deficits and high level of external debt (see "New Zealand Financial Institution Ratings Unchanged Despite Property Price Concerns," published on RatingsDirect on Aug. 22, 2016).

Residential property prices nationally have increased in excess of 10% in the past year. Following strong growth during 2011-2013, house price growth abated during 2014. Subsequently, our base-case expectation was that house prices would slow in the second half of 2015 and 2016 (see "New Zealand Property Market Should Remain Steady Despite Lower Official Cash Rate," published March 20, 2016). Since then, the growth in house prices has again accelerated. And while property prices in regions outside Auckland were relatively muted in the past, they have increased robustly nationwide in the past year.

At the same time, private sector credit has also grown (to about 157% of GDP so far in 2016 from about 152% in 2015).

In this article, we explain the rationale for our assessment of increased economic risks and how we factor this into our ratings on the financial institutions.

Frequently Asked Questions

Have you taken into account the macroprudential tools that the central bank implemented to contain these risks?

Yes, we have. We've also considered the central bank's recent proposal to further expand the scope of these tools (see "Round Three: As Housing Imbalances Resurface, New Zealand's Banks Ready Themselves For Further Macroprudential Limits," published Aug. 22, 2016). The macroprudential toolkit includes temporary restrictions on high loan-to-value ratio (LVR) lending and higher capital requirements for investor mortgages to address a build-up of risks facing the banking system. In our opinion, the impact of these tools would be challenged by structural constraints, such as low interest rates, a limited supply of new housing stock, and high net immigration. We note that macroprudential tools have had only a relatively temporary effect on Auckland's house prices, which have risen rapidly again following a short period of abated growth.

Is an asset price bubble about to burst?

That's unlikely. A sharp fall in property prices is only a stress-case scenario, in our opinion. Our base-case expectation remains that the heightened economic imbalances in New Zealand will unwind in an orderly manner--without a material rise in credit losses for the lending institutions. This has generally been the case over past property cycles, and the New Zealand economic outlook remains relatively benign by global standards. However, other things being equal, a rapid rise in asset prices would signal a higher risk of a sharp unwinding--particularly if the rises were accompanied by strong growth in debt funding for such assets.

How would a sharp correction in property prices affect the financial institutions?

We believe that in a scenario of rapidly falling house prices, almost all New Zealand financial institutions would be exposed to a drop in operating earnings and a significant rise in credit losses. A sharp decline in house prices in any country is generally accompanied by a weakening of other key macroeconomic factors, such as unemployment, household expenditure, corporate investments, and total economic activity.

In New Zealand's case, its external weaknesses could amplify the impact. We expect that the cost of external borrowings would rise, domestic credit conditions would tighten, the currency may depreciate sharply (damaging confidence and potentially limiting monetary policy flexibility), and economic growth would slow down. This would ultimately result in lower income levels. In such a scenario, financial stresses would be on a countrywide basis, including the corporate, small-to-midsize enterprises, and household sectors. We believe that this would significantly increase defaults by borrowers and losses on such defaults. In addition, there would be substantially fewer opportunities for profitable lending by financial institutions.

How would the increased risks affect your assessment of financial institutions?

In our opinion, other things being equal, the increased risks are generally likely to pressure all New Zealand banks and similar financial institutions that take deposits, extend credit, or engage in both activities. These institutions include mortgage lenders, credit unions, building societies, and finance companies.

In view of the increased economic risks, we have increased the risk weights in our capital analysis that are now applicable for the financial institutions' loans. Consequently, we estimate that for all the financial institutions we rate in the country, our forecast risk-adjusted capital (RAC) ratios would be lower by an average of about 11% than would otherwise have been the case.

We have reviewed our forecast capital ratios for each of the financial institutions we rate in New Zealand, taking into account the revised risk weights, their latest operating results, and updated business and financial plans. In our assessment, the impact on RAC ratios and consequently on the credit profiles for each of the financial institutions is potentially different. This reflects the differences in their current and expected asset mixes, our understanding of their capital strategies, and buffers above the threshold for a lower stand-alone credit profile (SACP).

What is a stand-alone credit profile?

S&P Global Ratings may assign an SACP as a component of a rating to provide information on an issuer's creditworthiness. The SACP is our opinion of an issuer's creditworthiness in the absence of extraordinary support or burden. It incorporates direct support already committed and the influence of ongoing interactions with the issuer's group or government. However, the SACP differs from the issuer credit rating in that it does not include potential future extraordinary support from a group or government during a period of credit stress for the issuer, except if that support is systemwide. The SACP also does not include the potential for the owner or government under stress to extract assets, capital, or liquidity from the issuer.

