MEMORANDUM FOR MFC

COPIED TO

FROM Chris Bloor

DATE 2/04/2015

SUBJECT **REVISITING THE CASE FOR REGIONAL TARGETING OF MACRO-PRUDENTIAL POLICY**

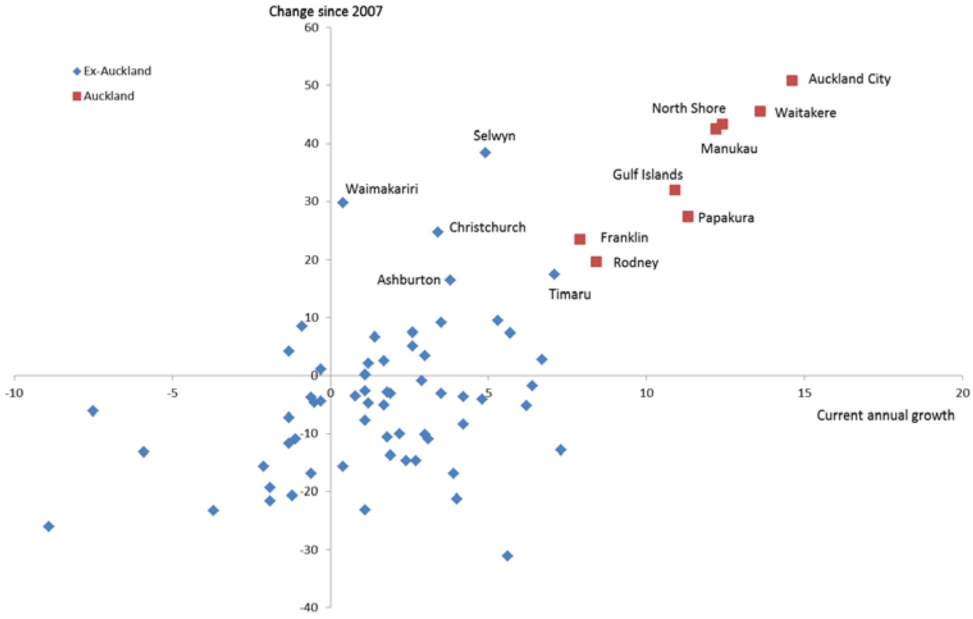
FOR YOUR Discussion

As part of a package of policy measures, we have been asked to consider the case for regional targeting of capital tools and to reconsider the case for regional targeting of LVR restrictions, specifically exempting lending outside of Auckland from the restriction. There are two issues to consider here: Is regional targeting justified based on our assessment of financial stability risk; and could we practically implement a regional restriction. This paper provides an exploration of the issues and also draw comparisons between the use of regional LVRs and capital overlays applied at a regional level. This paper is intended as a companion piece to #6074259, which provides further analysis of the credit losses that could be experienced in an Auckland-led housing slowdown.

House price gains are centred in Auckland

Figure 1 compares current annual growth rates in house prices with cumulative increases since the previous peak in 2007. All of the districts of Auckland stand out as being distinct from the rest of the country. However, growth has been significantly stronger close to the central city, than in fringe areas such as Rodney and Franklin. Canterbury also stands out for having strong cumulative growth since 2007, but there has been a significant easing in annual growth over the past six months. Outside of these regions, there is no district that has experienced more than 10 percent cumulative growth in house prices since 2007. And while there are 8 districts where house prices have grown by more than 5 percent in the past year, most of these are small and are possibly accounted for by data volatility.

Figure 1: House price growth by region



The rapid growth in house prices in Auckland has not been matched by growth in either incomes or rent. As a consequence, both house price to income and house price to rent ratios have become increasingly stretched and are at record levels. This is not the case for the rest of the country, where there is little evidence that valuations are becoming stretched.

