



## Consultation Paper:

### Adjustments to restrictions on high-LVR residential mortgage lending

The Reserve Bank invites submissions on this Consultation Paper by August 10 2016. Please ensure that responses are sent in before the closing date. Submissions received after this date cannot be considered.

Submissions and enquiries about the consultation should be addressed to:

Attention:  
Head, Macro Financial Department  
Reserve Bank of New Zealand  
PO Box 2498  
Wellington 6140

Email: [macroprudential@rbnz.govt.nz](mailto:macroprudential@rbnz.govt.nz)

When responding, please state whether you are doing so as an individual or on behalf of an organisation.

Please note that a summary of submissions may be published. If you think any part of your submission should properly be withheld on the grounds of commercial sensitivity or for any other reason, you should indicate this clearly

**July 2016**

#### → **RESPONSE ON BEHALF OF: Results Mentoring Pty Ltd**

**Submitted: 8<sup>th</sup> August 2016**

Results Mentoring Pty Ltd (ABN 84 116 115 667) is a leading Australasian provider of independent property market analysis and investment education.

Questions on this response may be directed to:

Simon Buckingham  
Director, Results Mentoring Pty Ltd  
PO Box 359, Mont Albert VIC 3127 Australia  
E: [simon@resultsmentoring.com](mailto:simon@resultsmentoring.com)  
P: +61 3 9890 5600

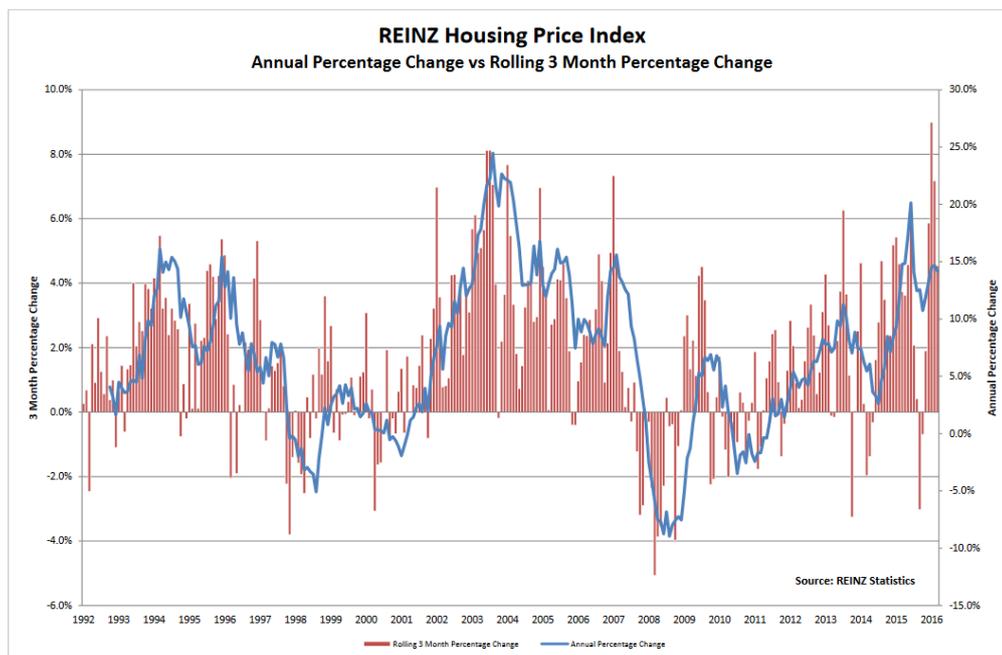
## Introduction

1. The Reserve Bank considers a sharp correction in house prices to be a key risk to the financial system, and one that is increasing the longer the current boom in house prices persists.

→ **[COMMENT]** This statement assumes that there is something “unusual” about house price booms, or that the current price boom has continued for an unusually long period. In fact, analysis of historical data demonstrates that house price booms generally last anywhere between 6 months and 3 years before prices stabilise or experience a (usually) small correction, due to the normal interplay between supply, demand and affordability.

A “boom” might be defined as a period in which property values generally increase in excess of 10% per annum.

As can be seen in the chart below of the REINZ Housing Price Index, several “booms” where the index increased by over 10% on an annual basis have occurred over the last 20 years, and the current boom is not particularly dissimilar in scale or duration. In fact, it is eclipsed by the boom that occurred between 2002 and 2005, which peaked at a 25% annual increase in the index in 2003.



It should be noted that NONE of these past booms, even those of far greater magnitude than the current boom, resulted in a severe or sustained downward correction (or so-called “bursting” of a purported asset bubble), nor significant fallout impacting the financial system.

The falls witnessed in 2008-2009 were a result of global factors (the GFC) rather than any over-inflation of local property asset values, as evidenced by the short-term nature of the falls and subsequent upwards correction.

A significant crash in property values within NZ would be historically unprecedented, and claims that there is an unusually high risk of such a crash occurring ignore historical patterns of market behavior including the typical duration and magnitude of past booms.

A severe downturn in house prices could have major implications for the banking system, with more than 55 percent of bank assets secured by residential property. Household debt is also now at record levels relative to income, suggesting that a housing downturn could have major adverse effects on households and the broader economy.

→ **[COMMENT]** Assessing risk exposure based on a ratio of debt to incomes is a massive oversimplification that ignores many more significant factors, not least of which being the cost of funds which has been substantially lower in relative terms this decade compared to previous decades, and is unlikely to rise appreciably for several years given current low inflation rates and anaemic economic growth.

Assessment of risk based on debt to income ratios also overlooks the significant fact that property purchases in this century are generally undertaken by households with dual incomes rather than single income families. In other words, measuring debt to income on an individual income basis is an inappropriate measure that ignores the reality that modern dual income households have approximately double the affordability of the single income households of the past.

Risks to the banking system are better mitigated through **regulation of debt servicing tests** (such as the Australian example of the regulator APRA requiring debt servicing ability to be tested by lenders at a minimum assumed interest rate of 7%) and through **setting maximum growth thresholds for lenders' writing of new loans to investors** whereby any bank exceeding those thresholds would be required to have higher capital reserves (again, see the Australian experience of APRA restricting lenders from growing their investment loan books by more than 10% per annum).

Importantly, the measures taken by APRA in the Australian lending environment have been **tested** and proven to result in more conservative lending practices and reduced volumes of investor lending by banks, providing increased financial stability.

***Disturbingly, this 'consultation paper' provides no analysis or commentary on the Australian experience.*** It is unclear whether this is 'willful ignorance' or a major oversight. At worst, this omission suggests that the research undertaken by the RBNZ in preparing its proposed policy has selected only evidence supporting a pre-determined outcome, rather than being comprehensive in its analysis to arrive at a logical conclusion.

The proposed imposition of extreme LVR reductions is an entirely *untested* approach in this part of the world, and risks unforeseen and unintended adverse consequences on consumer, investor and business confidence (including consumer and business spending behaviour) which may spill over into economic growth and employment.

**A far more logical and less risky approach would be to mirror the more moderate and proven approach adopted by APRA in Australia**, by setting explicit minimum thresholds for loan servicing tests, maximum growth thresholds for banks' investment loan portfolios, and requiring any bank exceeding the growth threshold to hold greater capital reserves.

2. The Reserve Bank put in place temporary restrictions on high loan-to-value ratio (LVR) bank lending in October 2013, and tightened these restrictions for Auckland investors in November 2015. Reduced availability of high-LVR loans has resulted in (i) an ongoing improvement in credit risk on bank mortgage portfolios and (ii) a temporary slowing of credit demand and house price inflation. In line with the objectives of macro-prudential policy, these effects have worked to reduce the financial system impact of a severe housing downturn.

→ **[COMMENT]** The key word used in this paragraph is 'temporary'. In reality these measures have failed to have any sustained impact on house price inflation or credit growth. The answer is therefore not to further tighten LVR restrictions which have already proven to be largely ineffectual in slowing house price inflation, but to apply different strategies such as the more effective Australian approach of regulating minimum debt servicing tests, banks' investment loan growth thresholds, and banks' capital raising requirements.

3. Despite the financial stability benefit imparted by the current LVR policy, growth in house prices and credit have remained elevated. As a result, the risk of a future correction in house prices has continued to increase. This consultation paper sets out the following proposed changes to the LVR restrictions, in order to further mitigate risks to financial stability:

- a. Applying a nationwide speed limit for all investor lending, permitting no more than 5 percent of lending at an LVR greater than 60.
- b. Applying a nationwide speed limit for all owner-occupier lending, permitting no more than 10 percent of commitments with an LVR of greater than 80.

These changes simplify the current LVR policy by removing the distinction between lending in Auckland and rest of New Zealand. Compared to the current policy, there is a large tightening in credit availability for investor lending, and a small tightening for owner-occupiers in the rest of New Zealand. Exemptions allowed under the current LVR policy will continue to operate, including for construction lending.

→ **[COMMENT]** This approach is illogical. As acknowledged by the RBNZ, tighter LVRs have failed as a mechanism to constrain growth in house prices and credit. Doing "more of the same" (only *more*) and expecting a different result is the very definition of insanity.

If the existing measures have proven ineffectual (as they have), then logically a very different approach is required. A parallel could be made with attempting to use a small sledgehammer to dislodge a few bricks, and when the small sledgehammer fails to fix the problem substituting it for a much larger sledgehammer. The obvious risk is that the larger sledgehammer results in significant unintended collateral damage, bringing the whole building down.

A very real danger in the RBNZ's proposed approach is that it triggers the very crash in asset prices that the RBNZ hopes to avoid, rather than stabilising growth in house prices and credit.

Again, the answer is therefore not to further tighten LVR restrictions which have already proven to be largely ineffectual in slowing house price inflation and credit growth, but to apply different strategies such as the *more effective* Australian approach of regulating minimum debt servicing tests, banks' investment loan growth thresholds, and banks' capital raising requirements.

4. The Reserve Bank will continue to explore whether additional macro-prudential measures may be necessary to mitigate growing risks around the housing market. Possible future measures could include a limit on high debt-to-income lending and/or additional capital overlays. However, rapid growth in house prices fundamentally reflects an imbalance between underlying housing demand and supply, particularly in Auckland. Broader measures are required to reduce these imbalances, with the relevant policy areas extending well beyond financial policy and the responsibilities of the Reserve Bank (Spencer (2016)). While these measures continue to be developed by central and local government, the Reserve Bank's policies are aimed at increasing financial system resilience, and also act to reduce housing demand at the margin.

→ **[COMMENT]** There is an acknowledgement here that the fundamental issue driving house price inflation (especially in Auckland) is **not** excessive demand, but a chronic lack of supply of housing in areas that the population actually wants to live in.

Contrary to the general view of this 'consultation paper', housing booms are not directly or primarily driven by the availability of credit. Considered research in recent years has demonstrated that house price inflation is most directly influenced by the combined dynamics of supply, demand, and rental vacancies (see for example: *Mastering the Australian Housing Market - John Lindeman, published 2010*).

Policies that attempt to attack only "demand at the margin" (for instance by attempting to constrain the availability of credit) are doomed to fail to achieve any sustained impact on house price inflation precisely because they deal only with one part of the equation.

Attempting to stifle one element of demand to create a quick-fix is fundamentally flawed. The real issue is not demand from investors (or any other group), but a persistent **lack of supply** in established areas where people actually want to live.

Successive governments over the last several decades have failed to grapple with the supply-side issues of the housing market, and it is only by addressing **supply** that any long-term fix for housing affordability will be found.

Recent political pressure put on the RBNZ indicated that politicians are looking for an "easy" band-aid solution, rather than grappling with the hard task of creating any kind of genuine housing policy or reforming the bloated and cumbersome red-tape that bogs-down town planning in NZ.

Multiple inefficient layers of policy, planning and regulation between Local and State Government, and substantial taxes that raise the cost of development – including GST and developer contribution levies – provide a negative impetus to the development of new supply in established but undersupplied areas (where people actually want to live) contributing to ongoing upward price pressure in those areas.

