RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Response to submissions received on the consultation on framework for restrictions on high-LVR residential mortgage lending

August 2013

Ref #5375117

1.0 Introduction

1. In June 2013, the Reserve Bank of New Zealand (Reserve Bank) released the consultation document: *Framework for restrictions on high-LVR residential mortgage lending*, accompanying draft Banking Supervision Handbook document "*Framework for restrictions on high-LVR residential mortgage lending (BS19*)", and draft changes to the Banking Supervision Handbook document "*Statement of Principles (BS1)*". [1] These papers set out technical details of the framework under which any restrictions on high-LVR lending would operate, should it be decided to introduce them. Consultation closed on 3 July 2013.

2. The Reserve Bank received twenty submissions, including ten from banks, three from individuals, and the remainder from a range of institutions and associations. This paper provides a summary of the substantive issues raised by respondents, and the Reserve Bank's response. It should be read in conjunction with the revised Banking Supervision Handbook document "*Framework for restrictions on high-LVR residential mortgage lending (BS19*)".

3. The Reserve Bank is making some changes to the way that LVR restrictions would be implemented but has not changed the essence of its proposed approach. Should a decision be taken to restrict high-LVR lending, this would be done by setting a limit on the proportion of high-LVR lending that banks are able to do, rather than restricting it altogether. This 'speed limit' approach would enable many high-LVR borrowers to continue to obtain funds from banks.

4. Submissions noted a variety of technical challenges that banks could face in meeting LVR restrictions, should they be introduced. These reflected both one-off issues, in the form of a substantial pipeline of high-LVR pre-approvals, and changes that would be required to forecast and monitor flows of high-LVR lending. Banks requested some form of tolerance, both over an introductory transition period, and on an on-going basis.

5. We sought additional information from banks regarding their stocks of high-LVR pre approvals, and likely drawdowns. The data confirmed that some banks could potentially breach an LVR restriction, even if they were to cease all new approvals of high-LVR lending as soon as it came into force. Accordingly, we have modified the framework to allow for a one-off transition period, during which banks could smooth their high-LVR lending over a longer, rolling, six-month period (rather than the normal three-month period).

6. A number of smaller banks also submitted on the difficulties that they might face in complying with an LVR restriction in the form of a 'speed limit', given the irregular and/or infrequent flows of their high-LVR lending. The Reserve Bank sees a valid case for applying LVR restrictions to smaller banks on a six-month rolling period basis; unlike the transition arrangements to cater for pre-approvals, this would apply for the entire duration of any LVR restriction that might be introduced. The cut off point for small lenders would be banks with total residential mortgage lending below $100 million per month, measured on a three-month moving average basis.

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[1] These documents are available at http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/.

7. As originally proposed, in calculating their compliance with a specific speed limit, banks would be permitted to exempt a limited number of categories of high-LVR loans. These include Housing New Zealand mortgage-insured loans, bridging loans, refinancing loans and high-LVR loans to borrowers who are moving home but not increasing their loan amount.

8. The revised framework also clarifies the intended treatment of branches of overseas banks operating in New Zealand. LVR restrictions would apply only to the New Zealand balance sheet of the registered bank and not to the offshore branches of the international bank. However, the bank branch registered in New Zealand would be required to notify the Reserve Bank of any intention to assist other parts of the international bank to write high-LVR mortgages.

9. A number of submitters raised the risk of avoidance of LVR restrictions. An extra section dealing with anti-avoidance has been added to BS19. This sets out a non-exhaustive list of methods that banks might use to actively avoid the impact of LVR restrictions. While the Reserve Bank recognises that banks and their customers may use such arrangements for legitimate business purposes, its expectation is that banks will not exploit or promote them to avoid LVR restrictions. Should concerns arise, the Reserve Bank would consider the size, timing and marketing of such measures, in determining whether the bank was entering into such arrangements to avoid LVR restrictions. The Reserve Bank would consider taking action against any bank found to be attempting to avoid the effect of LVR restrictions, which could include varying the standard LVR conditions, imposing an additional condition relating to LVRs, or take some other form as appropriate.

2.0 Submissions

2.1 Proposed LVR framework

10. The consultation paper set out the proposed prudential framework for LVR restrictions. LVR restrictions would be enacted by imposing standard conditions of registration on all registered banks, including branches of overseas banks.

Summary of submissions

11. The use of conditions of registration to implement the LVR restriction framework was questioned, given the significant consequences of breaching a Condition of Registration. It was argued that difficulties in forecasting high-LVR lending flows would make vigorous policing of an LVR condition of registration unreasonable.

12. Banks requested clarity over what would be considered a material breach, and what sanctions might apply. Some suggested sanctions could include restrictions on further high-LVR lending or capital deductions.

13. One submitter questioned the use of conditions of registration to address wider financial system stability versus individual banks' stability.

Reserve Bank's response

14. The Reserve Bank is aware that banks and other financial sector participants would face strong incentives to avoid LVR restrictions. The use of the conditions of registrations framework to enact LVR restrictions reflects the need to reduce such avoidance risks, and also the seriousness with which the Reserve Bank views the restrictions.

15. Non-compliance with any in-force LVR restrictions would amount to a breach of the conditions of registration. The Reserve Bank has a range of sanctions available to address such breaches; any applicable sanction would be determined on a case by case basis, in line with the Bank's normal supervisory and enforcement practices.

