RESERVE BANK OF NEW ZEALAND
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Date 10 July 2013

To: Minister of Finance

Aide Memoire on Loan to Value Restrictions

1. This note provides some additional clarification on the potential impact of Loan to Value restrictions in advance of the meeting with the Prime Minister tonight.

The number of first home buyers that would be affected by LVR restrictions

2. Table 1 below provides estimates of the current composition of borrowers within the housing market. We estimate that in the current market around 20-30,000 first home buyers (FHBs) are purchasing properties annually. Of these, approximately 13-19,000 are estimated to be high LVR borrowers based on information provided by the banks. FHBs are estimated to comprise about 40 percent of all high LVR borrowers.

Table 1: Composition of Borrowers in the Housing Market (Annual Basis)

	000s
Annual Home sales	85
Home sales with mortgages	60-65
Of which:	
Low LVR FHBs	7-11
High LVR FHBs	13-19
First home buyers - Total	20-30
Estimated Impact of a 10% speed limit on FHBs	
FHBs – unaffected or only mildly constrained	14-22
FHBs – moderately or severely constrained	6-8

3. A 10 percent speed limit on new lending at LVRs of over 80 percent would result in a reduction in the volume of new high LVR lending. We would expect a significant number of high LVR FHBs (5-8,000) would still be able to access high LVR loans through the banks, which would be met through the 10 percent high LVR speed

limit. This number could be higher if banks chose to give preference to first home buyers over other high LVR borrowers.

4. The remaining high LVR first home buyers would likely be constrained by LVR restrictions in some way. However, a proportion of these first home buyers – particularly those with LVRs of just over 80 percent – would be expected to work around LVR restrictions by borrowing from family members, saving a little more, taking out a small unsecured loan, or buying a slightly cheaper property. While the numbers are difficult to estimate, we believe around 2-3,000 high LVR first home buyers would fall into this category.

5. The balance of high LVR first home buyers (around 6-8,000) are likely to be moderately or severely constrained. These buyers would have to either purchase a significantly cheaper property or significantly delay their house purchase plans until they had saved a larger deposit or LVR restrictions were lifted. Some of these borrowers might be able to access assistance that they might not otherwise have used (eg via the Welcome Home Loans Scheme).

6. It should be noted that a significant number of FHBs (up to 11,000) are estimated to borrow at LVRs of less than 80 percent. We would expect these borrowers to remain unaffected by LVR restrictions.

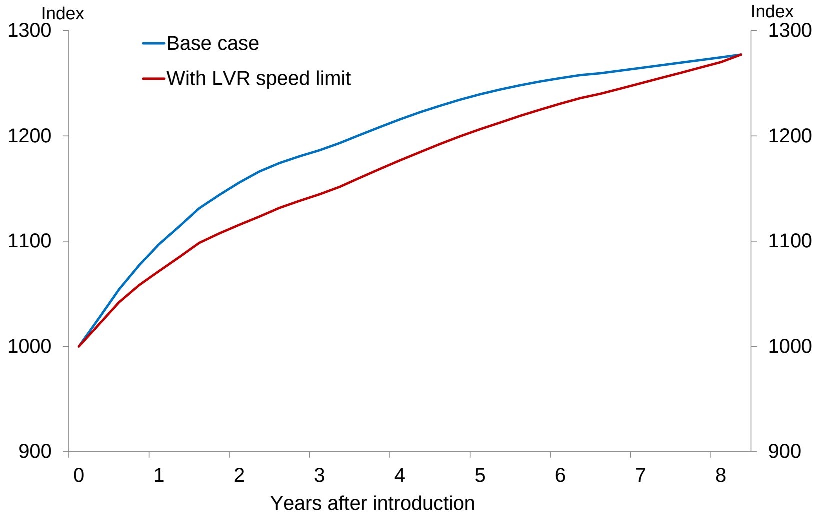
The impact of LVR restrictions on the housing market

7. The Reserve Bank's modelling suggests that imposing LVR restrictions could reduce the level of housing market turnover by 5-10 percent compared to the baseline. This would reflect the reduction in the flow of credit available to support higher market activity. The impact on turnover would be strongest in the period initially following the imposition of LVR restrictions, and the effect would be expected to gradually diminish over time.

