RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Date 31 July 2013

To: Minister of Finance

Intended use of High-LVR Speed Limits

1. Earlier this week we outlined our planned timetable around the announcement of LVR restrictions (scheduled for 20 August). We have also recently provided you with a draft of our response to submissions on the LVR restriction framework. This note briefly summarises the nature of the high LVR speed limits that we intend to introduce with effect from 1 October 2013, and the process from here.

2. The Reserve Bank believes that current developments in the residential housing market are a threat to future financial stability in New Zealand. While constrained housing supply is a key factor shaping housing market conditions, strong demand supported by low interest rates is underpinning rapid increases in house prices. House prices and household debt ratios are at historically elevated levels, highlighting the risks that could arise following an economic shock (such as a rise in unemployment or a sharp rise in interest rates).

3. Over the past 18 months, high LVR lending has increased as a share of banks' new residential lending with around 30 percent of new mortgages now being written at LVRs of above 80 percent (up from around 23 percent in late 2011). While many homeowners are able to comfortably service larger mortgages in the current low interest rate environment, high LVR loans are more vulnerable in the event of a housing market downturn or a marked change in economic prospects.

4. The Reserve Bank believes that measures to help dampen housing demand are appropriate to allow time for the housing supply response being developed by local and central government to stabilise the housing market, so that prices do not rise to unsustainably high levels and then fall as new supply comes on stream.

5. The use of macro-prudential measures such as LVR restrictions offer the possibility of greater flexibility around the timing and magnitude of increases in policy interest rates. This may help to alleviate upward pressure on the exchange rate that might otherwise occur as the Official Cash Rate increases.

6. In deciding to employ LVR restrictions, the Reserve Bank has considered the likely effectiveness of the other macroprudential options. This includes macroprudential capital overlays (either on all lending or residential mortgage lending). These would boost the resilience of the banking system to a future housing downturn, but in our judgement would not substantially affect current mortgage pricing or availability and

thus would not greatly impact current housing market dynamics. In contrast, we believe a high-LVR speed limit has the scope to materially affect both credit demand and house price inflation. We have already taken actions to boost bank resilience, including raising the risk weights applying to high LVR housing loans (from September 30), so that is less of a priority at this time.

7. An advantage of the high-LVR speed limit approach is that it does not curtail all high LVR lending; banks will still be able to lend to creditworthy, low-equity borrowers within the constraints of the speed limit. Speed limits will be implemented via banks' conditions of registration, and enforceable through the Reserve Bank's compliance framework.

8. As discussed with you, our proposed calibration is a 10 percent speed limit on residential mortgage lending with an LVR of above 80 percent effective from 1 October 2013. That is, no more than 10 percent of new mortgage lending can have an LVR exceeding 80 percent. However, certain mortgage activity, which routinely accounts for around 5 percent of new lending, would be exempt from the policy. The exemptions include:

   - Customers with high LVR loans wishing to switch banks (this exemption is intended to facilitate competition among lenders and borrower choice).
   - Customers with high LVR loans shifting home (this exemption is to ensure LVR restrictions do not impede labour mobility).
   - Bridging finance.
   - Lending under the Welcome Home Loans program would also be exempted.

9. We have considered the case for additional exemptions such as targeting certain regions or high-value properties, but believe this would be administratively complex and likely to compromise the effectiveness of the policy. Although house prices have risen most sharply in the Auckland region, house prices are generally high relative to incomes across the country, and it is not clear that a downturn would be disproportionately felt in Auckland.

10. In modelling the likely effects of LVR speed limits, we have made plausible assumptions about how prospective buyers are likely to respond to tighter credit conditions, including behaviour designed to avoid the LVR restriction policy (for example, by obtaining finance from family members). There are other variables that are hard to quantify, such as the way in which banks will use their capacity under the speed limit. Overall, our assessment is that the policy will lead to some first home buyers delaying their purchase, but that many first home buyers will still be able to purchase[1], while a substantial amount of the policy incidence will also be felt by other borrowers.

[1] See our 10 July memo, RBNZ #5356977, for more detail.

11. Because LVR speed limits are a new policy instrument, the calibration and policy rules may need to be revised once the instrument is operational. While international experience has been enlightening, New Zealand will be the first country to try a 'speed limit' rather than outright caps on high LVR lending. In designing the speed limit, we have tried to balance the risk of 'creative avoidance' against the potential inefficiencies of being overly prescriptive. It is likely that avoidance channels will emerge over time, which may need to be addressed.

12. In their submissions to our recent consultation many banks noted that they have a significant pipeline of residential loan pre-approvals, which in many cases remain valid for up to six months. This would create some difficulties for banks in immediately scaling back the flow of high LVR lending. We are addressing this by allowing banks to meet the speed limit initially on a 6-month average basis.[2] We will also be giving banks some warning of our approach, and would expect them to reconsider their policy around high-LVR preapprovals. This could see them reducing the duration and/or volume of such pre-approvals and applying greater conditionality. Contacts in other countries report similar issues arising when LVRs were first used.

13. Banks will shortly begin to provide us with standardised data on the flow of high LVR lending, and the amount of data provided will gradually expand as banks enhance their reporting systems. We will be analysing this data alongside a broader range of credit and housing market data in considering the effectiveness of the LVR policy. We will report publically in our Financial Stability Reports, and will discuss policy progress with you and your office, and the Treasury.

14. LVR restrictions will not be a permanent feature. In removing LVR restrictions, we would first be looking for evidence that housing market sentiment has become more balanced, with greater appreciation of the potential impact of rising interest rates and increasing housing supply. A related factor is that an environment of rising global interest rates (which would tend to raise longer term interest rates here and push the exchange rate down) would tend to weaken housing market sentiment here and make the use of OCR responses to remaining house price pressure more desirable.

[2] Larger mortgage lenders will then have to meet the restrictions on a rolling 3 month average basis. Because of the potential volatility of the high LVR lending flow for smaller lenders, smaller lenders will be able to use a rolling 6 month window indefinitely.

15. As noted earlier this week, we will announce the decision to make LVR restrictions effective through an on the record speech and accompanying media release (August 20). We will be publishing a Regulatory Impact Assessment on that date, and will provide this to your office by August 16.

Graeme Wheeler
Governor

Copies to: Gabriel Makhlouf, Secretary, The Treasury
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