Figure 2: House price to income by region

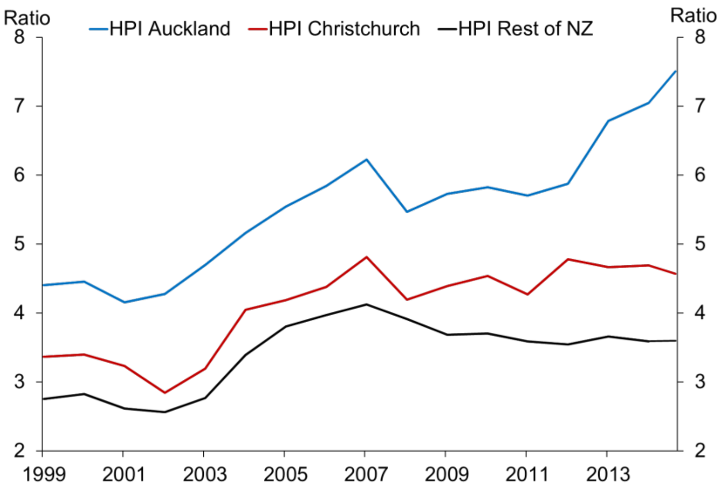
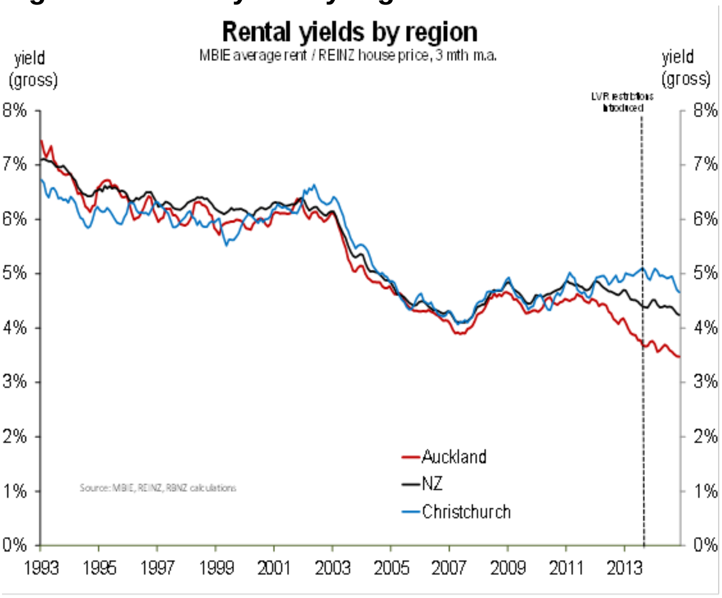


Figure 3: Rental yield by region



Spillover to other regions is key argument against regional targeting

One of the most difficult decisions if we were to go down the route of regional targeting is where to draw the boundary of the restriction. Whereever we drew the boundary, there would be an incentive for activity to move to the non-regulated zone which could cause undesirable distortions in the market. Because of this, we should try to avoid the situation where the boundary delineates areas that are reasonably close substitutes for each other.

Were we contemplating limiting LVR restrictions to the Auckland region, there would currently be a strong case for the policy to envelope the old TLAs of Auckland City, Waitakere, North Shore and Manukau. Beyond that, it is a little less clear cut. In particular, housing pressures appear to be less intense in both Rodney and Franklin. However, both of these areas are within commuting distance of central Auckland and could be considered close substitutes for anyone wishing to buy in the region. Thus to exclude them would be likely to cause distortions – we would expect demand in these areas to increase substantially. Given that price growth is already somewhat high in these areas, it would appear appropriate to include them within the net. Therefore, a sensible regional targeting strategy would be to include the entire Auckland super city.

This boundary is also convenient, as it cuts through a semi-rural area, with few townships nearby. To the North, the first township that would be excluded from the net would be Kaiwaka, which is 15km on from the last township in Auckland, Te Hana. To the South, Meremere is just outside of the boundary of Auckland, and is 25km from Pukekohe, although there are the small townships of Pokeno and Mercer in between. There would thus appear to be little risk of causing material distortions around the boundaries. However, the converse of this would be the accusation that we would be drawing towns into the net where there weren't material issues arising, such as Wellsford or Pokeno.

House price pressures may reappear elsewhere

While current house price pressure is concentrated in Auckland, there is a risk that it could spread to other areas if LVR restrictions were removed for other regions. Regional targeting opens up difficult political economy issues, which means that we would need to have transparent frameworks for considering when to bring other areas back into the net. One issue is that house price data tends to be quite noisy for smaller areas, given the small number of sales in each period. This suggests that we should consider house price movements within wider areas, and that we should consider levels rather than just annual growth rates.

At the current conjuncture, we should probably be most concerned about a re-emergence of house price pressures in the Canterbury region, given that prices are already well above 2007 levels. In contrast, in an area such as Wellington, house prices remain around their 2007 level, which might make one more relaxed were house prices to begin rising more rapidly.

There would be practical challenges to regional targeting

The first challenge with a regional restriction is how to define the area subject to the restriction and how banks would identify lending that takes place within the boundary. One option would be to target regional restrictions by territorial local authority, in this case Auckland City, encompassing Franklin in the South to Rodney in the North. Bank systems may not currently be configured to capture which administrative boundary the lending falls in, so system changes may be required to identify this lending. This could well present a larger problem for capital based measures, where existing lending will need to be classified by region without the benefit of being able to reconfigure lending scorecards to capture it. In contrast, an LVR limit would only apply to new commitments.

