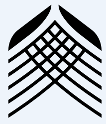

Reserve Bank
of New Zealand
Te Pūtea Matua

Financial strain on households and businesses in a higher interest rate environment.

FINANCIAL STABILITY REPORT SPECIAL TOPIC 1

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1 Financial strain on households and businesses in a higher interest rate environment

A key question in assessing the outlook for the soundness of the financial system is how households and businesses are adjusting to higher interest rates. In this special topic, we look at early signs of debt servicing stress and the risks it might have for households and businesses.

Household and business lending is steadily repricing to higher interest rates

New Zealand's monetary policy has tightened significantly since mid-2021 in response to a stretched labour market and strong inflation. This has been translating into higher effective interest rates for households and businesses. Around 60 percent of the stock of housing lending is either on a floating interest rate or on a fixed rate that reprices within 12 months, while for businesses around 80 percent of bank lending is either floating or repricing within three months. Since their low points in mid-2021, the effective interest rates paid on the stock of mortgage and business lending have risen by 185bps and 400bps respectively (figure 2.1). Based on current mortgage and swap rates, we expect the average effective interest rate on mortgages to reach 6.1 percent by the end of the year.

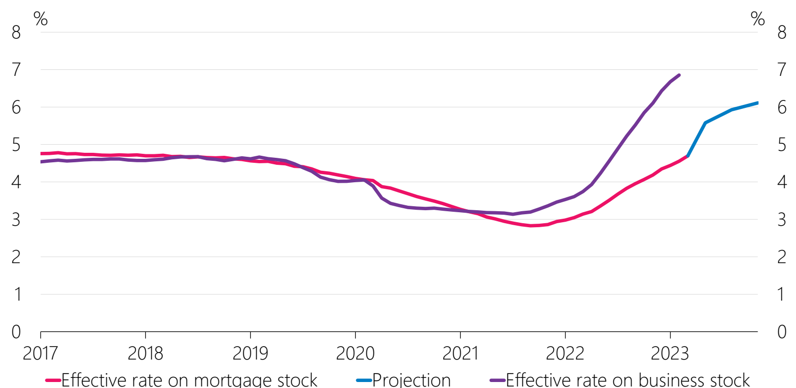
Debt servicing costs are increasing

Household balance sheets remain resilient, with most property-owning households still having substantial equity buffers. This has been due to a combination of the cumulative effects of past LVR restrictions that limited households' leverage and a rise in property valuations that has added to household wealth since 2019, which has yet to fully unwind. Nationally, house prices have returned to around the level in February 2021.

Debt servicing costs have risen significantly from historically low levels during the pandemic. For a household with a mortgage, the share of disposable income required to service the interest component of their mortgage debt will more than double from its recent low of 9 percent to around 22 percent by the end of this year (figure 1.2). Despite the significant rise, this would still be lower than the peak experienced in mid-2008. However, this increased debt servicing burden is distributed highly unevenly, with some borrowers, such as those who fixed at the low of mortgage rates in mid-2021, seeing far greater rises in their debt servicing costs than others.

Figure 2.1

Effective lending rates



Source: RBNZ *Bank Balance Sheet survey*, *Income Statement survey*, RBNZ estimates.

Note: The effective interest rate is the average interest rate paid across the stock of all mortgage lending and all business lending. This projection is based on current mortgage and swap rates as at the 27th of April.

For businesses, whose lending reprices faster than households on average, much of the increase in debt servicing costs has already occurred. Most businesses have been able to absorb the increases in debt servicing costs because of deleveraging over recent years and strong economic conditions.

Highly leveraged borrowers are the most at risk of significant debt servicing stress

Although increasing debt servicing costs alongside high inflation will constrain mortgaged households' budgets, we expect most borrowers will be able to continue to service their debt obligations without significant stress, given the servicing test buffers that banks have applied when assessing borrowers' loan affordability and the current strength in the labour market.

However, for households that borrowed during the period of very low interest rates between late 2020 and late 2021, current interest rates exceed some of the test rates used by banks during this period (figure 2.2). Therefore, some of these borrowers and other borrowers with high debt-to-income levels may begin to struggle to meet their repayment obligations as they reprice onto the higher rates. Around 25 percent of the current stock of mortgage lending was originated during 2021, with about a fifth of this being to first home buyers.