Until a coordinated policy approach is developed to address the supply shortages (particularly those concentrated in the Auckland area), housing price growth in such areas is likely to continue to be an issue.

5. Risks associated with the housing market have increased for a much longer period than expected at the time that the LVR policy was introduced in 2013.

→ **[COMMENT]** It is difficult to understand why the RBNZ thought that restricting LVRs in an environment of extreme supply shortage (the Auckland market) would make a significant difference. Our view at the time, based on simple analysis of the supply and demand dynamics of the Auckland market, was that such measures were unlikely to have any sustained impact, and if the RBNZ had adequately researched those dynamics at the time it would likely have arrived at the same conclusion.

Attacking “demand at the margin” through credit constraints is unlikely to have a significant impact in a market with chronic supply shortages.

There appears to be a weakness in the analytical capabilities of the RBNZ when it comes to understanding property market supply/demand analytics. We would be happy to provide consulting support or to steer RBNZ analysts in the right direction to enhance their understanding of these dynamics so that more informed policy making decisions can be made.

However, the policy remains a temporary measure that will be removed at the appropriate time. There are a range of criteria that will guide the removal decision, including that house prices and credit return to a more sustainable path, and that the risk of a resurgence in housing pressures following removal is acceptable.

→ **[COMMENT]** Increasing the severity of LVR restrictions only amplifies the risk of a greater impact on the market when the measures are ultimately removed.

Implementing an alternative approach that can remain on a more permanent basis (such as regulating the minimum servicing tests applied by banks when assessing loan applications, as per the Australian approach) would better manage both current credit growth concerns and ongoing management of risk.

In addition, the Reserve Bank will continue to monitor for signs that the policy is creating significant market distortions, such as a material and growing share of mortgage credit being financed by non-bank institutions that are not subject to the policy.

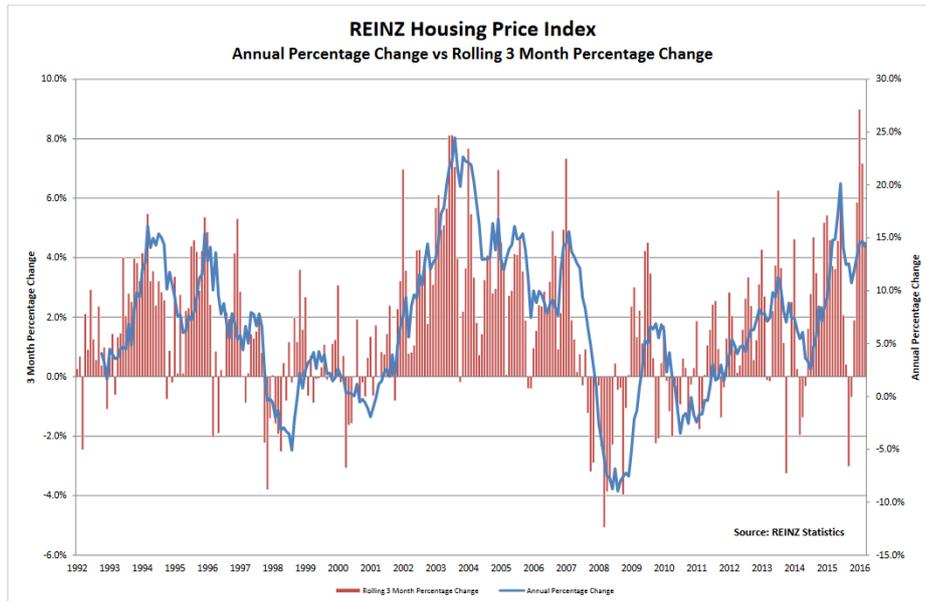
→ **[COMMENT]** The proposed policy will almost certainly create a skew in demand for lending from non-bank institutions. It would be naïve to think otherwise.

Once again, an alternative approach such as regulating the minimum servicing tests applied by banks (and non-bank lenders) when assessing loan applications, (as per the Australian approach) would better manage this risk.

## Problem definition

6. New Zealand house prices have increased by around 50 percent since 2010, driven by strong immigration, low mortgage rates and sluggish housing supply.

→ **[COMMENT]** This 'selective' interpretation of statistics ignores that house prices generally fell between 2008 and 2011, as illustrated in the chart of the REINZ Housing Price Index below:



When this is taken into account, **house price growth over the last 10 years has only totaled 58.9%** (RBNZ M10 Housing statistical tables – March 2006 to March 2016, change in House Price Index).

Over ten years this represents an average of only 5.9% per annum before adjusting for inflation, hardly an excessive average.

CPI inflation in NZ has averaged 2.2% over the same period, so in real (inflation adjusted) terms, house price growth has only averaged 3.7% above inflation.

Taking a 10-year perspective, recent house price inflation can therefore be seen as more a 'catch up' offsetting earlier price falls, rather than an unforeseen and dangerously excessive 'boom'. An average house price inflation of only 3.7% in real terms is hardly cause for concern about 'unsustainable' house prices.

With house prices becoming increasingly disconnected from underlying household incomes and rents, there is significant potential for house prices to fall very rapidly if the factors currently supporting the market reverse.

→ **[COMMENT]** This is a stretch. In order for there to be a significant general fall in house prices, we would likely have to see:

- Substantially higher unemployment, leading to a significant increase in mortgage defaults and distressed sales (highly unlikely)

- A material influx of new over-supply in areas currently experiencing high demand (highly unlikely)
- A substantial increase in the cost of finance (i.e. a rapid and sustained increase in interest rates). Also highly unlikely in the current economic climate (and for the foreseeable future).

→ **[COMMENT]** One other factor that could potentially trigger a sudden decline in house prices would be a sudden and dramatic departure of a large segment of buyers from the market (i.e. a substantial and sudden fall in demand). The only obvious potential trigger for such an exodus from the market would be ***precisely the restrictive LVR policies current being proposed by the RBNZ.***

By implementing such policies the RBNZ may inadvertently *create* the very house price crash it is attempting to avoid if it succeeds in driving a substantial portion of investors and home buyers out of the market.

There is a material and very risky contradiction in the proposed policies and the likely practical effect on buyer behavior from those policies.

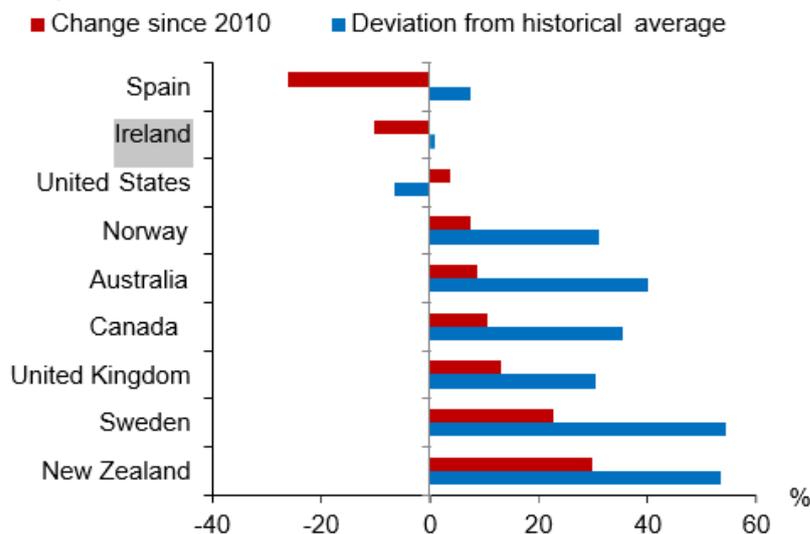
Average house prices in New Zealand are now around 6.5 times average household income.

→ **[COMMENT]** ***This is statistically incorrect.*** REINZ statistics for June 2016 show a median NZ house price of \$500,000. RBNZ statistics for March 2016 indicate a disposable household income of \$151,155 (C21 Key household financial statistics). **This represents a house price to household disposable income ratio of only 3.3 times.**

It appears that RBNZ analysis here has incorrectly used average *individual* incomes to derive the ratio, rather than *household* incomes.

When combined with the pre- existing imbalance built up prior to the GFC, the house price-to-income ratio is further from its historical average than in almost any other OECD country (figure 1).

Figure 1  
House price-to-income ratios in selected economies



Source: OECD.

Note: Data as of 2015Q4.

→ **[COMMENT]** The use and reliability of the OECD statistics in this ‘consultation paper’ is highly suspect when compared to the RBNZ’s own statistics on household incomes which suggest a household income to house price ratio of only 3.3 times (**see above**).

Furthermore, these statistics are substantially skewed by the concentration of population in Auckland and are therefore a distorted comparison (of house prices inflated by the Auckland median compared to average NZ-wide incomes).

The ratio of house prices to incomes in other parts of the country would be nowhere near so dramatic if the distorting influence of Auckland was removed. With incomes higher in Auckland than other parts of the country, it may be that the Auckland-specific ratio would be different also.

7. Unprecedented levels of household debt magnify risks associated with the housing market. The aggregate household debt-to-income ratio has now reached 163 percent, slightly above its pre-crisis peak. Based on private reporting data from major banks, the debt-to-income ratio on new lending is significantly higher, with around 30 percent of mortgage commitments extended at a ratio exceeding six times income. Although low interest rates are currently supporting loan servicing ability, elevated debt ratios leave the household sector more vulnerable when lending rates return to more normal levels or economic conditions deteriorate.

→ **[COMMENT]** This is all the more reason to adopt an approach similar to that implemented in Australia whereby mandated minimum servicing test must be applied by banks when assessing new lending applications, based on an interest rate that is considered reflective of “more normal levels” (in Australia this has been identified as an interest rate of 7%). Taking this approach in Australia has rendered tinkering with LVRs unnecessary.

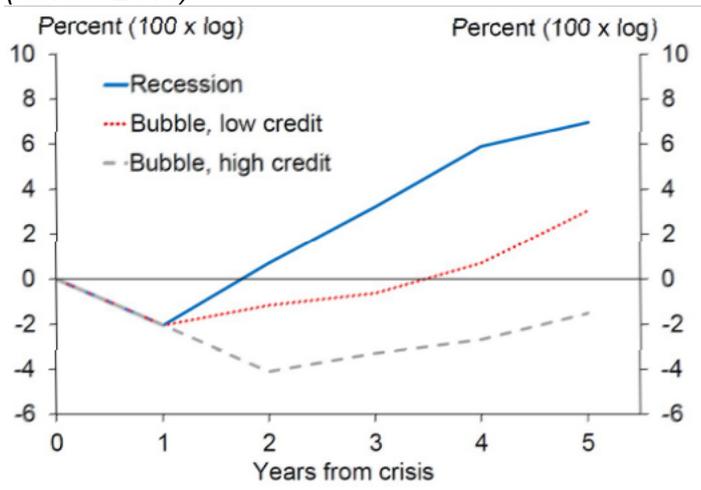
8. The Reserve Bank is concerned that the risk of a sharp fall in house prices poses a growing threat to the stability of the financial system. A severe housing downturn can directly place banks under pressure by creating rising mortgage loan losses, especially if unemployment increases. Several advanced economies experienced rapid rises in mortgage losses following the GFC, with losses reaching more than 5 percent of mortgage loans in both the US and Ireland. There is less evidence of residential mortgage losses having a large impact on bank balance sheets in earlier financial crises, possibly reflecting that the exposure of households and banks to the housing market was significantly lower (Kragh-Sorenson and Solheim (2014)).

→ **[COMMENT]** The economies that experienced rapid rises in mortgage losses following the GFC had far less robust mortgage lending practices than NZ, and those lax practices were also a direct contributor to the GFC and the housing downturns in those countries (most notably the US). This is not the situation in NZ where lending practices have been historically far more stringent.