8. We expect LVR restrictions to lower house price growth by 1-4 percentage points in the first year following their introduction compared to the baseline. It is likely that house price growth would also be somewhat lower in the second year. However, over a longer time period LVR restrictions would be expected to have a less material dampening effect on the level of house prices given our expectation that they would only be applied temporarily and that avoidance channels would tend to increase over time.

9. Figure 1 provides a stylised example of the likely evolution of house prices with and without LVR restrictions. The scenario is of strong house price growth in the near term, followed by a soft landing, broadly corresponding to the Reserve Bank's current forecasts. In this scenario, LVR restrictions exert a braking influence on house prices over the first two years, but house prices are the same as the baseline scenario after 8 years.

Figure 1: Stylised house price impact from imposing LVR restrictions



The impact of LVR restrictions on housing supply

10. The Bank does not believe that imposing LVR restrictions will have a significant negative effect on construction activity for a number of reasons:

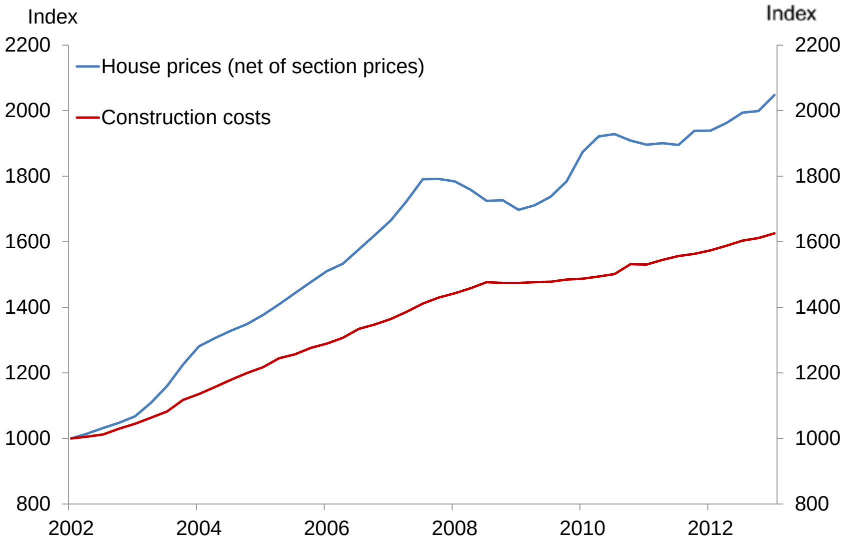
    - Property developers will not be captured by LVR restrictions so will not be constrained from financing new developments.

    - Banks are generally cautious in lending at high LVRs to finance new house building anyway, given uncertainties over costs and final valuations.

    - There is a significant shortage of houses for sale, particularly in Auckland. Therefore, where a potential purchaser of a new house is unable to do so, it is likely that a replacement buyer will be easily found (but at a lower price).

11. As noted, the Bank believes that the path of house prices in the short to medium term would be somewhat lower if an LVR restriction is imposed than would otherwise be the case. In principle, this would marginally reduce the incentive to build new dwellings. However, house price growth has significantly outstripped growth in construction costs over a number of years, even after accounting for rising land prices (figure 2). Accordingly, we believe price incentives to build new dwellings will remain strong, even if future house price inflation is dampened slightly by LVR restrictions. In Auckland in particular, it appears that other constraints, such as the availability of land and development costs, are likely to be far more binding on construction. As these supply constraints are gradually eased, developers will have every incentive to move ahead as the price/profit incentive will remain in place.

Figure 2: House prices and construction costs
(January 2002 = 1000)



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