Not Much To Fear At Present From Higher Overseas Interest Rates

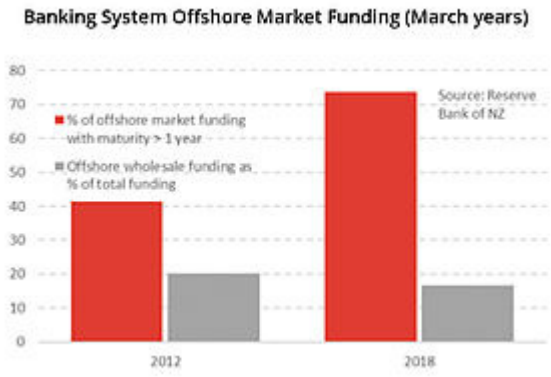
06 June 2018 CoreLogic research analyst **Kelvin Davidson** writes:

This week we take a look at recent RBNZ figures on our banking sector which provides some reassurance that an offshore-driven rise in local mortgage rates isn't of huge concern at the moment.

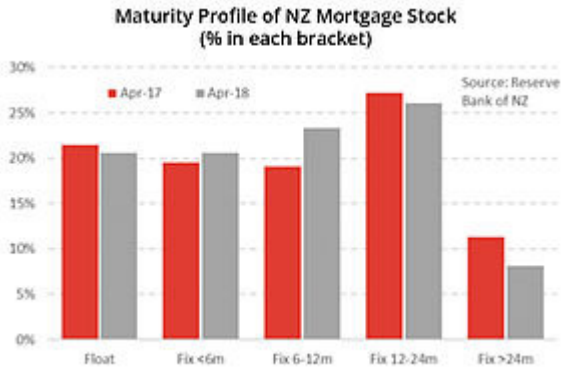
One of the key property market risks that we're keeping an eye on this year is whether or not higher offshore interest rates will flow through into increases in NZ domestic mortgage rates (a benchmark rate such as the US 10-year government bond yield has risen by about 1%-point over the past nine months). That flow-through risk could never be ruled out altogether. But recent data releases suggest that, at the moment, it isn't really much to lose sleep about.

For starters, last week's Financial Stability Report from the Reserve Bank (RBNZ) showed that, measured relative to the size of the economy, our banks have significantly reduced their reliance on offshore funding since the peak in 2008/09. This is shown in the first chart.

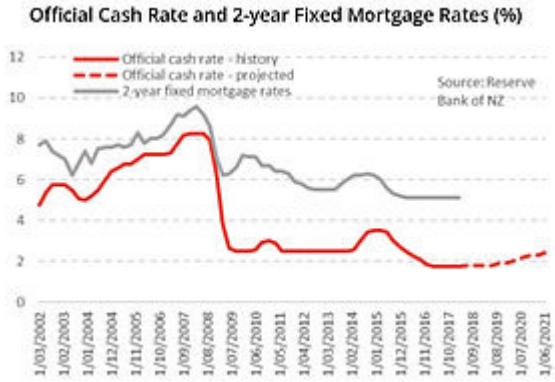
Secondly, not only has offshore funding become relatively less significant, but the maturity profile for that funding has lengthened – which, at least in theory, makes it less risky. As the second chart shows, the share of offshore funding with a maturity of more than one year has increased significantly between 2012 and 2018, from 41% to 74%.



Less reliance on short-term offshore funding can only be a good thing for the NZ banking sector, economy and hence the residential property market too. After all, we also know from other RBNZ statistics that 65% of borrowers (by value) in NZ are exposed to any rise in market mortgage rates by mid-2019. This is either because they are on floating rates or their fixed term is due to expire over the next 12 months.



Compared to a year ago, that debt maturity profile has actually shortened, with the third chart showing a higher share of borrowers in the 6-12m fix bracket. This will have arisen because of new or refinancing borrowers taking attractively priced short-term fixes, and as existing fixed loans have got closer to their expiry date.



Even if the banks hadn't reduced their exposure to offshore funding, there is another key aspect to the domestic interest rate environment that provides even more reassurance. In the years leading up to the Global Financial Crisis, the spread between two-year fixed mortgage rates and the official cash rate (OCR) averaged about 1.3%-points. Since then, it has jumped up to an average of 3.3%-points.

Things like higher capital adequacy requirements mean that the mortgage-OCR rate spread needs to be held higher by the banks than in the past. However, at least at face value, there would seem to be some scope here for any flow-through upwards pressure on funding costs to be partially

absorbed by the banks in their lending spreads rather than passing them fully on to borrowers.

Overall, the RBNZ's data on offshore funding makes it easier to see why domestic mortgage rates have been unaffected by the rises we've already seen in overseas interest rates. Even if overseas rates continued to rise, NZ's banks may be able to shelter borrowers from the full effects. And if shorter-term fixed rates are still attractively priced when mid-2019 rolls around, which seems likely, plenty of borrowers will surely fix again and insulate the market for at least another year.