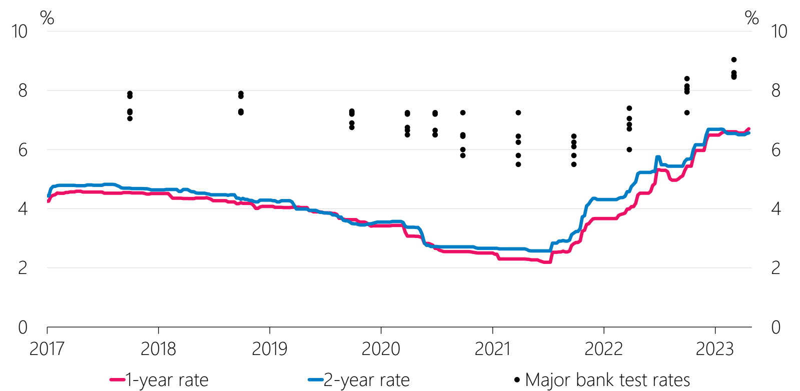
Two factors will lessen the degree of stress this repricing might cause. Firstly, affordability test rates are used to determine the maximum loan amounts that applicants can afford, and many borrowers borrow less than this amount. Secondly, nominal household incomes have grown strongly in the past two years.

Indicators of debt servicing stress are beginning to rise

Early-stage arrears (missed payments by a borrower of one to three months) have been increasing in recent months, and are currently back to where they were before the pandemic (figure 2.3). Compared to the Global Financial Crisis, these indicators so far remain low. Rates of non-performing mortgages and the number of mortgagee sales are also low albeit growing.

Figure 2.2

Mortgage serviceability test rates, compared to actual rates

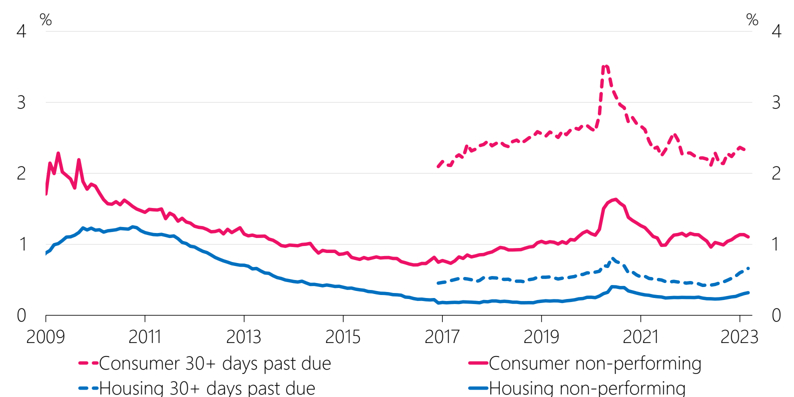


Source: RBNZ *Credit Conditions survey*, *Retail Interest Rates survey*.

Figure 2.3

Mortgage and consumer lending in arrears or non-performing

(seasonally adjusted)



Source: RBNZ *Bank Balance Sheet survey.*

Evidence from previous debt servicing distress periods shows that households with multiple forms of debt generally try to prioritise mortgage and utility bill payments. Data provided by Centrix has shown that those with multiple forms of debt including a mortgage are increasingly missing payments on non-mortgage debts.

When encountering stress, a borrower may be able to move onto a hardship programme at their bank. This could involve temporarily switching to interest-only payments or increasing the remaining term of the loan.

Banks have been proactively identifying borrowers who may face debt servicing challenges as they reprice to higher interest rates. So far they have reported relatively low numbers of customers encountering difficulties in meeting higher repayments. In part, this reflects the fact that many borrowers used the period of lower interest rates to make excess principal repayments ahead of their original schedules. These borrowers can now use this buffer to limit the rises in their repayments due to higher interest rates.

High interest rates and worsening economic conditions are expected to cause an increase in stressed business lending

Among businesses, the commercial property and agriculture sectors are relatively more leveraged, meaning they are more exposed to higher debt servicing costs on average. Debt in these sectors tends to be secured against property. This initially allows them to borrow more relative to their incomes, but also makes them more vulnerable to changes in interest rates and housing market conditions. Within the commercial property sector, falling land values and high debt servicing costs have put developers with large land commitments at risk of defaulting.

In the agriculture sector, falling dairy prices over the last six months alongside increasing farm input costs, such as those of fuel, fertilisers, and labour, are putting pressure on profit margins. Fonterra is now projecting a reduced midpoint price of $8.30 per kilogram of milk solids (kgMS) this season, driven by the slowing global demand, particularly from the Chinese market.