9. A sharp decline in house prices could also indirectly place the financial system under stress (Thornley (2016)). Housing busts tend to be associated with a large and persistent decline in economic activity, especially if preceded by strong increases in house prices and above average credit growth (figure 2). There is strong evidence that sharp reductions in consumption by highly indebted households played a role in exacerbating housing downturns during the GFC. Severe housing downturns can also result in increased losses on lending to other sectors exposed to the housing market, such as property development.

→ **[COMMENT]** Imposing significant restrictions on the ability of households to access equity tied up in real estate is more likely to negatively impact consumer confidence and consumer spending, as well as inhibiting development of new property and business investment, as it potentially restricts access to working capital. Rather than providing protection against declining economic activity and housing busts, **this approach actually increases the risk of recession.**

Figure 2  
Paths of GDP after housing bubbles in selected advanced economies  
(1870 – 2013)



Source: Jorda et al, 2015.

Note: A house price 'bubble' is defined as a period where house prices grow above their long-term trend, and there is an eventual price correction.

→ **[COMMENT]** This definition is an over-simplification as it ignores the reality that house prices never move in a straight line – rather the housing market over time (just like any market) is characterised by short periods of higher growth and longer periods of flat, low or negative growth.

'Low' and 'high' credit refer to whether credit growth is above average.

10. Stress tests conducted by the Reserve Bank, in conjunction with the Australian Prudential Regulatory Authority, suggest that banks would remain solvent under stress scenarios involving a severe downturn in the housing market. However, the tests also highlight the likelihood that banks would remain solvent partly by cutting back on new lending. This would tend to exacerbate the downturn in the housing market by making it more difficult for prospective house buyers to access credit, at the same time as the number of distressed sales is likely to be rising. The resulting illiquidity in the housing market could reinforce the economic downturn by amplifying the fall in house prices and increasing debt overhang among distressed borrowers. The reduced availability of credit to other sectors would also reinforce the economic downturn. Dampening this amplification of the financial cycle is a key objective of macro-prudential policy.

→ **[COMMENT]** Given this observation, why is the RBNZ proposing an approach that would create exactly this scenario (i.e. illiquidity in the housing market, and making it more difficult for prospective house buyers to access credit)?

Again, the RBNZ's approach here is contradictory – concerns about risks have been identified, but the proposed policy generates those same risks.

11. The current loan-to-value ratio policy has been in place since 2013. This policy is working to improve financial system resilience by increasing the equity buffers of households. Under the conservative assumption that the share of high-LVR loans would have otherwise remained constant, around \$20 billion in lending at an LVR of above 80 has not taken place as a result of the policy. In addition, around \$3 billion of investor lending at an LVR of above 70 has not taken place due to changes made in late 2015. The policy appears to have reduced the risk of a correction, by curbing the rise in house prices and credit growth by approximately five percent.<sup>1</sup> Nevertheless, the Reserve Bank believes that the risk of a severe downturn in the housing market is continuing to increase.

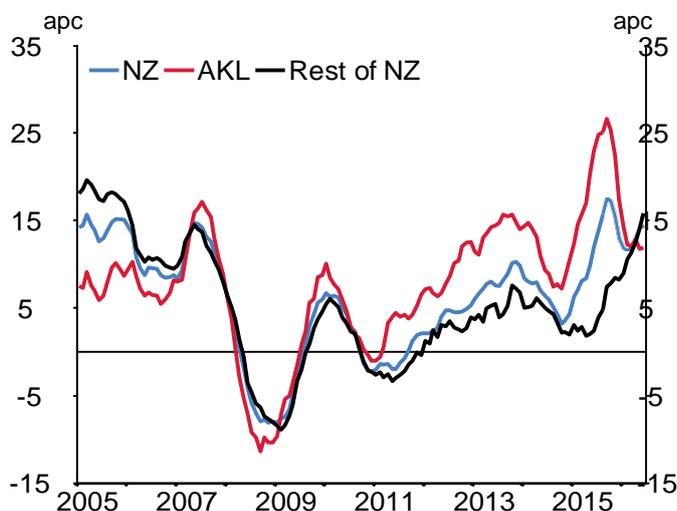
→ **[COMMENT]** So why propose policies that increase the risk of a housing downturn through extreme changes to LVRs, rather than adopting more moderate and proven approaches such as those recently implemented in Australia?

12. Recent housing market data suggests that house price inflation is now increasing rapidly across the country (figure 3). Risks remain most acute in Auckland, following a sustained period of rapid house price inflation since 2012. The ratio of Auckland house prices to average regional income has reached around 9 to 10 depending on the particular methodology applied. This is very elevated on a cross-country basis, and similar to major global cities such as London, San Francisco, and Sydney. Elevated house prices imply that debt-to-income ratios for a typical borrower in the Auckland region have become very stretched, making borrowers more vulnerable to a period of rising unemployment or rising interest rates.

→ **[COMMENT]** Counter to this assertion is the chart below which indicates that while other parts of the country have recently seen a somewhat overdue increase in house prices, the rate of increase in Auckland house prices has in fact been declining – probably reflecting the typical pattern of past housing booms which have come off the boil after a 3-year period:

<sup>1</sup>This is based on the counter-factual estimates in Price (2014) of 4 percent, and an assessment of the counter-factual impact of the 2015 changes using a similar framework.

Figure 3  
House price inflation  
(annual percent change, 3 month average)



Source: REINZ.

13. House prices in the rest of New Zealand increased by around 16 percent over the past year, with significantly higher rates in regions nearby Auckland.

→ **[COMMENT]** House price growth over 10% in one 12 month period is hardly cause for alarm, especially when this barely offsets 7 years of negative and low-single-digit growth.

Following several years of house prices tracking broadly in line with household incomes, the house price-to-income ratio outside of Auckland has increased to around the pre- GFC peak of 5.3.

→ **[COMMENT]** Once again, this is statistically questionable. REINZ statistics for June 2016 show a median NZ house price of \$500,000. RBNZ statistics for March 2016 indicate a disposable household income of \$151,155 (C21 Key household financial statistics). **This represents a house price to household disposable income ratio of only 3.3 times**, not 5.5 times.

Is the analysis mixing up *individual* incomes and *household* incomes?

There is a risk that rapid increases in house prices will continue, given recent falls in mortgage rates, market forecasts that interest rates will remain low for some time, increases in regional migration, and very low secondary market inventories.

→ **[COMMENT]** The issue highlighted here is predominantly one of available supply versus demand, and will only be solved on any long-term basis through policies that actively encourage the development of new housing supplies in populous areas.

A sustained period of house price inflation could push house price and household debt ratios towards the very elevated levels seen in Auckland.

→ **[COMMENT]** This is unlikely to be the case consistently across all towns/suburbs, as property market dynamics operate at individual suburb levels rather than across the entire market in any consistent way – highlighting a further limitation in macro-prudential measures: That they are a blunt instrument which fails to take into account variations in market dynamics at individual town and suburb level – treating the market as *homogenous* when it is not.

Towns and suburbs with suppressed local economies and housing markets are likely to be disproportionately affected (in a very negative and damaging way) by a generic approach to LVRs across the country. This will further damage consumer confidence, business confidence and the local economies within those areas.

14. The risk of a price correction in the rest of New Zealand could indeed become significant well before price-to-income ratios reach similar levels to Auckland, as there is currently less evidence of a fundamental shortage of housing.

→ **[COMMENT]** This statement highlights a lack of understanding of simple demand-supply dynamics.

Areas without a current supply shortage will provide natural resistance to house price inflation. Prices are unlikely to rise strongly in a market (for any product, and housing is no different) if there is sufficient supply to meet demand.

Prices rise strongly when demand significantly exceeds available supply, as has been the case in Auckland.

Areas with rising populations, such as the Bay of Plenty, are already seeing a proportionately larger supply response. Rising supply should help take pressure off prices, but could also increase the risk that an oversupply of housing emerges.

→ **[COMMENT]** It is the responsibility of local government to manage town planning and new housing approvals to minimize the risk of localized oversupply – NOT the responsibility of the Reserve Bank to attempt to use a blunt nation-wide generic LVR approach which is neither targeted nor an effective instrument for managing supply-side issues.

Regional evidence from the United States during the GFC suggests that a region need not necessarily reach a high price-to-income to experience a housing bust, especially if building activity rises sharply during the boom (Haughwout et al (2013)).

→ **[COMMENT]** Oversupplied housing estates in some parts of the US were fueled by a lack of effective town planning, irresponsible lending practices and poor assessment of the ability of new home buyers to afford the loans they were granted, in addition to many such loans being of a 'non-recourse' variety (too easy for borrowers to walk away from).

The comparison with the New Zealand situation is inappropriate, as there is a broad undersupply of housing in New Zealand and current lending practices are much more robust than the lending practices of the US leading into the GFC.

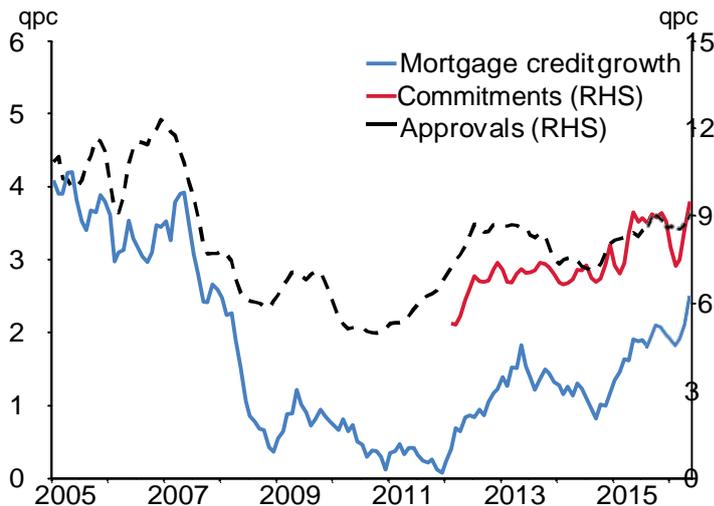
15. Evidence from past crises suggests that rapid growth in housing debt is a key early warning indicator of future periods of financial stress (Anundsen et al (2014)). Mortgage debt grew by 8.5 percent over the past year (figure 5). Given current projections of income growth and house price inflation, the aggregate debt-to-income ratio is expected to continue rising. A high rate of debt repayment among existing borrowers is reducing net credit growth, with gross mortgage commitments amounting to around 35 percent of outstanding debt over the past year. Debt-to-income ratios on new lending are already stretched, and are likely to come under further upward pressure in coming years.

→ **[COMMENT]** Debt-to-income ratios on their own are no reliable indicator of current or future financial stress, as this limited measure fails to take into account relative interest rates and the cost of repayments.

For example, the burden on a \$100,000 income of a \$500,000 debt at 5% interest is exactly the same as the burden of a \$200,000 debt at 12.5% interest, but the debt-to-income ratio for the former is 5:1 and only 2:1 for the latter.

It is therefore nonsensical to look at debt-to-income ratios as any measure of actual or potential financial stress in isolation from interest rates.

Figure 5  
Mortgage credit growth and commitments



Source: RBNZ *Housing Approval Survey*, RBNZ *Standard Statistical Return*, RBNZ *New Residential Mortgage Commitments*.

Note: Mortgage approvals are an approximation of actual mortgage origination trends.

16. Investor lending is growing strongly, rising from around 28 to 36 percent of overall mortgage lending over the past eighteen months (figure 6). This suggests that the share of investor loans on bank balance sheets has increased significantly (especially given that more than half of investor loans have been on interest only terms in recent months). Despite tighter LVR restrictions, the investor share of sales has increased in both Auckland and the rest of New Zealand. This suggests that many Auckland investors have been able to increase borrowing capacity by revaluing their existing properties.

→ **[COMMENT]** This highlights the ineffectual nature of LVR restrictions as a means of managing credit growth.

A far more effective mechanism would be to adopt the Australian approach of imposing minimum debt servicing tests and requiring any bank found to be growing its investment loan portfolio by more than 10% per annum to hold increased capital reserves.