16. Sections 1A(1)(b) and 68 of the Reserve Bank of New Zealand Act 1989 (the 'Act') establish the purpose for the implementation of macro-prudential regulations on registered banks in New Zealand, which is to promote the maintenance of a sound and efficient financial system. The powers to implement restrictions on loan-to-value ratios for residential lending are referred to under section 78(1)(fa) of the Act.

2.2 Nature of the LVR restrictions

17. The consultation paper sought views on the way that the first of the proposed standard conditions restricts high-LVR lending. The basic form of the condition was that no more than X percent of applicable new residential mortgage lending over each specified period can have an LVR greater than or equal to Y percent. The proposal specified the use of a three month rolling period – that is, the restriction would apply to each three month period ending on an end-calendar month date. Restrictions may be applied at more than one LVR threshold level, in which case they would be expressed cumulatively. The restrictions were intended to apply to all

banks registered in New Zealand, on a whole-bank basis. This means that their scope would extend to all residential mortgage lending that is booked out of the registered bank in any location, including head office or a branch in any other jurisdiction.

Summary of submissions

Q1: Do you think this is the most practicable way of framing restrictions on high-LVR residential mortgage lending?

18. Banks were divided on whether the high-LVR restriction should take the form of a portfolio cap or a restriction on the proportion of new high-LVR lending as proposed.

19. 'Tiered' speed limits:
    - Two banks supported the proposed approach of specifying multiple 'speed limits' (for example – no more than 15 percent of new lending to be at LVRs over 80 percent with no more than 5 percent of new lending at LVRs over 90 percent).
    - One submitter said that a multi-tiered limit would greatly increase complexity, and be more costly in terms of monitoring and systems changes.

Reserve Bank's response

20. The Reserve Bank confirms that LVR 'speed limits' would be applied to new high-LVR residential mortgage lending rather than being implemented as a portfolio cap. In addition to the gaming concerns raised by submitters to the macro-prudential policy consultation, the application of speed limits to new high-LVR lending reflects a key objective of the LVR tool, which is to mitigate extremes in credit and house price cycles.[2]

21. The broad sense of submissions is that tiered speed limits are feasible, although there would be some set-up costs, and that a single speed limit would be preferred. In general, the Reserve Bank favours simplicity in applying regulatory requirements, and in some circumstances this would weigh against the use of tiered limits. A decision as to whether speed limits would be set in a single rather than a tiered fashion would rest on a number of factors, including the relative level of uncertainty around potential calibrations, efficiency considerations and any potential risk of an acceleration of very high-LVR lending relative to high-LVR lending.

Q2: Do you think the way that the condition of registration is drafted would achieve the intended effect as described above?

22. Thresholds for LVR restrictions:
    - A submitter questioned whether a restriction on lending with an LVR above 80 percent would start at 80.00 percent or 80.01 percent.
    - Another asked what the relevance of a 60 percent speed limit would be; another submitter argued against setting a speed limit so low.

[2] Refer "Response to submissions received for the consultation on macro-prudential policy instruments and framework for New Zealand", May 2013, available at http://www.rbnz.govt.nz/financial_stability/macro-prudential_policy/.

23. Two banks suggested that bespoke conditions might be necessary for some banks, which face idiosyncratic difficulties in forecasting and meeting speed limits. Banks also requested a transition period (refer section 3).

Reserve Bank's response

24. For the purposes of LVR restrictions, the bottom of the LVR band would be excluded and the top of the band included e.g., a restriction on lending at LVRs above 80 per cent would not affect lending with an LVR of exactly 80.00 per cent or less. BS19 has been amended to reflect this.

25. Should LVR restrictions be introduced, the starting LVR band would be decided at that time. The Reserve Bank typically defines high-LVR lending as lending with an LVR above 80 percent, and it is not generally expected that *broad-based* LVR restrictions would start below that threshold. However, it is possible that a lower LVR threshold could be employed in the case of *targeted* LVR restrictions, should risks be significantly concentrated in particular segments of the housing market and these segments have lower than average LVRs. The use of targeted restrictions is not contemplated at this point.

26. The Reserve Bank does not favour bespoke conditions of registrations in this instance. Responding to banks' submissions to the macro-prudential policy consultation, a key consideration in framing LVR restrictions has been to ensure that they would apply as even-handedly as possible across the banking system.

Q3: Would your bank be able to comply with LVR restrictions through the use of its own internal buffers? What difficulties might this present?

27. Buffers:
    - Banks' responses suggest that they would typically run a material buffer below the speed limit. One bank noted that the size would depend on the form of the LVR restriction, and the technological and process changes required to support the imposition of an LVR restriction.
    - It was suggested that an internal buffer would not be required if the restrictions were not implemented via conditions of registration.

28. Tolerance:
    - Banks noted that they would need a number of new processes and it would be challenging to forecast and stop/start the flow of high-LVR lending.
    - One bank requested some tolerance around the maximum percentage levels for the LVR restrictions; another bank said it would cease all high-LVR lending initially.
    - Banks requested that limits be phased in, or applied in a graduated fashion that would allow banks to deal with their existing stock of pre-approvals (see section 3 for further details).

Reserve Bank's response

29. We note the likely use of internal buffers by the banks to ensure that they are able to stay within the terms of any restriction of high-LVR lending; the size of these buffers might diminish as banks gain more experience in managing their flows of high-LVR lending. Some banks already have internal limits on the flow and/or stock of high-LVR lending as part of their standard risk management framework, and would be able to leverage this framework in meeting any new regulatory requirements.

