2 Financial strain faced by households and businesses

In this special topic we assess how households and businesses are adjusting to the higher interest rate environment and softening economy (see Chapter 1), providing an update on early signs of financial stress. We also discuss the levels of defaults that are expected going forward.

Housing and business lending comprise around 63 percent and 34 percent of total bank lending. Commercial property, a component of business lending, makes up around 8 percent of total lending. Therefore, assessing stresses among these borrowers is an important part of our assessment of financial stability.

Households have come under increased budgetary pressure recently from rising debt servicing costs

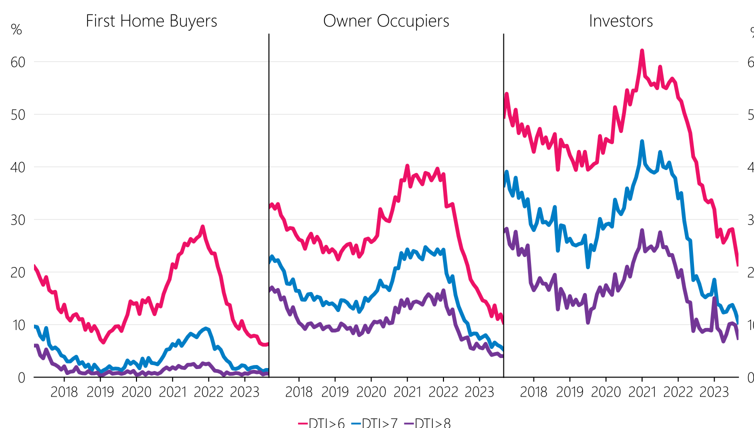
Against the backdrop of heightened cost-of-living pressures, rising debt servicing commitments have squeezed households' budgets. More borrowers are under pressure on their debt obligations. Early-stage arrears have increased over the past six months and have now surpassed the levels seen at the start of the pandemic (figure 1.3). Centrix data that also captures borrowers with missed debt repayments less than 30 days has shown a similar trend. However, these indicators so far remain significantly lower than they were soon after the Global Financial Crisis (GFC). Rates of non-performing mortgages and the number of mortgagee sales remain low despite increasing in recent months.

Evidence from previous financial cycles has shown households with multiple forms of debt generally prioritise mortgage and utility bill payments ahead of other expenses when faced with debt servicing stress. Recently, borrowers with a mortgage and other forms of debt are missing repayments on non-mortgage debts to a greater extent than non-mortgaged borrowers.[8] This suggests debt servicing strains faced by mortgaged households may be greater than shown simply by mortgage arrears.

We expect an increasing share of borrowers will face significant debt servicing stress. For many households that borrowed in 2020 and 2021, current interest rates exceed the test rates used by banks to assess affordability, and some may be particularly vulnerable to debt servicing stresses. Households that borrowed at high debt-to-income (DTI) ratios over this period are at risk, with estimated debt servicing ratios (DSRs) for borrowers from these two years expected to rise to around 50 percent by late 2023 (figures 2.8 and 2.9).[9] While household incomes have grown strongly in recent years, further increases in interest rates may result in a larger rise in loan defaults.

Banks report that the arrears which have occurred to date have largely been associated with unexpected individual events, such as illness or job loss, rather than hardship due to higher interest rates alone. However, there is a portion of lending still to reprice to higher interest rates and this will create more financial difficulties for some borrowers.

Figure 2.8
New lending by borrower type and DTI



Source: RBNZ *DTI New Commitments survey.*

8 Based on data received from Centrix.

9 A DTI is a metric showing a borrower's outstanding debt as a ratio to their gross income. A DSR shows the share of a borrower's income that is required to service their debt repayments.

Borrowers have options available to mitigate severe financial stress

Several factors have contributed to lessening the degree of stress among borrowers as mortgages have repriced higher. Firstly, the labour market has remained strong, with unemployment having risen only slightly from a low level. Secondly, while some borrowers were tested at affordability rates below current mortgage rates, affordability rates are used to determine the maximum loan amounts that applicants can afford, and many borrowers borrow less than this amount. Test rates for borrowers since 2022 have mostly sat above 8 percent, giving them a buffer were mortgage rates to move higher in the near term. Our loan-to-value ratio (LVR) restrictions have also limited borrower leverage. Finally, nominal household incomes have grown strongly in the past two years, which will benefit borrowers with older loans in particular.