17. The role of investors is somewhat stronger in Auckland than in the rest of New Zealand, partly reflecting the increasing unaffordability of Auckland property for owner-occupiers. Auckland property investors are also accounting for a significant share of housing purchases in the nearby regions of Hamilton and Tauranga, which have recently experienced strong house price inflation. This is likely to reflect (i) that rising Auckland prices have increased equity for these investors and (ii) tighter LVR constraints for Auckland investor purchases have increased incentives to purchase outside of Auckland. While these properties are likely to be purchased with less debt and at a higher rental yield than in Auckland, rising Auckland investor purchases appear to be a significant factor behind very rapid growth in house prices in Hamilton and Tauranga.

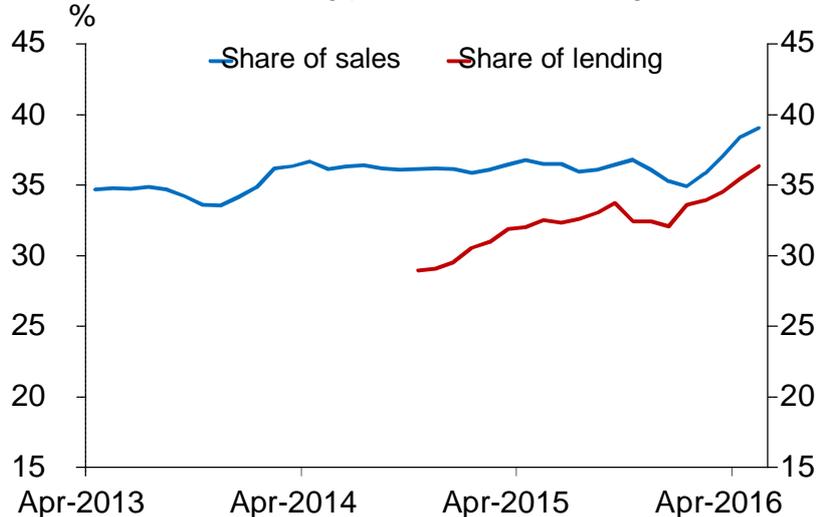
→ **[COMMENT]** An untargeted policy such as the blanket 60% LVR restriction proposed by the RBNZ creates a significant risk of artificial market distortions at a local (regional and suburban) level.

The RBNZ's own research (Bulletin Vol. 79, No. 1, January 2016) has previously highlighted significant divergence and variation in house price behavior between Auckland and other regions (and between the various regions themselves).

A blanket LVR restriction is likely to have a disproportionate and dangerously inconsistent impact on the property markets of different regions, because it fails to consider (and cannot by its very nature effectively consider) marked differences in the supply-demand dynamics of different regions and suburbs.

Figure 6

Investor share of housing purchases and lending



Source: Corelogic NZ, RBNZ *New Residential Mortgage Commitments*.

Note: The definition of investor is somewhat different for purchases and lending. Investor purchases captures all purchases by multiple property owners, while investor lending captures all lending for the purpose of building or purchasing investment property.

18. Rising investor defaults pose significant risks to the financial system, with a growing body of international evidence suggesting that loss rates on investor lending are significantly higher than owner-occupiers during severe housing downturns. There are caveats to applying evidence from other economies to New Zealand, including that mortgage origination standards can vary significantly across countries and time. These problems are mitigated by focussing on the differential between default rates for investors and owner-occupiers identified in international studies. Moreover, the tendency for higher investor default rates is consistent with a range of structural characteristics of investor loans in New Zealand. Direct evidence for New Zealand or Australia is limited as there has not been a severe housing downturn for many decades.<sup>2</sup>

→ **[COMMENT]** This last sentence highlights the different market dynamics and more robust lending practices in Australia and New Zealand, compared to other western countries that experienced substantial housing price falls following the GFC.

Again, an imbalance in lending to investors versus owner-occupiers can be mitigated by adopting the Australian approach of imposing minimum debt servicing tests and requiring any bank found to be growing its investment loan portfolio by more than 10% per annum to hold increased capital reserves. This Australian approach was a direct response to concerns about rapid growth in lending to investors, and an imbalance between investor and owner-occupier lending.

As recently as **2<sup>nd</sup> August 2016**, the **Reserve Bank of Australia** reported that it has become comfortable enough to reduce the cash rate following the effectiveness of these measures:

*“Supervisory measures have strengthened lending standards in the housing market. Separately, a number of lenders are also taking a more cautious attitude to lending in certain segments. The most recent information suggests that dwelling prices have been rising only moderately over the course of this year, with considerable supply of apartments scheduled to come on stream over the next couple of years, particularly in the eastern capital cities. Growth in lending for housing purposes has slowed a little this year. All this suggests that the likelihood of lower interest rates exacerbating risks in the housing market has diminished.”*

- *Statement by Glenn Stevens, Governor: Monetary Policy Decision - Number 2016-18 - Date 2 August 2016.*

Given the **proven effectiveness** of the measures implemented by APRA in achieving the kinds of outcomes in Australia that are sought by the RBNZ in New Zealand, ***it is baffling to see no consideration of the Australian approach in this ‘consultation paper’.***

**This would appear to be a major oversight in the RBNZ analysis.**

19. Detailed studies of the post-GFC experiences of Ireland (Kelly (2014)) and the UK (McCann (2014)) have found significantly higher default rates on loans to investors than owner-occupiers. This differential remains significant even after controlling for other relevant characteristics, such as LVR, loan vintage, and regional unemployment.<sup>3</sup> The Central Bank of Ireland (2014) and the UK Treasury (HMT (2015)) have drawn the same conclusion from these studies. The Basel committee has also recently proposed significantly higher risk weights for loans where repayment is materially dependent on the cash flow generated by the secured property (BIS (2015)).

→ **[COMMENT]** However, there is a risk of over-simplification in this approach as an investor with *multiple* investment properties diversified across different geographical locations would logically represent a *lower* risk of default due to the multiple streams of income, compared to a home owner or investor with a single property who lost their job.

20. Higher investor default rates partly reflect a greater incentive to default strategically than owner occupiers. Strategic defaults are defaults where the borrower has the ability to service the loan, but chooses not to because they are in negative equity. When house prices fall substantially, the size of the negative equity facing investors that own a lot of property (eg 5 houses) is much larger relative to their future labour income than it is for an owner occupier. Even if they face bankruptcy and losing their own home, default allows the investors to avoid servicing underwater mortgages with that future labour income indefinitely. In contrast, empirical evidence suggests owner-occupiers will tend to continue servicing loans if they can, in order to avoid losing their own home (see, for example, Gerardi et al (2015)).

→ **[COMMENT]** These are highly dubious conclusions, as most investors in New Zealand would be more likely to crystallise a loss rather than destroy their credit rating through default, due to the **full recourse** nature of loans in this country.

<sup>2</sup> Fitch Ratings (2012) has reported on empirical work using data from securitised mortgages in Australia, which suggests that investor loans performed similarly to owner occupier loans in normal times but significantly worse in business cycle downturns. Rating agency models of residential mortgage default also tend to treat investor loans as riskier at any given LVR.

<sup>3</sup> The findings of the literature on commercial property defaults is also relevant for investors with a large portfolio of residential property. An et al (2013) and Moodys (2013) find that defaults for commercial property borrowers rise sharply once the loan is in a position of negative equity.

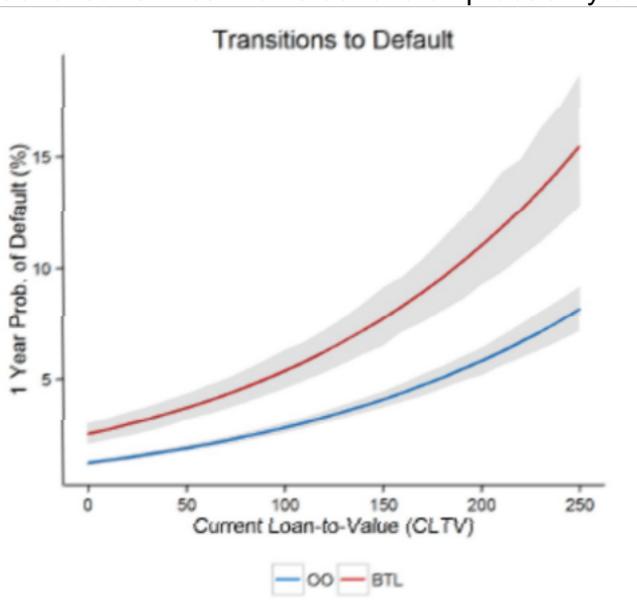
21. The income servicing an investment loan is also likely to be more correlated with the value of the underlying security. A sharp fall in house prices will often occur alongside a rise in vacancy rates in an area (for example, due to a rise in unemployment or outward migration). This will make loan servicing more difficult, particularly for investors that have very little free cash flow. Around 20 percent of investor lending is at very elevated debt-to-income ratios of above 7. Although investors tend to have more free cash flow than owner-occupiers at a given DTI, this figure suggests that many investors could struggle to service loans in the event of a sustained fall in rental income.

→ **[COMMENT]** This is stating the obvious. However, a sustained fall in rental vacancies would only result in a significant over-supply situation and would be localized – for instance in a suburb where substantial over-development had taken place or a transient population experienced very high unemployment resulting in an exodus from the area. Classic examples would be certain mining towns in Australia, however the impact of high vacancies and falling prices in those towns has been isolated rather than causing any significant pressure on the overall housing market or financial system.

A scenario where vacancies rose across the country and prices fell across the board as a result is so remote as to be beyond rational consideration.

22. Figure 7 highlights these points by showing the empirical relationship between LVR and probability of default (PD) for investors and owner-occupiers during the GFC in Ireland (Kelly (2014)). The relationship implies that an investor starting the crisis with an LVR of 60 would see their PD rise by around 55 percent if house prices fall by 50 percent. PD rises substantially more if LVR at origination is instead 75 percent, which is similar to typical levels amongst more leveraged New Zealand investors. The same scenario for house prices would now result in an increase in PD of around 75 percent – close to double the rate of owner-occupiers at the same LVR.

Figure 7  
Impact of current loan-to-value ratio on probability of default in Ireland



Source: Kelly (2014).

Note: Blue: Owner Occupiers. Red: Buy to let (Investors). Unemployment and loan vintage held constant (14 percent and 2006 respectively).

- **[COMMENT]** On what basis is the RBNZ anticipating levels of unemployment similar to Ireland during the GFC, or 50% falls in house prices in NZ?

There is no evidence of any economic trends to suggest that this scenario is at all likely. Basing LVR policy on such an extreme and unlikely scenario suggest that the policy is derived from unreasonable paranoia rather than reasonable probability and sound logic.

Furthermore, the Irish figures are based on the severe economic shock of the GFC in 2008, which bears little resemblance to current or foreseeable economic conditions in New Zealand. There is no reason to expect similar economic conditions in New Zealand, so developing policy based on a GFC-level scenario defies common sense.

23. In addition to placing banks directly under pressure through mortgage losses, rising investor default rates are likely to amplify a downturn in the housing market. As most investors own multiple properties, an investor going into default results on average in a much larger increase in distressed sales than for owner-occupiers. Strategic default incentives are also likely to be stronger for investors with large property portfolios. As discussed above, rising distressed sales could reinforce the downturn in housing market, increasing the risk of a prolonged period of debt overhang that extends the duration of the downturn in economic activity.

- **[COMMENT]** It is unclear what the RBNZ believes would be the trigger for distressed sales at this level. The current and forecast economic climate does not suggest any such triggers.

There seems to be a disconnect in the RBNZ analysis between the desire for improved stability and risk mitigation in the financial system in a reasonably robust economic climate, versus drawing on data from extreme global economic shocks in an attempt to justify a blanket 60% LVR policy.