Another significant concern for the dairy sector is increasing debt servicing costs. At an aggregate level, average interest costs per unit of production increased to $1.20 per kgMS from $0.50 per kgMS in mid-2021 (figure 2.4). Narrowing margins from rising costs and falling international dairy prices have led to more requests from farmers for working capital and overdrafts to meet short-term cashflow needs.

In the commercial property sector, capital values have started falling across property types, particularly for retail, but we expect further declines as values adjust to high interest rates and lower demand, for example due to increases in people working from home. Liquidity and credit demand in commercial property markets has been low. Higher interest rates and a poor outlook for the sector have contributed to an increase of 10 percentage points in closely monitored lending, from a low level since mid-2021.[1]

The capital value of Auckland prime retail property declined 16 percent over 2022.

The lower end of the retail and office markets would come under significant stress during an economic downturn, causing widespread vacancies.

Property operators' interest coverage ratios have already fallen with high interest rates. This has reduced the buffer available to deal with tenant stress and still meet debt servicing requirements. Banks are generally willing to work with stressed customers, looking at where property sales can be made to reduce debt, and where discretionary spending can be reduced to improve borrowers' ability to service debt. Banks have also indicated a willingness to renegotiate interest servicing covenants in their lending terms.

Figure 2.4

Dairy price index and interest servicing cost per kgMS of production

Source: RBNZ *Bank Balance Sheet survey*, *Income Statement survey*, registered banks' *Disclosure Statements*, private reporting, DCANZ, RBNZ estimates.

1 Closely monitored lending is all loans and advances reported to banks' management internally as warranting closer monitoring because of potential or actual deterioration in credit worthiness of the counter-party. This would also include all potentially stressed, 90+ days past due, and impaired loans.

In general, there has been a deterioration in business performance across most sectors. However, banks have maintained conservative lending standards in recent years and businesses appear to be adjusting to higher debt servicing costs without significant increases in loan arrears so far. No industry is showing a marked increase in debt servicing stress, including those most disrupted by the pandemic (figure 2.5). Banks have reported that businesses that survived the pandemic are generally quite resilient.

The financial system is well positioned to support the economy as debt servicing strains increase

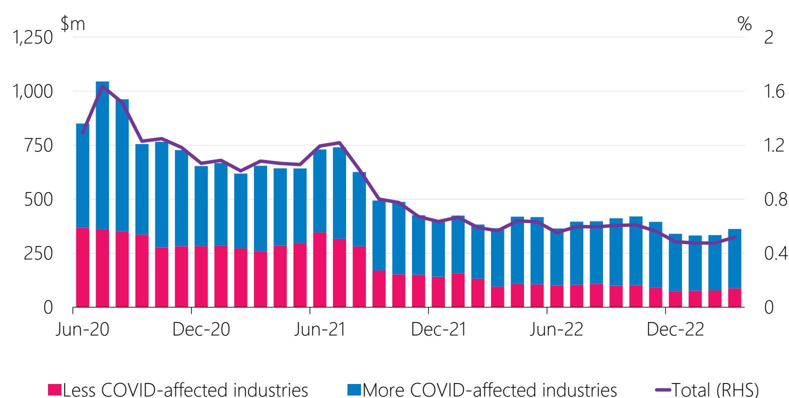
While we are not currently seeing widespread financial distress amongst households or businesses, in part this reflects the fact that the repricing of the stock of mortgage lending will take some time. Households are also adapting by reducing discretionary spending and drawing on savings, including working with their banks to extend the durations of their mortgages where they are ahead of their repayment schedules. Furthermore, the lack of acute stress showing up in banks' lending portfolios reflects the strength in the economy and labour market to date.

However, we expect more borrowers to fall behind on their payments this year, given the ongoing repricing of mortgages and expected weakening in the labour market. New Zealand's banking system remains resilient to a range of downturn scenarios, as demonstrated by our regular stress tests of their solvency and liquidity positions.

Figure 2.5

Industry breakdown of business sector lending in arrears

(30+ days past due or impaired loans, excluding agriculture and commercial real estate)



Source: *RBNZ Bank Balance Sheet survey.*

Note: 'More COVID-affected industries' include construction, wholesale and retail trade, accommodation and food services, transport and storage, education and training, health and community services, culture and recreation, and personal services. 'Less COVID-affected industries' include mining, manufacturing, utilities, communications, professional, administrative and support services.