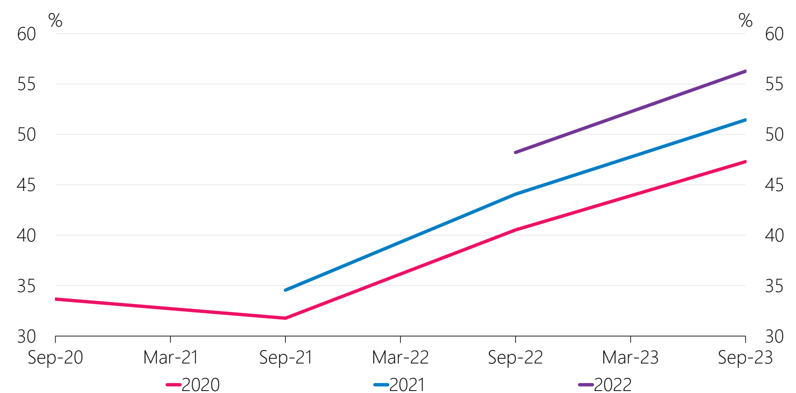
In addition, borrowers often have several options to respond to serviceability stress as it arises. This includes cutting discretionary spending, extending the remaining term of the loan if ahead of their original repayment schedule, or temporarily switching to interest-only payments. Banks have proactively identified and worked with customers who are at high risk of coming under servicing stress as they roll over to higher interest rates. They can offer formal hardship programmes, although the uptake of this has been very limited to date. However, if unemployment continues to increase, some indebted households will have fewer options to avoid missing their debt repayments.

Business lending generally remains healthy, although significant pockets of stress are expected to emerge

Business lending generally reprices faster than households on average, and most of the anticipated rise in businesses' debt servicing costs has already occurred. Business margins are low, but loan defaults remain low across all industries. General deleveraging over recent years, conservative lending standards by banks and robust economic conditions have put businesses in a strong position to adapt to higher debt servicing.

Figure 2.9

Estimated debt servicing ratio for borrowers with DTI of 7 that originated in different years



Source: RBNZ *DTI New Commitments survey*, RBNZ estimates.

Note: This chart shows a debt servicing ratio (including principal and interest) for representative borrowers at a DTI of 7 originating in September 2020, 2021 and 2022. It assumes principal will be repaid over a 30-year term and also makes adjustments for observed income growth. The other key assumption is that borrowers fix for 1 year and roll this forward each year it comes up for renewal. Figure 2.8 shows around 15% of lending was borrowed at a DTI greater than 7 in 2020, 20% in 2021 and 10% in 2022.

We expect financial hardship among businesses to rise as economic conditions soften. In particular, the commercial property and agricultural sectors are starting to experience challenges and may be vulnerable (see Special Topic 3 for developments in the agricultural sector). Debt in these sectors tends to be secured against property which, while initially enabling firms to borrow more relative to their income, also makes them more vulnerable to higher interest rates and deteriorating property market conditions.