There are far more sensible, effective and **tested** methods of supporting financial stability, such as those implemented in 2015 by APRA in Australia.

24. There is added risk associated with investor lending in the current market environment. With the potential size of a house price correction likely to be increasing (see above),

- **[COMMENT]** This is a baseless assertion that ignores historical evidence of the magnitude of past housing price booms and corrections in New Zealand and Australia. The assumption of a potentially large price correction appears to be based on a single measure (the ratio of house prices to individual incomes) which is not an adequate method of assessing either housing affordability or housing market risk.

A more appropriate method of assessing relative affordability and risk of significant price correction would be to index house prices against household incomes and interest rates.

There is a very strong argument that if the change in household incomes (incorporating the prevalence of dual income households in recent years) and movements in interest rates (representing the cost of servicing household mortgages) are taken into account, property values are about where they would be expected to be.

Even this would be an oversimplification however, as it ignores the significant variation in property values relative to incomes in different parts of the country.

Assessing risk and affordability based solely on a ratio of average individual incomes to median property prices ignores the practical realities that most properties are purchased by dual income households, and that interest rates are substantially lower today than they were 20 years ago (and that the outlook for interest rates is for rates to remain low for a considerable time).

lower LVRs may be required to maintain bank balance sheet resilience.

→ **[COMMENT]** The NZ experience since 2013 is evidence that lowering LVRs is an ineffective mechanism.

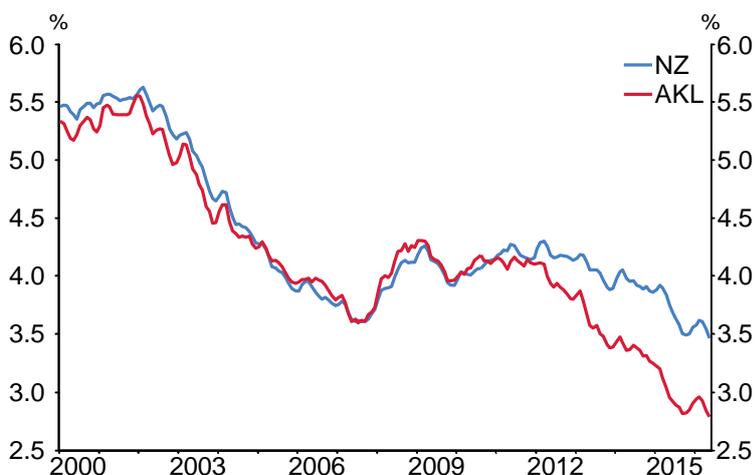
The very definition of “insanity” is to keep doing the same thing expecting a different result. Lowering LVRs further is simply applying a failed mechanism at a more extreme level, and carries more downside risks than potential benefits. A different, tested approach is required instead.

The Australian experience over the past 2 years demonstrate that alternative tested measures are available that have been proven to be effective.

Adopting the APRA measures, including mandated minimum thresholds for loan servicing tests, and requiring banks to manage their investment loan portfolio growth within defined limits (or face higher capital raising requirements), would be a far more appropriate and less risky approach.

Rising property values are also enabling many investors to take on more debt, at the same time as rental yields have declined sharply. Rental yields have declined to historic lows, particularly in Auckland, suggesting that many investors are primarily purchasing for capital gain (figure 8). Falling rental yields imply that investors looking to purchase additional property will have less free cash flow (for a given LVR).

Figure 8  
Imputed rental yields



Source: REINZ, Corelogic NZ, MBIE.

Note: Average rents divided by average house prices. This is likely to understate actual rental yields as investment properties have a lower than average value.

25. Investor lending can also be a strong driver of speculative rises in property markets, as the US and Irish experience indicates. Coates et al (2015) document a strong rise in investor activity in Ireland during the period of rapid house price appreciation up to 2007. Gao et al (2016) investigate the role of investors in the boom and bust in US house prices surrounding the GFC. Disaggregated regions with a greater share of purchases by investors during the boom experienced more pronounced price contractions in the wake of the GFC.

→ **[COMMENT]** Disproportionate rises in investor lending have been effectively addressed and countered in Australia over the past 2 years through implementation of mandated minimum thresholds for loan servicing tests, and requiring banks to manage their investment loan portfolio growth within defined limits (or face higher capital raising requirements).

The rate of growth in lending to investors within Australia has significantly diminished and is now considered to be at acceptable levels, allowing the RBA scope to lower the cash rate without being particularly concerned about the impact on the property market there.

The proven Australian approach would be a far more effective and less risky technique for the RBNZ to adopt. Again, **it is quite disturbing to see no analysis of this proven approach in the RBNZ's 'consultation paper'**.

Q1: Do you have any comments on the problem definition for this policy?
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→ See in-line comments above.

## Macro-prudential policy options

26. The Reserve Bank has a mandate to maintain financial stability in the face of increasing risks associated with the housing market. In addition to ensuring that underlying prudential settings are appropriate, there are a range of macro-prudential tools that could be used to build additional buffers in the financial system, and help dampen the current extremes in the housing credit cycle. There are three broad areas of macro-prudential policy options that are being considered by the Reserve Bank: adjustments to the LVR policy, restrictions on total debt-to-income (DTI) ratios, or macro-prudential capital buffers.

→ **[COMMENT]** Mandated minimum thresholds for loan servicing tests, and requiring banks to manage their investment loan portfolio growth within defined limits (or face higher capital raising requirements), are proven techniques under similar market conditions in Australia, and should therefore form the primary basis for consideration or macro-prudential policy consideration in NZ also. **Failing to consider these proven options would be a serious oversight by the RBNZ.**

Adjustments to LVR policy and restrictions on DTI ratios are unlikely to be effective, and as untested measures they are more likely to risk triggering the very falls in asset prices that the RBNZ is attempting to avoid.

27. The Reserve Bank has had loan-to-value restrictions on bank lending in place since late 2013. This has improved the resilience of bank balance sheets to a housing downturn, and helped to lean against the rise in credit and housing demand for a period. Possible changes that could reinforce the financial stability impact of the LVR policy are discussed in more detail below. Substantial investments have already been made by the banking system to measure high-LVR lending for key classes of residential mortgages. This is expected to limit the timeframes required to implement proposed changes to the policy.

→ **[COMMENT]** Yet LVR policy has proven ineffective in creating any sustained impact on house price growth.

Persisting with and amplifying an approach that has proven ineffective is nonsensical and fiscally irresponsible.

28. The Reserve Bank believes that new restrictions on the availability of high DTI lending could complement the current LVR policy by further mitigating housing credit risk. By improving the ability of households to cope with income or interest rate volatility, lower DTIs would further reduce the likely rise in mortgage defaults during a severe housing downturn. Tighter DTI requirements would also have some impact in lowering credit demand and house price inflation. A potential advantage of a DTI policy is that the borrowing capacity of restricted borrowers will grow in line with incomes. This suggests that a DTI restriction would help mitigate the relaxation of borrowing constraints under an LVR policy during periods of rapid house price inflation (for existing property owners).

→ **[COMMENT]** Alternatively, implementing a minimum interest rate threshold for use in debt servicing tests would achieve the same result (as has been proven in Australia) while being simpler, fairer and likely more cost-effective to administer.

29. The Reserve Bank will continue to investigate the case for a DTI limit in the near future. In coming months, the Reserve Bank plans to begin collecting DTI data from all registered banks, align the definition of investor loans in the collection with the proposed LVR policy, and investigate further measures to standardise the measurement of debt and income across banks. This improved dataset will enable the Reserve Bank to reach a judgement on whether DTI restrictions are desirable and, if so, how they should be designed. The use of DTI restrictions would need to be agreed with the Minister of Finance under the Memorandum of Understanding on macro-prudential policy.

→ **[COMMENT]** Again, WHY is the RBNZ investing time and resources into consideration of unproven methods when data is readily available on proven techniques that have been effectively applied in Australia since 2015? This seems to be an inefficient use of taxpayers' funds.

30. A macro-prudential overlay on bank capital would build additional loss-bearing capacity in line with rising risks around the housing market, which could then be drawn on in a future period of financial stress. The release of macro-prudential capital buffers would lean against the tendency of banks to sharply reduce new lending during downturns. Higher capital could also result in some upward pressure on lending rates at the point that capital requirements increase, although any impact in dampening the housing credit cycle would be much smaller than for DTI or LVR restrictions (which directly constrain borrowing capacity). The Reserve Bank is undertaking a fundamental review of prudential capital requirements for registered banks over the next year, and the possibility of introducing macro-prudential capital buffers will be considered as part of this process.

31. Although the Reserve Bank will continue to investigate the case for using a DTI restriction and/or a capital overlay in the future, the increasing over-valuation in the housing market

→ **[COMMENT]** The statement that there is “over-valuation” in the property market is highly subjective and emotive.

As noted above, this statement appears to be based on a single measure (the ratio of house prices to individual incomes) which is a dubious and overly-simplistic measure of valuation.

It can equally be argued that the housing market is not over-valued if house prices are indexed over time against changes in household incomes and changes in interest rates.

Even this more detailed analysis would be an oversimplification however, as it ignores the significant variation in property values relative to incomes in different parts of the country. It would be a nonsense to argue that house prices in many New Zealand regional towns are “over-valued”, where median prices declined following the GFC and have not risen appreciably over the past 7 years.

Assessing “valuation”, risk and affordability based solely on a ratio of average individual incomes to median property prices ignores the practical realities that most properties are purchased by dual income households, and that interest rates are substantially lower today than they were 20 years ago (and that the outlook for interest rates is for rates to remain low for a considerable time).

and rapid increases in investor debt suggests it is desirable to change the LVR policy in the interim. The Reserve Bank is proposing to:

- a. Apply a single speed limit for all investor lending in New Zealand, permitting no more than 5 percent of lending at an LVR greater than 60.
- b. Apply a single speed limit for all owner-occupier lending, permitting no more than 10 percent of commitments with an LVR of greater than 80.

→ **[COMMENT]** As previously noted, LVR speed limits have already proven ineffective as a means of constraining investor debt growth.

Far more effective alternative measures have been in place in Australia since 2015, and should form the basis of RBNZ policy in this regard.

32. Compared to the current policy, there is a large tightening in credit availability for investor lending, and a smaller tightening for owner-occupiers in the rest of New Zealand. There are two key policy judgements underlying these proposed changes:

- a. Firstly, the case for differentiating LVR policy by region has weakened. The Reserve Bank believes that the risk of a sharp fall in house prices is now increasing across most of the country. There has also been a significant increase in investor activity outside Auckland, particularly in nearby regions, which reinforces the case for a nationwide speed limit applying to investors.

→ **[COMMENT]** This statement attempts to treat the housing market in New Zealand as homogenous (it is not), and ignores the very high risk that a nationwide blanket LVR limit (a 'sledgehammer approach') is likely to have inconsistent and potentially quite damaging impacts on weaker markets in many parts of the country.

- b. Secondly, it is appropriate to have a significantly lower maximum LVR for investor loans than for owner-occupiers. Banks have always been less willing to lend at very high LVRs to investors reflecting that, as discussed above, investors are substantially riskier at any given LVR. Furthermore, from a wider efficiency perspective, the costs imposed on an owner-occupier that cannot purchase for a period due to the LVR policy are likely to be greater than for an investor (see below).

→ **[COMMENT]** The Australian experience over the past 2 years (again, somehow *ignored* by the RBNZ in this 'consultation paper') demonstrates that banks can be effectively encouraged to self-regulate and cut back on growth in investor lending without the use of government-imposed LVR restrictions.

33. Auckland investors are currently restricted to a maximum of LVR of 70 percent, compared to a maximum LVR of 80 percent for Auckland owner-occupiers. The Reserve Bank is proposing a lower limit of 60 percent for all investor loans. This reflects that, since 2015, risks on investor lending have increased further, reflecting the increasingly overvalued housing market, a growing exposure of the banking system to investors, and falling rental yields. The empirical evidence discussed above also suggests that probability of default remains elevated for investor loans at an LVR of above 60 percent. In addition to potentially increasing bank loan losses, increases in stressed sales among these investors are likely to have significant feedback effects on the housing market.