30. We believe there is a valid case for a one-off transition measure to handle existing pre-approvals (see section 3). However, we do not favour tolerance in the application of LVR restrictions, either in the form of some sort of “tolerance buffer” or treating “LVR speeding” breaches differently from other types of breaches:
    - It would be difficult to land on a tolerance that applied evenly across banks and would complicate the calibration of any LVR restriction as well as reducing its effectiveness.
    - All breaches of conditions of registration are regarded as serious matters by the Reserve Bank, and would be treated as such.

Q4: Would you prefer the policy to allow more flexibility in the time period that high-LVR restrictions would be based on each time they are applied, or is it useful to have the certainty in advance?

31. Submitters overwhelmingly favoured certainty around the time period over which LVR restrictions would be measured. One bank said it would like ex-ante certainty as to the volume of high-LVR lending it could undertake in a month, i.e. that the Reserve Bank specifies the volume of high-LVR lending the banks could undertake.

Reserve Bank’s response

32. Reflecting the weight of submissions, the applicable rolling time periods will be specified as part of the base LVR framework, rather than being determined each time an LVR restriction is applied.

33. Speed limits are intended to allow banks the discretion to continue some high-LVR lending to creditworthy borrowers; we believe that the majority of banks would want to retain the flexibility to make their own decisions about the volume of lending within the constraints of the high-LVR speed limit.

Q5: Do you foresee any problems in operating under a three month rolling timeframe?

34. Different views were expressed on the appropriate rolling time period, with some banks submitting that three months was sufficient and others asking for six to twelve months. It was suggested that six months would better reflect the time required for a purchaser to find a property.

35. Submitters argued that it would be difficult for smaller lenders, whose residential mortgage lending could be irregular and infrequent in nature, to meet a speed limit, even if applied over a three month rolling time period. This could lead to unintentional speeding.

36. Various suggestions were made, including the use of *de minimis* thresholds, buffers to allow non-material breaches, or a modified time period e.g. rolling six months for banks under a specified new lending threshold.

37. A number of banks noted that pre-approvals can be valid for up to six months and that this would complicate meeting a speed limit. Pre-approvals could be made conditional on the bank being within its speed limit, but this would reduce the certainty for borrowers around availability of finance. Another submitter suggested that such a condition might present consumer law issues.

Reserve Bank's response

38. We agree that smaller lenders, whose lending is irregular or infrequent in nature, could find it difficult to operate within an LVR speed limit that is measured over a three-month rolling period. For such lenders, a six-month rolling time period would apply. BS19 has been changed to reflect this. The cut off point for small lenders would be banks with total residential mortgage lending below $100 million per month, measured on a three-month moving average basis.

39. We note that the practice of issuing unconditional pre-approvals for a six-month term could make it difficult for banks to manage flows of high-LVR lending within a speed limit measured over a three-month period. Should LVR restrictions be introduced, there would be a transition period in recognition of this (refer section 3). We expect that industry practice would evolve in this area, for example, by reducing the terms and/or volumes of high-LVR pre-approvals, and/or tightening conditionality around high-LVR lending pre-approvals. These would be matters for each bank to consider as part of its risk management strategy.

Q6: Do you see any problems with this proposed scope of high-LVR restrictions for overseas branches?

40. Two international banks submitted that it could be practically difficult for them to comply with an LVR restriction on the activity of offshore branches within their group, as they would need to put in place formal reporting systems to track such lending worldwide, which would be difficult to implement and maintain. The size of such lending would likely be very small.

41. It was also questioned as to whether such restrictions would apply to those branches which do not originate residential mortgage lending.

Reserve Bank's response

42. The conditions of registration, as currently drafted in BS19, apply the restriction to banks on a whole bank basis. This means that the restriction extends to mortgage lending secured on residential property in New Zealand that is booked out of the registered bank in any location, including its head office or a branch in any jurisdiction. The aim of this approach is to reduce opportunities for disintermediation, whereby credit growth could be displaced from the regulated New Zealand banking system towards offshore lenders.

43. However, we agree that this approach could create significant compliance costs for banks to set up systems to monitor offshore flows of immaterial amounts of residential mortgage lending into New Zealand. The efficiency costs in this case could potentially outweigh the benefits of any reduced disintermediation risk. The Reserve Bank has therefore decided that any restriction would apply to the New Zealand balance sheet only (i.e. loans originated by the registered bank in New Zealand), rather than on a whole bank basis. This would mean that the restriction would not apply to the offshore branches of these banks, and so they would not need to put in place processes to ensure their global banking did not breach the restriction.

44. The Reserve Bank recognises that this could still create opportunities for disintermediation through those offshore branches. However, it would be difficult for offshore branches or the parent to originate material amounts of mortgage lending in New Zealand, without the assistance of the New Zealand branch or subsidiary in

managing the credit risk assessment and marketing process. Therefore, the Reserve Bank also intends to require the New Zealand registered bank to notify the Bank of any intention to assist any other part of its banking group in engaging in New Zealand residential mortgage lending. The Reserve Bank would closely monitor such activity. BS19 has been modified accordingly.

45. The Reserve Bank may, in exceptional cases, exclude a registered bank from the general imposition of the standard conditions. This would for instance be the case if the bank was prevented from originating mortgage loans by its existing conditions of registration.

2.3 Definitions

46. There are currently two sets of definitions of key LVR terms that are used for capital purposes: those set out in BS2A which are used by standardised banks and those set out in BS2B which are used by 'internal models' (IRB) banks.[3],[4] The Bank is working towards a single definition as far as possible, which could also be used for the purposes of LVR restrictions. In the interim, it is proposed that, should LVR restrictions be introduced, banks would measure LVRs according to their current capital approach and comply with the LVR restriction on this basis. For banks on the standardised capital approach and for overseas branches, this means using the specific definitions set out in BS2A, but for IRB banks it relies on banks' existing modelling approaches, within the parameters of BS2B.