Vulnerabilities are emerging in the commercial property sector

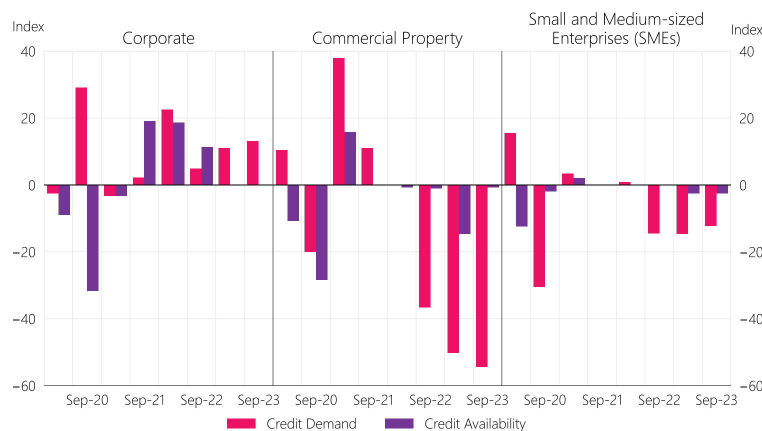
In the commercial property sector, high interest rates and other market developments have placed significant downward pressure on capital values. This is particularly the case for lower-quality office properties due to ongoing structural trends, such as increased prevalence of working from home. Vacancies for lower-grade office properties are beginning to rise, putting downward pressure on rents. With the large increase in debt servicing costs seen over the past two years, interest coverage ratios have also fallen. These factors have contributed to an elevated level of lending being closely monitored by banks. Serviceability stress in the sector could increase if the economy contracts and vacancies increase further.

Weaker demand and high construction costs mean there are few viable commercial property development projects at present.

Several factors support the debt serviceability of commercial property operators. Commercial property loans generally have lower LVRs than residential property, usually less than 50 percent, and lenders require a buffer of net earnings above interest payments. In addition, banks have reported that some stressed commercial property operators have other income sources to continue to meet debt servicing requirements. Nevertheless, some property owners may need to sell portions of their portfolios to reduce debt levels if market conditions allow. Banks have increased provisions to prepare for future losses, which will help to buffer the impact on the financial system of a severe downturn.

Figure 2.10

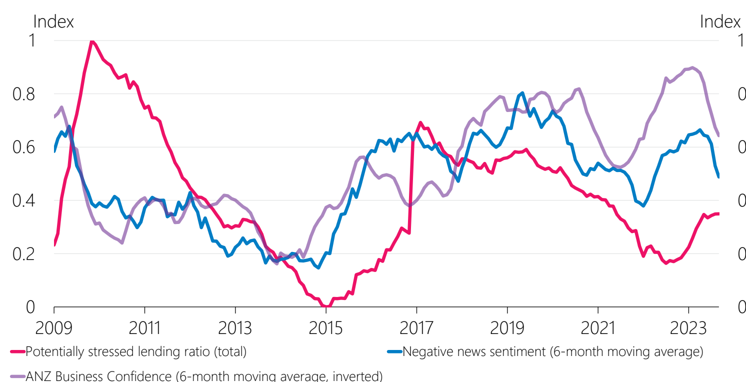
Change in demand and availability of credit from businesses



Source: RBNZ *Credit Conditions survey.*

Figure 2.11

Forward-looking indicators of stressed lending



Source: ANZ *Business Outlook survey*, RBNZ estimates.

Note: The negative news sentiment indicator measures the proportion of news article content estimated to have a negative sentiment. All series have been normalised to the scale [0,1] for comparability.

Business credit demand has softened as expected, while credit availability remains stable

Demand for credit from commercial property providers and other businesses has been subdued as interest rates have increased (figure 2.10). Credit demand for capital expenditure is low as higher funding costs curtailed the viability of capital investment, although working capital demand is high, particularly from SMEs. Credit availability for businesses remains stable as banks' risk appetites are largely unchanged.

Non-performing loans are expected to continue to rise for households and businesses

Indicators suggest that financial stress will continue to increase. Consumer and business confidence remains weak, reflecting increased debt servicing burdens and the weaker outlook for the economy. Consumption is expected to decline as household budgets continue to tighten. A range of forward-looking indicators, such as measures of confidence and negative news sentiment, suggests continued weakening in loan performance in the short-to-medium term (figure 2.11).[10]

10 The news sentiment indicator is collated from a database of business news articles. Machine learning algorithms are used to estimate the positive or negative sentiment of each article. More technical details of how this series is estimated will be provided in a forthcoming analytical note.

Similarly, the largest five New Zealand banks individually project non-performing loans (NPLs) as a share of lending could rise to around 1 percent by early 2025, a more than doubling from their current levels (figure 2.12). Our analysis of loan performance also suggests a similarly negative outlook, based on the economic outlook from the August *Monetary Policy Statement*, with unemployment rising to 5.3 percent.[11] It is important to note that if economic conditions deteriorate by more than projected, then lending stress could be more severe.