An alternative would be to target lending by postcode. In theory banks should know the postcode of the houses to which they are lending, although it is possible that even this could present system challenges if banks record borrower address rather than collateral address. One issue with postcodes is that they don't neatly align with administrative boundaries. For example, the 0975 postcode straddles the Auckland/Northland boundary, while the 2583, 2675, 2677, 2678 postcodes straddle the Auckland/Waikato boundary. In each of these cases only a small number of lifestyle blocks that are outside of the Auckland boundary would be affected, but there could be reputational risk associated with this inexact targeting.

Multiple collateral loans would create difficulties

For both capital and LVR purposes, banks pool together all mortgages and collateral at the borrower level. This could present challenges for regional targeting if borrowers own properties in multiple regions. In the ANZ property investor survey, 24 percent of respondents reported owning investment property outside of the region in which they live.

There are a number of options for approaching this challenge. The most conservative approach would be to classify the loan as an Auckland loan if any of the collateral backing it is in Auckland. This would be the simplest approach, and would minimise avoidance opportunities. However, it could be perceived as unfair, especially for borrowers who only have a minor exposure to Auckland. It could also have the unintended consequence of encouraging borrowers to split their Auckland and non-Auckland exposures between different banks, which may have efficiency consequences.

For the purposes of LVR restrictions, the exemption could be based off the location of the current property purchase, regardless of other properties in the collateral pool. However, this could have undesirable consequences as it may encourage investors to leverage up their Auckland exposures in order to purchase elsewhere. For example, an investor with an 80 percent LVR on a $1m Auckland property portfolio may purchase a further $1m in property in Hamilton at a 100 percent LVR in order to generate an overall portfolio LVR of 90 percent. Banks would only be willing to do this because of the existing equity, and the net result would still be an exposure that is very heavily exposed to a downturn in the Auckland market.

In the case of capital-based tools, the stock of existing lending would need to be allocated by region. It may be possible for banks to proportionately pro-rate exposures by region, based on the regional share of collateral. We would have to consult banks on the technical feasibility of doing this as it would imply allocating different capital requirements to portions of the same loan.

There are a range of options on how to administer regional LVR restrictions.
One option would be to exempt high-LVR lending that is outside of the target area. This would be the simplest method to apply, as it would just require a minor amendment to the new commitments survey to capture lending that is exempt due to being outside Auckland. This option would also be scalable, as regions could be moved in and out of the restriction by adjusting the definition of the exemption. Another advantage of this option is that it does not require banks to be able to accurately classify all lending by region. The burden would be on banks to ascertain that a loan was to a property outside of Auckland in order to take advantage of the exemption. For this option there would also be the opportunity to make it a blanket exemption, or to place conditions on it. For example, it could be for lending at LVRs of less than 90 percent, to owner occupiers, or for the purpose of purchasing property (as opposed to top-ups).

However, with this option the speed limit would need to be recalibrated in order not to ease the restriction in Auckland. We do not have sufficient data to recalibrate the restriction to Auckland exactly, but we should be able to get reasonably close. It is likely that around half of new mortgage commitments are to Auckland, but we don't know what share of lending is high-LVR. If Auckland had the same high-LVR share as the rest of the country, and allowing for some 75-80 percent LVR lending to transition back to the 80 percent+ bucket in the rest of the country, the measured share of non-exempt high-LVR lending would fall from 7.1 percent to 3.7 percent under unchanged lending flows.[1] Depending on whether banks target a proportional or fixed buffer to the speed limit, a revised speed limit of around 6 percent would allow high-LVR lending to remain unchanged in Auckland.

The other alternative would be to set a specific restriction for Auckland. This would require a larger reconfiguration of the new commitments survey, although could plausibly be captured through a reasonably small memo item. However, it would be somewhat cleaner in that the 10 percent speed limit could be retained. We would also have the option of retaining a higher speed limit for the rest of the country if we desired. One thing that we need to consider is

[1] For the purposes of the speed limit calculation, it doesn't matter whether high-LVR lending in the rest of the country increases, as exempt lending is excluded from both the numerator and the denominator of the speed limit.

how we would handle adding new regions to the restriction under this option if we deemed this necessary. The easiest option would seem to be to be to group all regions subject to the restriction into the same speed limit, with reporting on an aggregate basis.