Summary of submissions

Q7: Would this approach to defining the key terms allow you to meet LVR restrictions on your housing lending in accordance with BS19 if they were to be applied in the short term (that is, before further work on standardising definitions across BS2A, BS2B and the reporting template had been completed)?

47. Banks generally favoured use of consistent definitions across the market, and across capital and macro-prudential requirements. Submitters emphasised the importance of tight and consistent definitions across market participants to reduce the potential for avoidance, for reasons of fairness and to make it easier for the market to compare performance.

48. Residential mortgage loan:
    - Submitters requested clarity as to whether residential mortgage lending should be defined according to the Basel asset class definition, or according to the type and purpose of the mortgage. One submitter interpreted BS19 as meaning that LVR restrictions would apply to any new lending where residential property forms any part of the security bucket taken to secure that lending, irrespective of the purpose of the lending. Another suggested that allocation of loans to the residential mortgage asset class or the SME retail asset class is not consistently applied across banks, which could see

[3] Refer paragraphs 17 – 25 of consultation paper.
[4] Internal models banks are those banks that are accredited by the Reserve Bank to use their own models in the calculation of their minimum capital requirements in accordance with the requirements laid out in BS2B of the Banking Supervision Handbook. This is also known as the Internal Ratings-Based (IRB) approach.

inconsistency in application of LVR speed limits and an incentive to categorise such loans as SME retail.

- o Several banks requested that residential mortgage lending for business purposes be excluded from LVR restrictions.
- o Submitters argued that tight and consistent definition of a residential mortgage loan was particularly important to reduce the risk of avoidance through lending that is not captured in the definition.

49. Loan value:
    - o It was argued that unsecured lending should not be included because banks hold capital against this separately. One IRB bank expressed a preference for retaining the current BS2B definition (which does not include unsecured lending). It argued that:
        - Including unsecured lending would require underlying modelling changes, as it would imply they were secured and therefore have lower capital outcomes.
        - Under the Credit Contracts and Consumer Finance Act (2003), treating unsecured lending as secured for Reserve Bank prudential purposes could require disclosure to customers of the extent to which the lending is secured at the point of the commitment. Further consultation and a longer timeframe for implementation would be needed.
        - If all lending secured under the terms of an all obligations mortgage were in scope, this would constrain the use of unsecured lending.
    - o A submitter suggested that loan values be measured by exposure at default, as it reports the total credit risk obligation.

50. New commitment:
    - o A submitter argued that tying this definition to the point where banks instruct a solicitor may encourage banks to think differently about when they choose to instruct.
    - o One submitter was unclear as to whether a top-up would result in the entire loan balance being counted against the speed limit, or just the top-up amount.

51. Valuation rules:
    - o A submitter suggested that, in the absence of rules around when a valuation could be made, banks would be likely to adopt processes that update valuations at all possible credit events.
    - o Another submitter suggested that the frequency of valuations and differences in valuations should be reviewed, to ensure consistency and that the system cannot be 'gamed'.

52. Complex arrangements:
    - o Guidance was requested on LVR calculations in cases such as cross collateralisation (treatment of multiple parties, entities, loans and securities).
    - o It was suggested that certain conditions may need to be imposed on the use of additional security to prevent it from being used to undermine the LVR restrictions. For example, it might be prudent to require that the additional security is not discharged earlier than the residential property mortgage that also secures the loan. This condition would seek to prevent lenders from taking, for example, security over a deposit account, making advances under the loan, and then immediately discharging that security.
    - o A non-bank submitter argued that the LVR should be calculated as the ratio of the loan to the value of the property it is being used to purchase, and should

not include any additional securities, on the grounds that this would prevent investors and second home buyers using existing security to borrow more and push up prices.

Reserve Bank's response

53. Residential mortgage loan:
- o The LVR restrictions are intended to address excessive growth in residential mortgage lending. As noted by submitters, extending them to capture other types of lending activity that might also involve the use of residential properties could see a much broader impact which goes beyond the intent of the tool. An example supplied by one submitter is that of lending to a small business or a farmer (where the prime security is something other than residential property- machinery, inventory or livestock perhaps) but residential property is taken as collateral security. In practical terms, as long as this was not classified as residential mortgage lending in the sense of the Basel asset class, it would not be subject to any LVR restriction. BS19 has been amended to make this clear.
- o It is expected that the Reserve Bank review of bank capital adequacy requirements for residential mortgage loans (Housing Review Stage II) will provide some guidance on asset class boundary issues, such as lifestyle blocks, dual-use properties (e.g. residential and commercial), and multi-dwelling properties.[5] As noted in the consultation document, any implications for the LVR restriction framework will be reviewed at that time.
- o The Reserve Bank is aware of the potential for avoidance via reclassification of lending to other asset classes. We reiterate that banks would be expected to respect the spirit of the regulation, as well as the letter. Should an LVR restriction be introduced, we would expect banks to continue to categorise loans according to their current processes. The Reserve Bank will be monitoring for any signs of deliberate reclassification in order to avoid restrictions, and would not be inclined to treat such behaviour leniently.