There is considerable uncertainty about future lending stress and these forecasts should be interpreted with caution. Bank lending quality has improved overall since the GFC. Business lending and high LVR residential mortgage lending comprise a smaller share of total bank lending. As a result, projected lending stress could be less severe than expected based on previous experience. The combination of high interest rates and low unemployment makes the current economic environment unique in recent history, and as a result the pattern of lending stress may differ from what is projected. In addition, lending stress may not rise smoothly as unemployment rises and may accelerate when unemployment rises above some threshold, although this relationship has changed over time (figure 2.13).

The financial system remains well positioned to facilitate economic activity as debt servicing stress increases

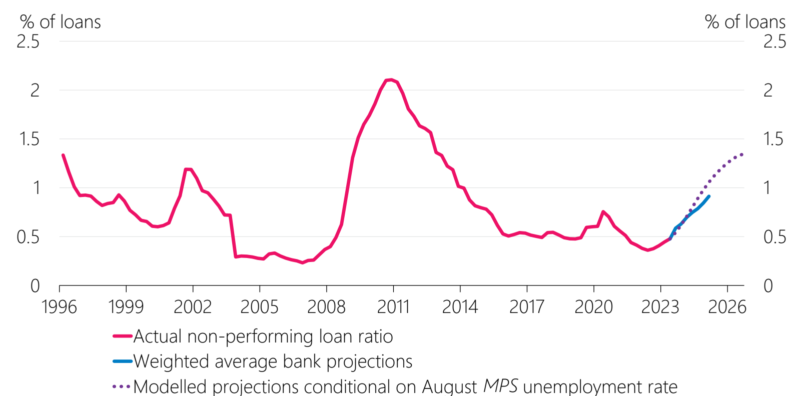
Overall, financial distress amongst households or businesses is rising from a low level as budget pressures increase for many borrowers. Households have been able to adapt by reducing discretionary spending and working with their banks to manage the increased debt servicing burden. Even so, financial stress is expected to rise, based on our projections and those of banks.

The New Zealand banking sector is in a good position to support customers and weather potential challenges on the horizon (see Chapter 4).

Figure 2.12

Total non-performing loans

(seasonally adjusted)

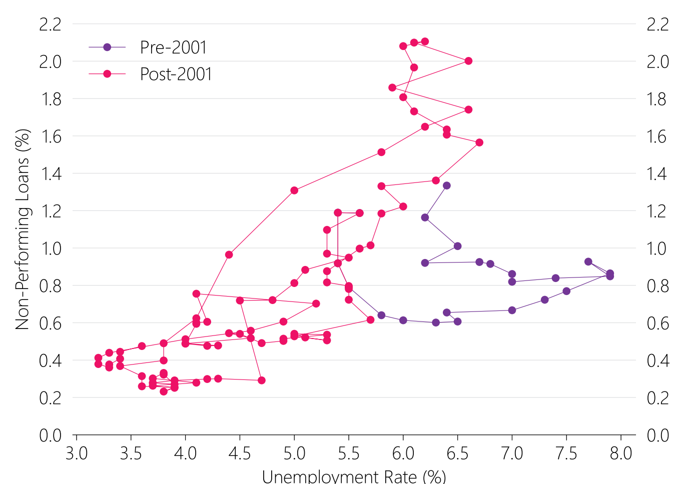


Source: RBNZ *Bank Balance Sheet survey,* RBNZ estimates, bank projections.

Note: This chart displays total non-performing loans as a share of total lending alongside forecasts from a structural macro-economic model and the weighted average of the largest five banks' projections for their own loans.

Figure 2.13

Relationship between unemployment and non-performing loans



Source: Stats NZ, RBNZ estimates.

11 This projection uses a Bayesian vector autoregression (BVAR) model of key macro-economic variables which are conditioned on the published forecasts from the August *Monetary Policy Statement*. Further details of this model will be explained in a forthcoming analytical note.