Your ratings on all banks and financial institutions in New Zealand--including the four major New Zealand banks--remain unchanged despite your view that risks facing these financial institutions have increased. Does this mean that all of these financial institutions are immune to increased economic risks?

No, on the contrary, we consider that all the financial institutions operating in New Zealand now face higher economic risks than one year ago. Although our ratings on these entities remain unchanged, we see reduced headroom against a downgrade or lowered SACP if systemic or institution-specific risks increase.

Nevertheless, actual and target business mix towards lower-risk asset classes, and higher current and target capital levels have mitigated the impact of increased risk weights on our forecast RAC ratios for a number of these institutions. We forecast that capital levels for all but two banks would remain above the levels needed to maintain current SACPs, albeit with some weakening; the exceptions are ASB Bank Ltd. and Rabobank New Zealand Ltd. Our assessment takes into account the updated information on each of the financial institutions in addition to the higher risk weights that we now apply in their capital analysis.

We have lowered our assessment of ASB Bank's SACP to 'bbb+' from 'a-' (which is now on par with the SACP of the three other major banks in New Zealand) and Rabobank NZ's SACP to 'bbb-' from 'bbb', reflecting our view that their forecast capital levels will moderate. Our revised forecast RAC ratio over the next two years for ASB Bank is within the 7%-10% range (in line with that for the three other major banks in New Zealand); and 10%-15% for Rabobank. Nevertheless, our ratings on these two banks also remain unchanged, reflecting our assessment of likely timely financial support from their respective parents, if needed.

You lowered your ratings and SACPs on a number New Zealand financial institutions in 2015 based on a similar rationale of increased economic imbalances. Why do you need to adjust your assessments again now?

We did indeed take a number of rating actions in August 2015 to reflect similar risks (see "Various Rating Actions Taken On New Zealand Financial Institutions Reflecting Rising Economic Imbalances," published Aug. 14, 2015). At the time, our base-case expectation was that house price growth in New Zealand would remain relatively muted over 2016 and 2017. But we now believe that the risk of a sharp correction in house prices has increased since last year. Contrary to our base-case expectations last year and even earlier this year, house price growth has rebounded after a short period of abated growth.

We believe that a build-up of this cyclical risk often continues over a period of a few years and is difficult to predict. Consequently, we review and adjust our assessment of economic imbalances in each banking system over the cycle as updated information becomes available. Although in our assessment, economic imbalances in New Zealand have worsened twice in the past 12 months, the risks could further heighten if growth in house prices or private sector debt remains escalated or further accelerates.

Do you think that the financial sector in New Zealand has now become "risky" and that a number of financial institutions are facing imminent default?

Not really. New Zealand doesn't fall in the group of high-risk banking systems by global standards, as reflected in our score for the country's Banking Industry Country Risk Assessment (BICRA) of '4' on a scale of '1' (lowest risk) to '10' (highest risk). We consider that New Zealand's resilient economy, conservative banking regulation, and low risk-appetite support its banking sector.

In our opinion, partly tempering these strengths are the country's moderately high private sector debt; material dependence of the banking system on offshore and wholesale funding; and New Zealand's high external debt and current account deficit. Additionally, we have maintained high ratings by global standards for a predominant part of New Zealand's banking system that is owned by major Australian banks.

Do the increased economic risks affect your assessment of the SACP of the parent groups of the foreign-owned banks, including New Zealand's major banks?

A subsidiary's SACP indeed forms a part of our assessment of the credit profile of--and consequently the ratings on--the consolidated group. Nevertheless, the New Zealand operations of these foreign-owned institutions do not comprise, in our opinion, a large enough part of these groups to significantly affect the credit profiles or ratings on their parent groups.

Related Research

- Round Three: As Housing Imbalances Resurface, New Zealand's Banks Ready Themselves For Further Macroprudential Limits, Aug. 22, 2016
- New Zealand Financial Institution Ratings Unchanged Despite Property Price Concerns, Aug. 22, 2016
- New Zealand Property Market Should Remain Steady Despite Lower Official Cash Rate, March 20, 2016
- Various Rating Actions Taken On New Zealand Financial Institutions Reflecting Rising Economic Imbalances, Aug. 14, 2015