54. Loan value:
- o From a macro-prudential point of view, the Reserve Bank has concerns regarding the suggestion that unsecured lending should not be included in the LVR calculation:
  - The LVR definition aims to capture the debt of the borrower relative to the security available to the bank. This reflects that high-LVR lending is riskier both for the borrower – who has little or no equity to draw on should s/he face repayment difficulties – and for the bank which faces a greater risk of loan losses should the borrower default. As such, the total amount of debt that is secured on the property is relevant and the definition of loan value would ideally capture this.
  - Moreover, excluding credit card limits and personal loans from the loan amount could undermine the effectiveness of any LVR restriction that might be introduced, as it means that a borrower could take out a personal loan or use his or her credit card to increase the deposit on a house, thus circumventing the LVR restriction.
- o Whether or not the definition used for LVR restriction purposes will be able to be harmonised with the definition used for capital purposes will depend on the outcome of Housing Review Stage II.

[5] More information about the Reserve Bank's Housing Review is available at: http://www.rbnz.govt.nz/regulation_and_supervision/banks/policy/5190364.html

- The Reserve Bank expects banks to measure loans using their existing measurement practices until further notice. Those banks that measure and report loan values on an exposure at default basis should continue to do so. However, the Reserve Bank will be considering the approach to residential loan values as part of Housing Review Stage II and will consult on any proposed changes as part of this process.

55. New commitment:
    - The Reserve Bank acknowledges that some banks might choose to adjust their practices around when they choose to send documentation to the loan applicant's solicitor in order to influence the timing of its lending flows (and potentially the pattern of its LVR flows recorded for a particular month). Since the documentation will inevitably need to be sent to the solicitor if the loan is to proceed (i.e. the commitment will need to be created sooner or later), the Reserve Bank regards this as a matter for the bank that should not affect the efficacy of LVR restrictions over time.
    - In the case of lending for top-up purposes which results in total customer borrowings exceeding the applicable LVR threshold, only the amount of the top up would count towards the speed limit.
    - We note also that the BS19 definition of new mortgage lending that is subject to LVR restrictions has been amended to clearly capture the case of additional lending subsequent to first origination of the residential property mortgage.

56. Valuation rules:
    - The Reserve Bank will be considering rules around valuations as part of the Housing Review Stage II. In the interim, banks are expected to follow their existing valuation practices. Should an LVR restriction be introduced, we would expect banks to continue to categorise loans and update valuations in line with their current practices until further notice. The Reserve Bank would investigate any evidence of a change in practices aimed at avoiding LVR restrictions and would not be inclined to treat such behaviour leniently.

57. Complex arrangements (multiple securities and multiple borrowers):
    - These issues will be considered as part of the Housing Review Stage II. In the interim, LVRs should be calculated according to the bank's current practice for LVR Disclosure Statement reporting.
    - The Reserve Bank would not expect banks to use additional security on a temporary basis to circumvent any LVR restrictions that might be imposed. Such behaviour is now addressed under a new "anti-avoidance" section of BS19. Refer also response to Question 12.

2.4 Exemptions

58. The consultation paper proposed a limited number of exemptions, with the intent of reducing the efficiency costs of imposing LVR restrictions without unduly undermining their effectiveness. The proposed exemptions relate to lending under the Housing New Zealand mortgage insurance scheme (Welcome Home Loans and Kainga Whenua), refinancing, LVR 'portability' and bridging loans. The portability and bridging loan exemptions cover the case of a single person who is the borrower, owner and occupier of the old and new properties. The refinancing exemption assumes that the same person (natural or legal) is the borrower before or after the refinancing.

Summary of submissions

Q8: Do you think the drafting of these exemptions in BS19 achieves what it is intended to?

59. A submitter suggested that a three month restriction on the bridging loan exemption would not be sufficient in some cases, particularly for new buildings which would require at least nine months.

60. A submitter noted that the bridging finance and portability exemptions, as drafted, would not be able to be used together, as the post-bridging leg of the loan would have to be treated as non-exempt under section 9(1)(d)(iii) of the draft BS19.

61. A submitter noted that banks could potentially be reporting on different loan value definitions depending on whether they are standardised or IRB banks, and questioned which definition would form the basis for the portability assessment.

62. A submitter noted that the refinancing exemption, as drafted, would not apply to cases where the LVR has increased solely due to a fall in house prices.

63. A submitter noted that Kainga Whenua loans are not residential mortgage loans strictly speaking, as the bank does not secure the loan against a residential mortgage.

64. Some submitters argued that exemptions should be applied more broadly, to capture a number of other cases, and to widen the definition of eligible borrowers:
    - Additional exemptions were requested for leaky homes, homes subject to insurance claims, construction loans, customers in financial stress, foreign currency borrowers, lenders' mortgage insurance (LMI), debt consolidation;
    - It was argued that the portability and bridging loan exemptions should also be available to non-owner-occupiers. There was a question over whether the refinancing exemption is restricted to owner-occupiers only.

Reserve Bank's response

65. BS19 has been amended to allow twelve months in the case of bridging loans, and six months in the case of portability. The point around the interaction between bridging finance and portability exemptions is well made. This was not intentional and BS19 has been amended to correct this.

66. The portability assessment will be based on the residential mortgage loan amount. BS19 has been amended to include guidelines on verification of third-party information.

67. We have amended the rules around portability to remove the LVR test. The LVR test added complexity and would increase the compliance costs for banks using this exemption. It could also frustrate the ability of some borrowers to take advantage of the exemption where transaction costs in the sale process reduce the deposit available for a new house purchase. The condition that the loan size does not increase still effectively prevents borrowers from using the portability exemption to trade up to a more valuable property.