→ **[COMMENT]** What this really reflects is that LVR restrictions have proven and ineffective tool, and that alternative measures (such as those applied effectively in Australia over the past 2 years) should be used instead.

35. The proposed LVR limit will also have some impact on DTI ratios for property investors, resulting in improved resilience to a reduction in income or increase in interest rates. In the extreme case where an investor services their debt entirely using rental income, a cap on LVR directly constrains DTI at a given rental yield. For example, a decline in the portfolio LVR for an investor from 70 to 60 percent would see DTI fall from around 12 to 10 at a 6 percent rental yield. In reality, the transmission of the LVR limit to DTIs is more complex, as (i) many high-LVR investors will also use labour income to service the loan and (ii) any further falls in rental yields would relax the implicit limit on DTIs under the LVR policy.

→ **[COMMENT]** Such measures are unnecessary if simpler mandatory minimum interest rate thresholds are imposed for the banks to apply in servicing tests, as has been effectively implemented in Australia since 2015.

36. LVR restrictions are becoming increasingly common internationally. Most advanced economies that use LVRs apply a maximum LVR for owner-occupiers that is equal to or higher than 80 percent, as under the Reserve Bank's LVR policy. Several countries impose tighter LVR limits on investor lending, with Singapore, Hong Kong and Israel having caps in the 50-60 percent range. In addition, the Bank of England is currently consulting on an interest coverage ratio limit of 125 percent for investor loans, and the US and Canada both have limits on the ratio of debt servicing payments to pre-tax income of around 40-50 percent applying to conventional insured mortgage lending. Based on plausible assumptions for rental yields and origination mortgage rates, these servicing policies may effectively constrain LVR to below 50 percent for many investors.

→ **[COMMENT]** It is extremely odd (and worrying) to see that the RBNZ has overlooked the policies currently being applied quite effectively in Australia (which probably has the most similar property market dynamics to New Zealand of any developed country) that DO NOT involve government-imposed LVR restrictions.

The RBNZ really needs to explain its highly selective use of data here, and why it is ignoring the most relevant case study – being the Australian experience.

Q2: Do you have any comments on the analysis of possible macro-prudential options or the rationale for the proposed LVR restrictions?

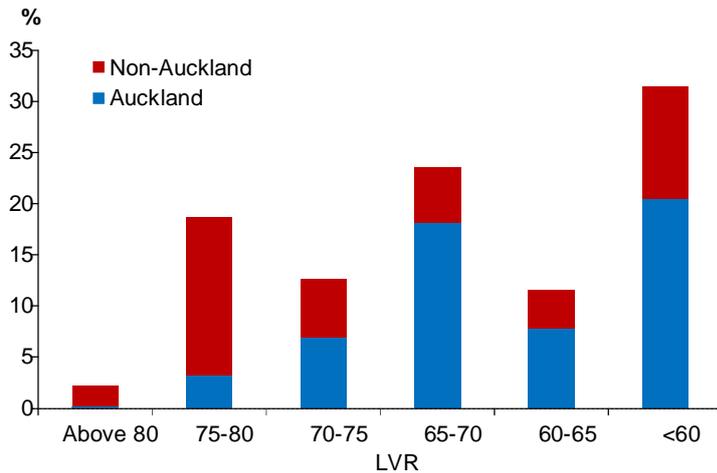
→ **See above in-line comments.**

→ The omission of any analysis at all of the Australian approach to macro-prudential options in a very similar environment is of **grave concern**. Without such analysis, the discussion of macro-prudential options and proposed LVR restrictions is woefully inadequate.

## Effectiveness in mitigating housing risks

37. Based on the current LVR distribution, the proposed nationwide investor speed limit would potentially affect around 70 percent of investor lending (figure 9). The potentially restricted lending would be split roughly evenly between Auckland investors (primarily at an LVR of 60-70 percent) and non-Auckland investors (primarily at an LVR of 70-80 percent).

Figure 9  
Distribution of investor lending by LVR  
(November 2015-current)



Source: RBNZ *Residential New Mortgage Commitments Survey*.

38. Following the introduction of the current Auckland investor limit, there has been a material decline in average LVRs without any significant reduction in Auckland investor purchases. This suggests that many affected investors have been able to continue transacting at a lower LVR by:

- a. leveraging owner-occupied or non-Auckland investment properties using the combined collateral exemption
- b. leveraging property that was previously held outside of the collateral pool
- c. shifting to purchasing lower value property, eg an apartment rather than a standalone house
- d. more actively revaluing existing properties, especially in an environment of rapid house price increases

Alternatively, different investors with more equity may have replaced those constrained by the LVR rules. The Reserve Bank estimates that, of the total amount of 70-80 percent LVR lending that might have otherwise occurred in the absence of the policy, around 50-66 percent has continued to transact either by making use of the combined collateral exemption or shifting to an LVR of just below 70. While this development is likely to have reduced the longevity of the impact on Auckland house prices, the policy continues to have a sustained impact on the resilience of the financial system by lowering LVRs for investor loans.

39. The proposed changes to the LVR policy involve a substantial increase in required deposit for restricted borrowers, especially outside of Auckland. In addition to bringing about a larger reduction in LVR on new investor lending, the proposed policy is likely to result in a greater proportion of affected investors choosing not to (or being unable to) transact. Borrowers now have reduced debt capacity (particularly for non-Auckland rental properties), and may have used more of their capacity (as described above) to make purchases in the last 12 months. Whereas around 20 percent of Auckland investor lending currently has an LVR exceeding 70, the proportion of investor lending with an LVR of above 60 would be expected to fall to around 10-15 percent. The lending at above 60 would mainly reflect investors using the combined collateral exemption to get higher leverage on owner occupied properties that are in a collateral pool alongside investor properties.

40. The proposed LVR limit is expected to result in a significant reduction in average LVR and improved servicing ability for investors seeking new lending (table 1). Based partly on the experience with the current Auckland investor limit, the average LVR for an investor in the top half of the LVR distribution would be expected to fall from around 73 percent to just below 60 percent. This shift in LVR would also generate a significant improvement in servicing ability. For example, the interest coverage ratio based on rental income would increase from around 73 percent to just above 97 percent under plausible assumptions for interest and principal and rental yields.

→ **[COMMENT]** The simple imposition of a minimum mandated interest rate threshold for the purpose of banks' loan servicing test on new lending (as implemented in Australia in 2015) would likely have a similar benefit without the complexity and without the risk of a substantial shock to the property market that is created by the proposed LVR restrictions.

Table 1  
Distribution of investor lending under proposed policy

	May 2015	Current	Proposed LVR changes
% of loans with LVR > 70	50	33	
% of loans with LVR > 60	73	68	10-15*
Mean above median (MAM) LVR	77	73	58*
Rental interest coverage ratio at MAM LVR	73	77	97*

Note: MAM refers to the average value in the top half of the distribution. \* indicates a projection under proposed new limits. Rental interest coverage ratio is the ratio of rental income to total mortgage payment, and assumes a rental yield of 6 percent, expenses equal to 25 percent of rental income, and interest and principal repayments of 8 percent of the outstanding balance.

41. The proposed policy is expected to materially lower downturn loss rates over time, and reduce the scope for rising defaults to exacerbate falling house prices. Based on the Irish evidence, the improvement in investor LVRs shown in table 1 might reduce the loss rate on new investor lending by up to 35 percent, during a scenario where house prices fall by 50 percent and unemployment rises sharply. This resilience impact would strengthen over time as lending flows originated under the new policy become a progressively larger share of the stock of investor loans. Turnover rates of investor lending suggest that this effect would have mostly worked through the system within 3 years.

→ **[COMMENT]** On the contrary, sudden implementation of a radical reduction in LVRs on new lending could trigger significant falls in asset values due to the removal of a large section of demand from the market, creating the very pressure on the financial system that the RBNZ is seeking to avoid.

42. Bloor and McDonald (2013) set out a framework for analysing the impact of LVR restrictions on the housing credit cycle. The approach first estimates the reduction in number of purchases by restricted borrowers, and then uses an empirical model to relate this to housing prices, sales and credit. Applying the same general framework to the proposed LVR amendments yields an estimated 5-15 percent reduction in house sales, and a 2-5 percent reduction in both house prices and mortgage credit. These effects would be somewhat larger outside of Auckland, reflecting that there are currently tighter restrictions on Auckland investor lending in place.

→ **[COMMENT]** This last sentence is particularly concerning, as a more marked reduction in house prices outside Auckland is likely to have a significant impact on consumer, business and investor confidence in the local economies of those areas – potentially creating a negative feedback loop that precipitates price falls and financial/economic stress rather than reducing risk.

The objective of any macro-prudential measures should be to create stability and manageable growth in lending and asset values – not to trigger a deflation in values which then *endangers* broader economic growth.

43. Although the horizon for these effects is approximately one year, this could vary depending on the underlying rate of house price inflation. Faster house price growth tends to reduce the longevity of the impact of LVRs on borrowing capacity and house prices, particularly when limits are applied to investors. This reflects that investor restrictions are likely to apply mainly to existing owners of property, many of whom may be actively seeking to use any extra borrowing capacity to purchase more property.

44. All else equal, the reduction in financial distress amongst investors in the downturn scenario, along with the small reduction in peak house prices described above, is expected to reduce the size of the peak to trough decline in house prices. This makes it more likely that the housing market will remain orderly, encouraging lenders to remain active, and giving more homeowners confidence about their financial position. The risk of a “spiral” where a growing excess supply of properties on the market push prices down further and thus push more borrowers into financial distress (causing more properties to go on the market) is reduced.

→ **[COMMENT]** The artificial distortion created by “temporary” LVR restrictions actually **undermines** orderly market behavior, by creating pent-up demand that is ultimately released back into the market when the LVR restrictions are relaxed (potentially resulting in another ‘boom’ – but this time one created by the RBNZ’s own policies).

This risk appears to have been ignored by the RBNZ in its dogged persistence with LVR restrictions. The very real danger in pursuing the proposed policies is that the RBNZ finds itself less and less able to relax the restrictions over time, precisely because of the risk that pent-up demand from investors and home buyers with lower deposit funds / equity builds like a pressure-cooker, where any reduction in LVRs then causes a run on the property market and rapid inflation in housing prices.

Rather than exacerbating this risk through the implementation of even tighter LVR restrictions, the RBNZ should be considering the implementation of permanent mandated minimum interest rate thresholds for the purposes of banks' loan servicing tests, as has been implemented in Australia since 2015 (and which has simply and effectively constrained borrowers' exposure to risks of future interest rate increases while limiting the rate of growth in lending to investors).

Furthermore, setting limits on the rate at which banks are permitted to grow their investor loan books is more likely to deliver an effective reduction in risks to the financial system (as has been the case since the implementation of such policies in Australia in 2015), without creating artificial and dangerously temporary distortions within the property market itself.

45. The proposed changes are also expected to potentially restrict an additional 5 percent of non-Auckland owner-occupier lending (2 percent of overall lending). This reflects that these borrowers have been shifted to a bucket which (i) has a lower speed limit of 10 and (ii) does not contain non-Auckland investors (who undertake very little lending at an LVR of above 80). This change is expected to have a relatively minor impact on the housing market.

→ **[COMMENT]** As the proposal is an untested approach, the assertion that the change will have a “relatively minor” impact on the housing market is highly suspect.

However, the reduced proportion of high-LVR mortgage loans outside of Auckland will increase the resilience of bank balance sheets to the growing risk of a sharp correction in house prices.

→ **[COMMENT]** The simple imposition of a minimum mandated interest rate threshold for the purpose of banks' loan servicing test on new lending, and requiring banks to manage their investment loan portfolio growth within defined limits or face higher capital raising requirements (as implemented in Australia in 2015 and now proven to be effective) would achieve this objective without the avoidable risk of a substantial shock to the property market that is created by the proposed LVR restrictions.

