Westpac InstitutionalBank

Finance company stakeout

Losses painful for investors but small in context

- **New Zealand finance companies have felt the chill of the global credit market freeze.**
- **Finance company failures do not represent a systemic risk.**
- **Potential economy-wide impacts have been overstated.**
- **Interest rate cuts would not help and are not warranted.**

Over the past month the world has witnessed a credit squeeze, where lenders have become hard to find. It all started with defaults on "sub prime" mortgages in the collapsing US housing market. A variety of investors all over the world found they had exposures to sub-prime mortgages, and suffered big losses. The biggest difficulty was that nobody knew who held the dud debt, so investors were reluctant to lend to anybody at all. Panic ensued, until central banks stepped in with liquidity measures and "last resort" lending. Markets have calmed, but sentiment is fragile.

New Zealand has felt the effects – not least a 10c drop in the NZD. The biggest chill has been felt in the finance company sector. So far this year, four finance companies have been placed into receivership (in addition to three failures last year). Access to international credit (e.g., through foreign commercial paper programmes) has virtually dried up and a loss of investor confidence has increased the difficulty of accessing retail funds for many companies.

Banking system not in danger

These finance company collapses – and there could be more – are going to be painful for some. But the ramifications for the wider financial system will be relatively minor. The main problem currently facing the industry is access to funds, not asset quality. It is smaller finance companies that rely on a regular flow of deposits from the public that are in trouble. The best rated companies have diversified asset holdings, diversified funding sources, often a large parent company, and good processes. Reinvestment rates have remained adequate for these companies.

In terms of size, finance companies are only a small part of NZ's financial system. Their total assets of around $19bn compare to total system assets of close to $400bn, meaning finance companies account for less than 5% of the financial system. The Reserve Bank has noted that "[finance company] failures do not in themselves pose a threat to financial stability." [1]

The main consequence for finance companies will be wider interest rate premia. The sector spread has been consistent with that paid by US BB rated corporates, which has widened in the past month from 2% to 3%. In the past there has been insufficient differentiation of risk within the finance company sector.[2] The current bout of uncertainty will see that change dramatically, with investors becoming far more discerning of the risks posed within the sector.

Only minor consequences for economy

Investor losses are so far too small to materially affect the economy. Total deposits involved in the seven recent finance company collapses amount to just over $1bn. Investors will not lose the lot, so actual losses will be more like $0.5bn – a mild hiccup on the stock exchange. And for failures that have occurred because of liquidity constraints and not deteriorating asset quality, investors' 'losses' will massively overstate economy-wide losses. As one investor group bails out, another will pick up assets cheap: more of a transfer, rather than loss, of wealth.

The second impact will be difficulty securing finance, particularly for lower income consumers and high-risk property developers. But banks are likely to step into the breach, limiting the credit crunch. Also, we expect consolidation (mergers and acquisitions) within the finance company sector, as strong companies absorb

[1] Reserve Bank of New Zealand: *Financial Stability Report*, November 2006.
[2] See our Bulletin: *Finance companies: what price risk?* 28 July 2006.

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weak ones. Ultimately, only the very riskiest of businesses or consumers will lose access to credit – not necessarily a bad thing.[3]

Perhaps more important will be the effect on general economic confidence. Credit difficulties are going to exacerbate the housing downturn, which has already begun. This could create a vicious circle, as the weaker property market causes lenders to tighten their lending standards. Also, the weaker property market will crimp consumers' ability to borrow for consumption. We fully expect the second half of 2007 to be a weak period for the New Zealand economy.

But the weakness will be short-lived. New Zealand is experiencing its biggest terms of trade boom in decades, and 2008 is going to be a great year on average, which is what the RBNZ must set policy for. Skyrocketing dairy prices are set to inject $3.6bn of cold hard cash directly into the economy – equivalent to 2.1% of GDP. Dairy farmers' spending will benefit the rest of the country, and the whole lot will have its own confidence effect. The dairy boom completely dwarfs the finance company collapses in terms of economic impact.

How will the RBNZ respond?

Some are postulating that the present finance company difficulties will encourage the RBNZ to cut interest rates. We disagree. It is not a systemic problem. Interest rate cuts would not assist finance companies, as they are facing a funding problem (as well as a required repricing of risk). The RBNZ would only cut interest rates if there were to be significant adverse real economy impacts, which is not close to happening.

Better 'solutions' revolve around mandatory ratings, transparency of reporting, and prudential supervision. But ultimately it is the responsibility of investors to be aware of what they are putting their money into. It is up to investors to inform themselves of related party transactions, the rate of impaired assets to receivables, core earnings, liquidity provisions, and concentration of credit and funding risk.

The finance company collapses are not enough to get the RBNZ cutting, but what if the world-wide credit crisis hurts New Zealand by stalling the world economy? It is highly likely that the US economy will slow, but Asia and Europe are booming. Debate is still raging as to whether the world can de-couple from its historical reliance on the US consumer – we come down on the side that the US is less important than it once was.

Even a wider slowdown in the world economy, which is not inevitable, would most hurt New Zealand if our commodity prices fell substantially. As soon as the sub-prime crisis erupted we were watching soft commodity prices like hawks. By and large, they continued rising. We expect commodity prices to hold onto most of their gains, especially dairy, since much of the price action has been related to supply issues rather than demand.

Finally, what about a scenario where the wider world economy falters *and* soft commodity prices begin to fall dramatically? Even in that scenario, we still don't foresee early OCR cuts. If NZ's commodity price boom faltered, the NZD would plummet. That would push inflation well into the 4%+ range. The RBNZ would not hike rates in such an environment – they would rightly view the inflation as a short-term spike. But equally, they would be reluctant to cut for fear of creating higher inflation expectations. 2006 serves as a good precedent for this scenario.

If it all sounds a bit like "no roads lead to cuts," that is because of the uncomfortable position in which the RBNZ finds itself. Inflation has averaged 2.95% over the past three years, and the RBNZ's forecasts suggested it will average just a whisker below three percent over the next three years. It is a real line-call to say that the RBNZ has met its minimum obligation to keep inflation between 1% and 3% on average over the medium term. The RBNZ cannot take any more risks.

For early cuts to eventuate, the economy would have to be substantially weaker than the RBNZ's expectations. That seems unlikely when one considers how weak their most recent forecasts were – house price inflation at zero by 2009, a dramatic slowdown in consumption, nil employment growth and unemployment at 5%. In short, the RBNZ has to be 100% sure that it has burst the housing bubble if it is to get on top of inflation.

The RBNZ has long been warning that the economy is grossly unbalanced, with excessive risk-taking, excessive debt, overpriced assets, and unsustainable consumption. Higher interest rates are an attempt to address those imbalances. They will be viewing these finance company collapses as a painful and unfortunate bump along the road to a more balanced economy. After all, the rebalancing was never expected to be pain-free.

Market implications

We expect that H2 2007 will be full of weak data, causing markets to price in early OCR cuts. The RBNZ will respond by reminding markets that although the economy is weak, it is not yet weak enough to contain inflation. They will continue to emphasise that they will take adverse economic shocks as relief from inflation pressure rather than harbingers of lower interest rates. Interest rates and the currency will trade like porpoises, diving on weak data and leaping on RBNZ reviews.

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[3] The RBNZ noted in its November 2006 *Financial Stability Report* that: "Another potential concern… would be the loss of financing to particular sectors in which non-bank lenders play an important niche role. Examples include second-hand car finance and mezzanine finance for property development. But in our view other lenders would be willing to expand or move into such areas, which would most likely mean that only the most marginal business would be affected other than temporarily."