68. The refinancing exemption is intended to apply to all borrowers; BS19 has been amended to reflect this. The key motivation for the portability and bridging loan exemptions is to reduce efficiency costs due to borrowers being trapped in their home, which could have flow-on effects to labour mobility. This is not an issue for investors, who by definition do not live in the property; therefore these exemptions will remain applicable to owner-occupiers only.

69. Kainga Whenua loans would fall outside the proposed BS19 definition of 'residential mortgage loan'. This is because such loans are not "fully or partially secured" by a mortgage over residential property. For the avoidance of doubt, the BS19 guidelines have been amended to exclude loans made under Housing New Zealand's Kainga Whenua programme. The reference to a Kainga Whenua exemption has therefore been removed as it is superfluous.

70. The intent of exemptions is to mitigate efficiency costs without unduly undermining the effectiveness of LVR restrictions. The suggested additional exemptions risk complicating the framework significantly, while providing limited efficiency benefits. They also raise the risk of policy leakages. For these reasons, the Reserve Bank will not be extending the range of exemptions. We note however that banks would remain able to engage in such high-LVR lending within the capacity under their speed limits.

Q9: Should more complex borrower cases be covered by such exemptions, and do you see practical ways of capturing them?

71. Submitters raised a number of instances where the owner is not a single, natural person e.g., family trusts and companies. In these cases, there may not be an effective change of ownership but the conditions as drafted would not exempt them.

72. Similarly, ownership of the 'old' property might be jointly held, with the new transaction only involving one of the previous parties, perhaps due to bereavement or matrimonial separation. It was argued that these cases should also qualify as 'same ownership'. In the case of separation, the question was asked as to which party would qualify for the exemption.

Reserve Bank's response

73. The Reserve Bank agrees that the draft wording around 'same ownership' is too narrow as originally proposed. The exemptions wording in BS19 has been amended to handle the case where there are multiple owners, or the form of legal ownership changes but the substance of the ownership does not change.

Q10: What practical challenges do you foresee in operating these exemptions?

74. Submitters raised a number of practical difficulties in recording and verifying exemptions. It was noted that where the customer was switching between banks, information sharing could be required between the banks in order to utilise the exemptions. Clarity was requested around the extent to which banks could rely on information supplied by the customer, and the level of verification required of such information.

Reserve Bank's response

75. BS19 has been amended to include guidelines on verification of third-party information.

76. The Reserve Bank is aware that banks do not currently have systems in place to handle exemptions, and that building such processes will entail a range of costs. The exemptions have therefore been expressed in a permissive rather than a prescriptive way: banks have the option of choosing not to offer exemptions should they feel that the likely costs would outweigh the benefits.

2.5 Lower-ranking mortgages

77. The consultation paper sought views on the proposed conditions regarding lower ranking mortgages. Condition 2 aims to ensure that registered banks prevent – to the extent possible – other lenders providing lower-ranked residential mortgage lending that would see the total LVR exceed any in-force LVR restriction. It requires a bank to include in the standard terms and conditions for residential loan contracts that the borrower may not grant any additional security over the property without the bank's agreement. The condition also requires that the bank must not give such agreement unless the total of all amounts secured against the property, as a percentage of the property value, would remain at or below the lowest point of the restricted LVR ranges. Condition 3 aims to prevent banks from making a new loan secured by a second or lower ranking mortgage over residential property if there is an existing mortgage over the property held by another lender, unless the total LVR of all mortgage loans secured on the property, including the new loan, would remain at or below the lowest LVR threshold specified in the restriction.

Summary of submissions

Q11: Do you expect to face any legal or practical challenges in complying with these restrictions on lower-ranking residential mortgage lending?

78. On condition (2), submitters noted that while banks include requirements for the borrower to seek the bank's agreement before taking out a lower ranking mortgage, such conditions are not always specified in the loan documents. In some cases they will be specified in the mortgage document. It was also noted that the mortgagor/borrower could elect to ignore conditions and the bank would have no way of knowing this.

79. Submitters noted that the move to online registration of titles means that a lower ranking mortgagee no longer needs to request the certificate of title from the senior mortgagee. The former could therefore register the lower ranking mortgage without the latter's knowledge.

80. A submitter noted that the mortgagee usually only discloses the priority amount, not the amount of lending so it might not be possible to know whether the LVR calculated on the combined loan amount would exceed any LVR restriction.

Reserve Bank's response

81. The Reserve Bank recognises that, should the mortgagor fail to respect the terms of the mortgage and/or loan document, it is possible that the senior mortgagee would not be consulted (or otherwise informed of) a lower ranking mortgage. The Bank

notes that there are, however, legal incentives for consent to be obtained. The consequences for the mortgagee could include the calling of the loan by the first mortgagee; if the second mortgagee were aware of the breach by the mortgagor, it could be liable under torts law. These would reduce the likelihood of such behaviour.

82. To the extent possible, the bank should prevent other lenders providing lower-ranked mortgage lending that would see the total LVR exceed any in-force LVR restriction. The wording of BS19 has been amended to reflect this, and to provide for the varying practices in this area, so that the condition may be specified in the loan and/or mortgage documents as appropriate.

83. BS19 has been amended to provide guidelines on verification of third-party loan amounts.

Q12: Do you think this is the most effective way of limiting the extent to which LVR restrictions could be undermined?