Q3: Do you have any comments on the expected impact of the policy in increasing financial system resilience or dampening house price and credit growth?

→ **See in-line comments above.**

## Possible unintended consequences

46. There is a risk that restrictions on high-LVR lending result in an increase in high-LVR lending by institutions that are not subject to the policy. The Reserve Bank believes this would result in a decrease in financial system stability and efficiency, as non-bank lenders would likely have more costly and less comprehensive processes for mortgage origination. In addition, growing lending outside of the banking sector would undermine the benefits of the policy in limiting the rise in house prices and household indebtedness.

→ **[COMMENT]** The RBNZ should look to the Australian example over the past 2 years where the risk of rapid credit growth among non-bank lenders is somewhat mitigated by the Australian Securities and Investments Commission (ASIC) which is responsible for the regulation of non-bank lenders, working in cooperation with APRA and encouraging non-bank lenders to implement similar minimum interest rate threshold servicing tests as the banks are required to apply.

47. To date, there has been very little evidence of growing high-LVR lending outside the banking system. The incentives for non-banks to enter the market are limited by the temporary nature of the LVR policy, and the fact that banks have a speed limit of high-LVR loans available. In addition, non-bank lenders are a very small component of the financial system, with the non-bank deposit taking sector in particular having declined substantially since the Global Financial Crisis. However, the risk of a material increase in non-bank high-LVR lending is likely to increase under the proposed restrictions, which could potentially constrain a large part of the market for bank investor loans. The Reserve Bank will continue to monitor for any sign that an increased share of properties are being financed outside of the banking system.

→ **[COMMENT]** This risk would be better mitigated if policies such as those operating in Australia (minimum interest rate thresholds for servicing tests, etc.) were applied across all lenders in NZ, rather than the proposed LVR restrictions which are actually creating this risk.

48. LVR restrictions can also have wider efficiency costs if they result in some prospective buyers needing to delay house purchases. As the proposed LVR policy involves a much larger tightening in borrowing capacity for investor loans, any effect on house purchases is likely to be concentrated among investors. The relatively small tightening in borrowing capacity for owner-occupiers outside of Auckland could also have efficiency costs. First-home buyers that meet the relevant criteria can undertake high-LVR lending via the Government's Welcome Home Loan scheme, which is exempt from the LVR policy.

→ **[COMMENT]** The problem with "delayed" purchases under the operation of the proposed policy is that the RBNZ has repeatedly stated that the LVR restrictions are "temporary". It will become progressively more and more difficult for the RBNZ to reduce or remove the LVR restrictions over time as more and more potential entrants to the housing market emerge. Any material reduction in the LVR restrictions is likely to trigger an influx of buyers and a surge in demand for housing and in house prices as a result.

Rather than exacerbating this risk through the implementation of even tighter LVR restrictions, the RBNZ should be considering the implementation of permanent mandated minimum interest rate thresholds for the purposes of banks' loan servicing tests, as implemented in Australia in 2015.

Such tests are based on longer-term average interest rates and act to both:

1. ensure that new borrowers are in a position to weather future interest rate rises without undue financial stress; and
2. reduce the amount of lending that might otherwise have been available at current historically low interest rates.

This in turn acts to slow the rate of growth in both investment lending and (as a consequence) house prices, but because it is a permanent measure, it does not create the risk of a future surge in house prices from artificially pent-up demand.

49. For an individual investor that is constrained in purchasing by the LVR policy, delayed purchase results in a lower exposure to the housing market than they would otherwise have chosen.

→ **[COMMENT]** This can be equally and more simply achieved through the implementation of permanent mandated minimum interest rate thresholds for the purposes of banks' loan servicing tests.

This may represent an efficiency cost (although some of the demand to hold investor property is possibly related to it being taxed relatively lightly compared to other assets like bank deposits, so reduced investor demand from LVR policy may not be inherently inefficient). However, any efficiency cost is likely to be much smaller than if an owner-occupier needs to delay purchasing, which could entail delays in entering the housing market or being able to shift cities for a new job.

50. There is some risk that the proposed changes to the policy could put upward pressure on rents. The Reserve Bank believes that the effect on rental inflation will be limited. Over time it is possible there will be some reduction in the supply of rental property, in line with a relative shift from investor to owner occupier purchases. This transition will also result in a reduction in demand to occupy rental properties. There could be some upward pressure on rents if this transition results in fewer people occupying each dwelling, but any effect is not expected to be large.

→ **[COMMENT]** Basic economic rules of supply and demand suggest that the proposed policy will place upward pressure on rents, disadvantaging tenants in established areas over time.

The practical reality is that most tenants want to live somewhere convenient – close to where they work, where the kids go to school, and near the amenities and activities they enjoy (cafes, shops, sports etc.), rather than in new housing estates which tend to be located in fringe areas.

The proposed LVR policies provide a disincentive for investors to buy established houses and to make those properties available for rent, creating a lack of "rental supply" in established areas. Over time, the effect of this policy will be fewer houses available for rent where renters actually want to live - hitting family homes in established suburbs the hardest.

Low availability (low supply) and strong demand for rental accommodation in established areas is likely to result in higher rents as tenants compete for increasingly scarce rental housing stock in established areas.

It is not reasonable to expect most tenants to become home buyers in the short term, due to the LVRs and deposit saving requirements imposed.

51. The LVR policy already includes an exemption for mortgage lending to fund the construction of new dwellings, which is designed to mitigate any negative effect of the policy on housing supply. This exemption will continue to apply under the proposed policy settings, and is available for both investors and owner occupiers.

→ **[COMMENT]** There is a fundamental flaw in the argument that lower LVRs on new construction will incentivise investors to create new supply rather than investing in established housing:

The higher LVR allowance on new housing only applies while the house is in fact "new". Upon completion and once occupied, a house ceases to be "new" under the policy, and therefore any subsequent purchase of the house by the majority of investors would have to be at the lower proposed 60% LVR level.

This stands to make re-selling more difficult if fewer investors are interested in buying established properties, which actually provides a disincentive for building or buying brand new homes in the first place.

Rather than encouraging investment in new housing developments, this awkward paradox within the policy (that new housing becomes established housing and loses its LVR concessions on resale) risks turning investors off new housing - undermining the construction industry, employment, and economic growth.

52. There are likely to be some costs incurred by the banking system to enact the necessary system changes in order to meet the new speed limits. These are not expected to be significant relative to the previous LVR changes, and mainly reflect work required to slightly modify the definition of an Auckland non-property investor (see below).

53. Table 2 summarises the discussion in the previous two sections through the lens of a cost-benefit analysis. The proposed policy is expected to have significant benefits by mitigating the increase in stressed investor sales and bank losses during a severe housing downturn, and reducing the probability of a sharp house price correction by dampening current rapid increases in house price inflation and mortgage lending. There are costs associated with the policy, including systems changes for banks (expected to be smaller than for previous changes), and any costs arising from delayed housing purchases for some buyers (expected to mainly affect investors). The Reserve Bank will continue to monitor for signs of any significant unintended consequences from the policy, including a growing share of high-LVR lending financed by institutions that are not subject to the policy.

Table 2

Summary of the principal costs and benefits of the proposed LVR policy

Benefits	Comment	Costs	Comment
Reduce bank downturn loss rates over time.	There is evidence that investors have higher default rates than owner-occupiers.	Increased risk that non-regulated institutions engage in a material amount of high-LVR lending.	Little sign of any growth in non-bank lending in response to current LVR policy.
Dampen house price inflation by approx 2-5 percent in first year of implementation.	Longevity of this impact could decline if underlying house price inflation remains elevated.	Some buyers may need to delay housing purchases. Any effect concentrated among investors.	Efficiency costs for investors delaying purchases lower than for owner-occupiers.
Reduce amplification of a housing downturn from distressed investor sales.	Share of investor loans on bank balance sheets is increasing.	Changes required to bank systems and processes.	Expected to be smaller than for previous LVR changes.
Simplify existing LVR policy, removing regional boundary effects.	Higher risks around Auckland housing market, but rest of NZ is expanding fast.	Unintended impacts on rents or supply of housing.	Effect on rents expected to be small, and construction lending is exempt.

→ **[COMMENT]** This summary omits any comparative cost-benefit analysis of alternative and more proven policies, such as those implemented in Australia.

Q4: Do you have any comments on possible unintended consequences from the policy?

→ **See in-line comments above.**

→ In addition, there is a substantial risk to broader economic confidence and economic growth that appears to have been glossed over by the RBNZ proposal.

If the proposal results in a fall in property values, as has been suggested by the analysis, then this is highly likely to impact consumer and business confidence.

In addition, few property transactions combined with less lending activity will impact growth adversely in multiple industries, including the financial sector, real estate industry, construction industry, various trades, and related downstream suppliers.

There is a very real risk of damage to economic growth as a result of the impact of a lower LVR regime than present.

Because the policy will have an uneven impact on different property sub-markets around the country, this impact is likely to be most severe in areas where the economy is already weak or in the early stages of recovery.

The current proposal pays little attention to the practical reality that much business investment, construction activity, and consumer spending is based on the ability to leverage against real property assets.

Limiting the ability of consumers and business owners to leverage against the equity in their property assets is more likely to undermine consumer spending, and therefore business investment, construction activity, and economic growth – contrary to the objectives of the RBNZ.

***It is not clear in this ‘consultation paper’ that the RBNZ has given the implications for consumer/business confidence and economic growth sufficient consideration in arriving at the proposed LVR restrictions.***

At a time when inflation is at historic lows and economic growth is below desirable levels, it would seem extraordinarily dangerous and economically irresponsible to introduce policies that undermine consumer and business confidence. However, the proposed LVR policies risk doing exactly that.

Before rushing ahead with the proposed LVR policies, the RBNZ must take the time to give due consideration to alternative macro-prudential options. A more prudent course of action would be to seriously consider implementing similar policies to those now in place within Australia that have proven to be effective without significantly damaging consumer or business confidence and economic growth.

Q5: Is the construction exemption still suitable with the proposed policy changes?

→ Anything that encourages the creation of new supply *in areas that are not already oversupplied*, is a positive step in a market where demand generally outstrips supply.

However, it should be noted that the construction exemption is merely a *lesser disincentive*, as opposed to being an actual *incentive* for the creation of new supply where it is needed.

Attempting to stifle demand from investors for established housing in order to create a quick-fix for ‘financial stability’ or housing affordability is an approach that is fundamentally flawed.

The real issue is not demand from investors (or any other group), but a persistent **lack of supply** in established areas where people actually want to live.

Until state and local government take the hard steps necessary to address the **supply** side of the equation (instead of artificially attempting to suppress demand), no long-term fix for housing affordability will be found.

This requires the political will to create a genuine national housing policy, and to reform the cumbersome structures and bureaucratic red-tape that characterise town planning - including the multiple inefficient layers of policy, planning and regulation between state and local government, as well as the substantial taxes and levies that raise the cost of development – including GST and developer contribution levies.

Only by increasing the housing supply *in areas where the population actually wants to live*, will any long term solution of housing affordability be achieved.

Q6: For regulated entities, please quantify costs in relation to implementing this proposed policy change.

→ N/A

## Specific policy details

54. The proposed policy change would be enacted through changes to the Banking Supervision Handbook document “Framework for Restrictions on High-LVR Mortgage Lending” (BS19) and changes to bank conditions of registration. This consultation document has been released alongside a proposed redraft of BS19. The proposed conditions of registration are in the appendix to the proposed BS19.