84. A number of submissions noted that LVR restrictions raised issues around the potential for unsecured lending to undermine LVR restrictions:
    - o One submitter argued that although the existence of an all-obligations mortgage might restrict unsecured lending occurring at the same bank, banks would be likely to make top-up loans (via unsecured loans or credit cards) that could be utilised for paying deposits at other banks. The introduction of guidelines on how to verify the use of monies borrowed was also suggested.
    - o Submitters also raised the possibility of second or third tier lenders providing borrowers with top-up loans at higher interest rates to finance their deposits.
    - o A submitter questioned whether unsecured lending by a subsidiary finance company, where a caveat was used to record a mortgage interest, would be captured when calculating the total LVR exposure for the group. It was also asked whether such lending could be deemed to be against the “spirit” of the regulation if it were interpreted as an artificial construct designed to circumvent the regulation.

85. The risk of disintermediation away from the banking system was raised, whereby lenders that are not subject to the LVR restrictions (e.g., non-bank deposit takers such as finance companies) could increase their activity in high-LVR mortgage lending. One submitter argued that reducing information asymmetry issues would be critical for the effective implementation of LVR restrictions. It was suggested that asymmetry could be reduced by measures such as comprehensive credit reporting of debtor obligations, a bureau or clearing house for LVR transfers, or common identification of LVRs held on securities.

Reserve Bank’s response

86. Submissions included examples of a number of ways in which banks could contrive to avoid LVR restrictions. Widespread engagement in such behaviour would seriously undermine the effectiveness of LVR restrictions, and with this in mind, BS19 has been amended to include an anti-avoidance section.

87. BS19 now sets out a non-exhaustive list of methods that a bank could use to actively avoid the impact of LVR restrictions:
    - o entering into a series of separate contracts to create what in substance is a single residential mortgage loan transaction;

- o entering into an arrangement with a borrower to channel funding to the borrower through a third party, to enable the borrower to purchase a residential property with total borrowing which would count as a high-LVR loan for the bank if it was all provided by the bank;
- o directing the borrower to another lender who lends the borrower an amount such that the bank can provide a new residential mortgage loan to the borrower with an LVR less than the LVR restriction threshold; or
- o arrangements involving the use of additional collateral to hold the LVR on a residential mortgage loan below the LVR restriction threshold.

88. The Reserve Bank recognises that such arrangements can be used for legitimate business purposes, and as such is not ruling out those uses. Rather, the Reserve Bank's expectation is that banks will not exploit or promote such arrangements to avoid the LVR restrictions. Should concerns arise, the Reserve Bank would look closely at the extent to which, and over what period, any registered bank was increasing its use of such arrangements, measured by total volume or as a proportion of all of its residential lending. The Reserve Bank would also be concerned about more prominent marketing of products based on such arrangements.

89. If at any point it appears to the Reserve Bank, taking into account the considerations above, that an individual bank is entering into arrangements to avoid any LVR restrictions, or is systematically exploiting areas of uncertainty in the definitions, the Reserve Bank would consider taking action against that bank. Such action could address the concern directly by varying the standard LVR conditions or by imposing an additional condition relating to LVRs, or could take some other form as appropriate. The Reserve Bank has also considered the case for proscribing avoidance activity through a condition of registration but is not following this path at this point. It does not rule out the introduction of such conditions in the future should it prove necessary.

90. The Reserve Bank acknowledges the risk of disintermediation, whereby borrowers may be able to avoid LVR restrictions by borrowing from unregulated sources. Such borrowing would reduce the effectiveness of LVR restrictions in addressing excessive credit growth, but would present less risk to the resilience of the financial system, given that these lenders sit outside the 'core' system.

91. The Reserve Bank would closely monitor for signs of disintermediation if LVR restrictions were to be introduced. The risk of disintermediation could be mitigated to a degree by the temporary use of such restrictions. In addition, the current dominance of the banking sector in financial intermediation (relative to history) may help to reduce the scope for opportunistic lending by non-bank lenders. Nevertheless, it will be important to carefully monitor and report developments in the non-regulated finance sector, including the activity of overseas lenders. The Reserve Bank intends to consider the case for extending the framework to non-bank lenders in due course.

92. The Reserve Bank acknowledges the importance of timely and reliable information for the effective implementation of LVR restrictions. Should LVR restrictions be introduced, the framework would be actively monitored and assessed on an on-going basis. Where issues are identified, including any significant information gaps that are impeding effective operation, these would be addressed as appropriate.

93. BS19 has been amended to prohibit a registered bank from entering into arrangements that are contrived to allow the combined lending of the parties to circumvent any LVR restrictions that might be in place.

2.6 Changes to BS1

94. The consultation paper sought views on a number of changes to BS1, including housekeeping changes that were unrelated to the proposed framework for LVR restrictions.

Q13:	*Do you have any comments on the proposed changes to BS1?*

Summary of submissions

95. One submitter welcomed the clarifications around publication of the capital plan.

96. Another submitter suggested that each of the macro-prudential tools should be clearly spelled out in BS1 together with the conditions around their use.

Reserve Bank's response

97. The remaining macro-prudential tools – sectoral capital requirements and adjustments to the core funding ratio – will be incorporated into BS1 in due course following consultation on the details of their use. Until this process occurs, it is not possible to definitively set out such details, including any conditions for their use.

3.0 Implementation issues

3.1 Pre-approvals

Summary of submissions

98. A number of banks submitted on pre-approvals of home loans. Pre-approvals can be for a term of up to six months, and have limited conditionality. Where there are conditions, these typically pertain to the borrowers' circumstances, and the property to be purchased.

99. Should LVR restrictions be introduced, some banks noted that they might already have a substantial pipeline of pre-approvals which could be drawn down at any point, potentially up to six months after issuance. This pipeline, over which they have little control, could potentially see them exceed speed limits that might be applied.

100. Banks requested a transition period, with suggested options including tolerance around speed limits, phasing in of speed limits, transitional times for existing pre-approvals, exemption of existing pre-approvals.

Reserve Bank's response

101. The Reserve Bank has considered the issues raised by submitters, and sought further data on this topic. We agree that that the stock of pre-approvals already issued by some banks could pose problems in complying with any LVR restrictions that might be introduced.

102. As noted in the consultation paper, it is not the Reserve Bank's intention to frustrate existing contracts, and cancelling such pre-approvals would not be a preferred path.

103. Accordingly, should LVR restrictions be introduced, the Reserve Bank would lengthen the initial period over which compliance is measured. This would allow banks to compensate for any initial pre-approval driven spike by running below the speed limit for a period of time. This initial time period that compliance would be measured over would be six months, and would revert to the standard measurement period thereafter.

104. This would be a once-off measure. Over the longer term, banks would be expected to manage their high-LVR pre-approvals in such a way that they would not present an obstacle to meeting any LVR restrictions that might be imposed. Refer also section 2.2.

3.2 Timeframes

Summary of submissions

105. A preference was expressed for the work on definitions to be completed prior to any use of LVR restrictions. A number of submitters said that it would be difficult to assess the proposed LVR framework in the absence of clear definitions.

106. Banks noted that there could be significant costs and additional work, including multiple rounds of system changes, associated with using interim definitions.

107. A bank suggested that not finalising definitions prior to using the tool could see undue cautiousness or an expectation that the current approach would continue.

Reserve Bank's response

108. The Reserve Bank acknowledges the comments around the timeframe for implementation of the LVR framework. It is regrettable that the definition work is incomplete at this time, but given the long timeframes for Housing Review Stage II (with implementation potentially not complete until early next year), the Reserve Bank believes that interim arrangements for the LVR framework need to be put in place. This reflects the significant current risks around the housing market, and the need for the Reserve Bank and the banking system to be ready to address these risks, should it be judged necessary.

4.0 Other policy considerations

4.1 Notice periods

109. Some banks argued that two weeks is insufficient notice for the imposition of LVR restrictions, and that at least one month's notice should be supplied.

Reserve Bank's response

110. The notice periods for LVR restrictions were consulted on in the macro-prudential policy consultation, along with notice periods for the other macro-prudential instruments. As noted in the Bank's response to that consultation, the proposed notice periods for each instrument aimed at striking a balance between the need to act pre-emptively, and the need to provide a reasonable time for banks to meet the macro-prudential requirement. For the avoidance of doubt, it should be noted that the proposed notice period for LVR restrictions provides the Reserve Bank with scope to provide a notice period greater than two weeks should this appear necessary.

4.2 Targeted LVR restrictions

Summary of submissions

111. Two submitters from regional New Zealand argued that imposition of LVR restrictions would choke the flow of lending to regional centres, as banks would prioritise lending to more desirable locations (larger centres) and higher value loans. It was suggested that LVR restrictions should be targeted to those areas that have had a certain percentage growth in the last 12 months.

112. Another submitter suggested the introduction of LVR restrictions with different levels of targeting. Investors in certain regions would be restricted to maximum LVRs of 60 per cent; first-home buyers and anyone building a new home would be able to borrow a maximum of 90 per cent; all other residential mortgage borrowers would be limited to a maximum LVR of 80 percent.

Reserve Bank's response

113. The recent consultation on macro-prudential policy considered a number of issues around targeting. As part of its response, the Reserve Bank noted that LVR restrictions would typically be applied in a broad-based fashion, reflecting that broad exemptions would not necessarily be appropriate and could significantly dilute the effectiveness of the instrument.

114. The Reserve Bank does not rule out the possibility of targeting LVR restrictions in the future if risks were found to be significantly concentrated in particular segments of the housing market, such as investors. However, the potential costs of a more targeted approach include a higher probability of circumvention, the risk of introducing other distortions into the housing market, and a number of practical difficulties, including how best to delineate and measure the targeted segment.

4.3 Non-prudential matters

Summary of submissions

115. One submitter argued that investors are crowding "genuine" home buyers out of the market. This submitter suggested a range of responses, including requiring a higher

deposit (30 percent to 40 percent) from purchasers of multiple properties, and eliminating tax incentives for look-through companies to purchase property.

116. One submitter suggested banning foreign investors from buying in New Zealand. Another submitter argued that introducing LVR restrictions would advantage overseas buyers who would not be subject to an LVR restriction. The submitter argued that this could lead to an increase in outflows from New Zealand in the form of rent payments and capital gains. It was suggested that any introduction of LVR restrictions should be offset by measures to reduce the competitiveness of overseas buyers.

Reserve Bank's response

117. The non-prudential measures noted above are outside the scope of this consultation, and the Reserve Bank's powers. The Reserve Bank notes that the laws and regulations relating to foreign investment in New Zealand, including the purchase of real estate by non-residents, are for the government to determine.

Glossary

Banking Supervision Handbook documents

BS1	Statement of principles – bank registration and supervision
BS19	Framework for restrictions on high-LVR residential mortgage lending
BS2A	Capital adequacy framework (standardised approach)
BS2B	Capital adequacy framework (internal models based approach)

DS	Disclosure Statement
IRB	Internal ratings-based approach
LMI	Lenders mortgage insurance
LVR	Loan-to-value ratio
RBNZ	Reserve Bank of New Zealand