## Calculation of speed limit

55. The proposed policy changes simplify the existing three speed limits on high-LVR mortgage lending into two categories, namely:
- € Non-exempt property investment loans at LVRs of greater than 60 percent divided by all non-exempt property investment loans.
  - € Non-exempt non-property investment loans at LVRs of greater than 80 percent divided by all non-exempt non-property investment loans.
56. The two types of residential mortgage (property investment and non-property investment) in the proposed BS19 are defined in the same way as for capital purposes (in BS2A and BS2B). We also retain the definitions of Auckland and non-Auckland lending for each of these two categories, but these are not used in the proposed policy (we would like banks to continue to measure them and provide statistical reporting splitting flows by these two regions).
57. The definitions described above are largely the same as in the existing BS19, but there is one category of borrowers that need to be treated differently. The existing definitions within BS19 classify an Auckland owner occupier with a loan also secured on rental properties outside Auckland as an Auckland owner occupier. This reflects the relatively strict treatment of Auckland lending under the current LVR policy. It would be quite problematic for the proposed policy if these customers were able to borrow 80 percent while most non-Auckland investors were only able to borrow 60 percent. So our new definitions shift this small category of borrowers into the property investor category.
58. Since 2015, banks have developed the systems required to report to the Reserve Bank on loans based on the location and nature of the property securing the loan (including reporting to the RBNZ on whether non-Auckland loans are for property investment or not, even though the LVR limits currently in force do not make a distinction). This should make it relatively easy to switch to administering the new speed limits.
59. The proposed harmonisation of the definition of property investor loans across BS2 and BS19 also means that the reporting of the flows of property investment loans (including their LVRs and DTIs) will provide information about the evolving credit risk of the stock of owner occupied and investor mortgages.
60. We recognise that this change (as well as the new speed limits), if implemented, is likely to require some system work by banks. Because we consider that this change is necessary to the functioning of the policy we suggest that planning to allow for the possibility of this system change could be worth commencing soon. We are asking banks for feedback on the complexity involved in the change.

Q7: How large are the systems changes required to reclassify property investors that have an Auckland owner-occupied property?

→ **The RBNZ should be asking the banks for their views on the changes that would be necessary if an alternative policy approach, such as that implemented by APRA in Australian in 2105, were to be adopted.**

## Calibration of speed limits

61. The introduction of LVR restrictions via speed limits recognises that in some cases it is appropriate for banks to provide loans at higher LVRs. The speed limits allowing banks to provide a small proportion of high-LVR loans, in order to fund purchases for more creditworthy borrowers and/or take into account the impact of special borrower circumstances.
62. As in the 2015 changes, the Reserve Bank sees less need to allow a flow of lending at higher LVRs to property investors. We consider that a 5 percent speed limit for investors (as with the current Auckland investor limit), in combination with the available exemptions, will allow for special cases or errors.
63. For the non-property investment limit, we are proposing to allow 10 percent of lending to be at LVRs above 80 percent. This allows a more material amount of high LVR lending to owner occupiers. We have been pleased generally with how banks have appeared to use this limit since 2013, with a high proportion of lending under the speed limit going to first home buyers and relatively low DTI customers. Relative to the current restrictions, the proposed 10 percent limit results in a tightening for non-Auckland non-property investors, particularly as they are now separated from the non-Auckland investor lending.

Q8: Is the proposed speed limit for property investment loans suitable to achieve desired objectives?

Q9: Do you have any comments on the calibration of the owner-occupier speed limits?

→ **These questions assume that further LVR restrictions are an appropriate measure in the first place, which is highly questionable.**

**As noted above, alternative measures such as those proven to work in Australia would be a far less risky and more effective approach.**

64. Treatment of customers with multiple collateral types is an important complexity for the LVR regime. In 2015, RBNZ considered approaches to limit the incentives of investors to split lending across multiple banks in order to increase borrowing capacity. The RBNZ initially considered approaches that involved splitting loans (with multiple different types of collateral) across multiple speed limit categories, but finally settled on an approach where Auckland investors were placed entirely in one speed limit category with an exemption available for combined collateral.
65. We propose that the combined collateral exemption will be redrafted so that it reflects the new LVR limits. We have generalised the drafting of the exemption so that it should not need to be redrafted if there are any further changes to the LVR policy in the future. In the proposed policy, it will effectively allow investor borrowers who have their own home as part of the collateral package to borrow 80 percent against their own home and 60 percent against investment property. This greatly reduces the incentive to 'split-bank' in order to borrow more, which would have been an inefficiency of the proposed policy if this exemption was not included.
66. There are a number of other exemptions available within BS19, including the ones added since 2013 covering the construction of new dwellings and major non-routine repairs of dwellings. We propose retaining these, and are interested in any feedback about their continued relevance and effectiveness.

Q10: Do you have any comments on the effectiveness and appropriateness of the combined collateral exemption, or any of the other exemptions within BS19?

→ **Again, a more effective (and simpler approach to manage) would be the setting of mandatory minimum interest rate thresholds for loan servicing tests, along with limits on the rate of investment lending growth permitted by lenders, as was implemented in Australia in 2015.**

### Measurement periods and transition arrangements

67. The Reserve Bank proposes that the policy changes take effect from 1 September 2016. This should allow banks to alter systems and processes to cope with the alterations to the limits discussed above.

68. There is some risk that there could be a “rush to buy” prior to these changes being formally enacted. As with the 2015 changes, our expectation is that banks will observe the spirit of the proposed restrictions, and will act to curtail lending at LVRs of above 60 percent to property investors in advance of 1 September.

→ **[COMMENT]** This recommendation, and the actual behaviour evidenced by the banks as a result, is **deeply concerning**.

For a ‘consultation paper’, there has been a distinct lack of public consultation prior to what is, in effect, an early implementation of the ‘proposed’ policies.

This gives the impression of either a ‘panicked’ reaction to political pressure, or an unreasonable desire to implement the proposed policies *regardless* of public consultation... unfortunately calling into question the RBNZ’s political independence and commitment to the principles of consultation and democratic process.

This is further compounded by the *seemingly selective analysis* in this paper – most notably the complete lack of any consideration within this paper of the entirely relevant Australian experience over the past 2 years – including the various macro-prudential measures implemented in that country that have proven to be effective in addressing the very issues that the RBNZ is concerned about *without the need for government imposed LVR restrictions*.

69. Currently, compliance with the LVR policy is measured over a three-month rolling window for banks with monthly lending of consistently more than \$100m, and over a six-month rolling window for banks with monthly lending of less than \$100m. Our proposal is that these speed limit windows will remain the same (we do not propose that the larger banks get an initial 6 month window with these restrictions, as in 2013 and 2015).

70. We propose that the existing LVR restriction apply to lending committed until 31 August 2016, with compliance assessed based on the measurement period ending on this date. The new speed limits will take effect from 1 September, but compliance with these new limits will not be assessed until the end of the first measurement period – either 30 November 2016 for larger banks, or 28 February 2017 for smaller banks.

71. For the avoidance of doubt, these changes do not affect the transitional arrangements for BS2A/B, which were established in 2015 to give banks until 1 November 2016 to classify their entire stocks of residential mortgages as either property investment or non-property investment, with different risk weights applying to the property investment lending. Those transitional arrangements will have ended by the time the BS19 changes are made, so we also propose to delete the text describing the transitional arrangements from BS2A/B (see Annex 1 for the proposed changes to BS2A/BS2B).

Q11: Will the proposed implementation timeframes and transition arrangements create any significant difficulty?

→ See above in-line comments.

### **Residential mortgage lending that is not in the residential mortgage asset class**

72. The boundary of BS19 is lending that is classified in BS2A and BS2B as a residential mortgage loan. This definition excludes some lending that is secured by residential property but is classified in another (often corporate) asset class. This lending tends to take two forms. The first is lending that is predominantly for business purposes, but may be partially secured by residential mortgage collateral. The second is loans to large scale property investors, who banks manage on an individual basis as business customers.
73. While large scale property investors do not have particularly high LVRs, the Reserve Bank understands that some will have LVRs around 70 percent. It would be inequitable if large investors in this asset class were still able to borrow at that sort of LVR while smaller residential mortgage investors were restricted by formal LVR restrictions. However, there would be significant difficulties in redrafting the LVR restrictions in order to bring these investors into scope.
74. BS19 states that banks should not seek to avoid the LVR restrictions by (7(2)f) “providing lending primarily reliant on residential property as security, as opposed to lending that is also reliant on other sources of funds such as business cash flows, that is treated as outside the residential mortgage asset class (for example in the corporate asset class) and where the lending would be high LVR if a residential mortgage loan.”
75. In the context of the proposed new LVR restrictions, the clause quoted above means that banks should not typically lend at LVRs greater than 60 percent to customers that fit the description in 7(2)f. For example, a customer in the corporate asset class with 8 rental properties, who would have difficulty servicing their loan without the rental income from the properties, and is seeking to buy another property (which would make their overall LVR 65 percent), should not obtain finance. In contrast, a customer who has used their house (and one rental property) as collateral to fund a café operation, but is expected to be able to service their mortgage entirely using cashflow from the café and other non-rental income, should not be affected by this clause (normal bank credit criteria would still of course apply).
76. To date, we haven’t required reporting on lending that meets the 7(2)f criteria, but we think the new (lower) investor LVRs make the case for more regular reporting stronger. We will be asking banks to track the lending they are doing which meets 7(2)f (both low LVR and high LVR) and report to us on the characteristics of that lending.

Q12: Will there be any significant difficulty associated with reporting lending to large scale residential property investors as defined in clause 7(2)f of BS19?

→ N/A

## Data requirements

77. The proposed changes will necessitate some minor adjustments to the new commitment survey to monitor compliance. As noted above, we expect to liaise with banks separately on the necessary changes.

## Timeline and next steps

78. The consultation period for these proposals will run until August 10. Shortly after that, the Reserve Bank expects to release a summary of submissions and final policy, with the policy taking effect from 1 September 2016.

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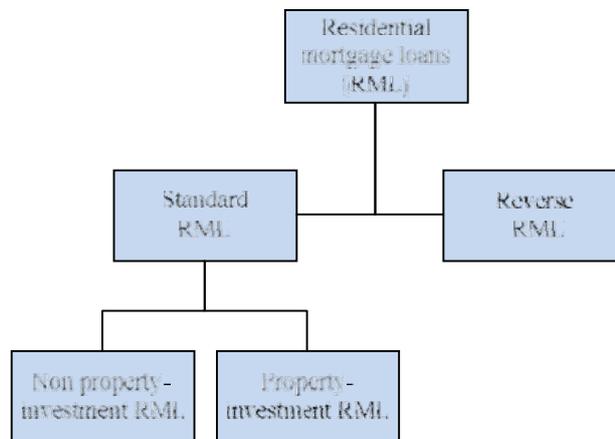
## Annex 1: Proposed text to be removed from BS2

“residential mortgage loan” means a loan secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor, or a related party of the mortgagor, or a tenant of the mortgagor. A loan may not be classified as a residential mortgage loan if the mortgaged property is predominantly used for farming or commercial activities. Without limitation, a property will be considered to be predominantly used for farming or commercial activity if:

- (i) the mortgaged property would be marketed as a farm or a commercial property; or
- (ii) the principal or interest payments are predominantly serviced from the income generated by the use of the property for farming or commercial activity, except where that income is rental income and the property is used for a residential purpose.

For the purpose of this section, predominantly means more than 50 percent.

~~From 1 July 2016, a A residential mortgage loan must be classified as either a standard residential mortgage loan or a reverse residential mortgage loan. Prior to July 1 2016, all residential mortgage loans are classified as standard residential mortgage loans.~~ The diagram below depicts the sub-classification of residential mortgage loans.



A standard residential mortgage loan originated ~~on or after 1 November 2015, and from 1 November 2016 a standard residential mortgage loan originated before 1 November 2015,~~ must be further sub-classified into either a non property-investment residential mortgage loan or a property-investment residential mortgage loan.

~~All residential mortgage loans originated before 1 November 2015 are classified as non property investment residential mortgage loans until 31 October 2016.~~ A non property-investment residential mortgage loan is eligible for retail treatment irrespective of exposure size.