Consultation Paper: Framework for restrictions on high-LVR residential mortgage lending

The Reserve Bank invites submissions on this consultation paper by 3 July 2013.

Submissions and enquiries about the consultation should be addressed to:

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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.

5 June 2013

Introduction

1. The Reserve Bank released a document setting out its finalised macro-prudential policy framework on 17 May 2013, following a consultation process over March and April. The framework includes four macro-prudential tools, including quantitative restrictions on the share of high loan-to-value ratio ('LVR') loans to the residential property sector.

2. As foreshadowed by Deputy Governor Grant Spencer, the Reserve Bank is now looking to incorporate operational details of the macro-prudential policy instruments into the Banking Supervision Handbook, so that the instruments can be deployed if necessary.

3. This consultation paper seeks views on the details of the mechanism by which the Reserve Bank would implement the LVR restrictions tool. The Reserve Bank is starting work on this tool first, as it will require a number of changes to the existing prudential framework. Feedback during the consultation process also suggests that it is likely to require significant pre-positioning work by some registered banks. As specified in the macro-prudential framework, the intention is that LVR restrictions might be imposed with a notice period of as little as two weeks, so it will be important that banks are prepared as much as possible in advance.

Proposed framework

4. As set out in the policy position paper, quantitative restrictions would typically take the form of 'speed limits' which restrict the share of new high loan-to-value ratio (LVR) lending that banks may undertake.

5. LVR restrictions would be enacted by imposing three standard conditions of registration on all registered banks, including branches of overseas banks. The primary change to the conditions of registration would set out the threshold(s) at which the restriction would apply, and permissible high-LVR lending shares. It is proposed that two subsidiary conditions would restrict banks from engaging in or permitting high-LVR lending above any in-force restrictions. As is the case for many of the other standard conditions of registration for banks, we intend that the conditions themselves will be as concise as possible, and will use cross-references to background detail that will be contained in a new policy document.

6. The necessary policy document will be added to the Banking Supervision Handbook. We attach a draft of this document which also includes the proposed standard wording of the LVR conditions of registration as an Appendix.

7. The Reserve Bank's intention in undertaking this consultation is to ensure that the banking system is sufficiently well positioned so that LVR restrictions could be applied in the relatively near future should this be considered necessary. Accordingly, some of the arrangements proposed in this note are interim in nature and may be refined in due course. Note that no decision has been made about imposing LVR restrictions.

8. We also note that stage two of the Reserve Bank's review of bank capital adequacy requirements for residential mortgage loans (the "Housing Review stage two") is expected to result in some changes to LVR definitions, particularly the definitions of loan amount, value amount (the 'L' and the 'V'), and residential mortgage loan, as well as new rules around what constitutes a credit event. These stage two changes – which are expected to be finalised in mid-July – are likely to apply to the definitions used for LVR data purposes also.

Nature of the LVR restrictions

Restrictions on high-LVR lending

9. Each restriction would be specified in the form of a 'speed limit': no more than X percent of applicable new mortgage lending over each specified period can have an LVR greater than or equal to Y percent. The form of the proposed restrictions on high-LVR lending can be seen from the wording of condition (1) in the standard conditions of registration included as Appendix 1 to the draft BS19. BS19 includes further explanation in Section 6, and a worked example in Section 10.

10. If more than one 'speed limit' applied, then such limits would be expressed cumulatively rather than in separate bands. For example, the limits might state that no more than 5 percent of new lending may have LVRs over 90 percent, and no more than 10 percent of new lending may have LVRs over 80 percent; rather than, no more than 5 percent of new lending may have LVRs over 90 percent, and no more than 5 percent of new lending may have LVRs between 80 percent and 90 percent.

11. The potential thresholds for LVR quantitative restrictions would range between 60 per cent and 100 per cent, with 5 percent intervals. However, the Reserve Bank generally defines high-LVR lending as lending with an LVR of 80 percent or more, and it is not expected that LVR restrictions would typically be imposed below this threshold.

12. When setting LVR thresholds, one consideration would be the ability to monitor banks' residential mortgage lending above any given LVR threshold(s). A new LVR data collection is expected to be introduced in the second half of the year, which would include the 5 percent granularity described above. In the interim, should the Reserve Bank decide to apply LVR restrictions, these might use existing Disclosure Statement LVR reporting bands i.e. 80 percent, 90 percent, and 100 percent.

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

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

13. We note that these proposed restrictions would be imposed by condition of registration, with all the implications that has for any breach. We acknowledge that banks may find it difficult to predict the share of high-LVR lending exactly. One way of alleviating this may be to apply LVR restrictions on a three month rolling basis (see below).

14. Another possibility would be for banks to operate internal buffers above the minimum requirements, as banks have typically done for liquidity requirements. We have also considered the possibility of allowing some form of tolerance in the system. For example, if we wanted to impose a 20 percent speed limit on loans with LVRs above, say, 80 percent, we could stipulate a tolerance above this limit (for example, an actual proportion of loans up to 21 percent). Overall we do not favour this approach as it would be difficult to land on a tolerance that applied evenly across banks, and it would complicate the calibration of restrictions.

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

Time period

15. The proposed standard condition applies LVR restrictions on a three month rolling basis: that is, the limits would apply at the end of each calendar month to the total lending which the bank has committed itself to over the three calendar months up to that date. Alternative approaches would, for instance, be to apply the limits to the flows over each calendar month, or over each quarter separately. We think that the first of these would be more challenging for banks in managing the flows towards the end of each month, while the second would not allow sufficiently frequent monitoring of the impact of the policy. The calendar month frequency for the proposed reporting on the new commitments template would allow the Reserve Bank to monitor banks' compliance over three month rolling periods.

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?

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

Overseas bank branches

16. We intend that the restrictions will normally also apply to all overseas-incorporated banks that are registered as banks in New Zealand. In common with a number of other conditions of registration, the LVR conditions will apply to the registered bank as a legal entity, which means that their scope extends to mortgage lending booked out of the registered bank in any location, including head office or a branch in any other jurisdiction. However the scope of the policy is restricted to mortgage lending that is secured on residential property in New Zealand.

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

Definitions

17. A number of terms that need to be defined for the purpose of specifying restrictions on high-LVR lending are already used elsewhere in our banking supervision framework. These include “residential mortgage loan”, “loan value” and “loan-to-valuation ratio”.

18. A challenge for implementing LVR restrictions is that there is not full consistency of these definitions between those in “Capital Adequacy Framework (Standardised Approach)” (BS2A) and those in “Capital Adequacy Framework (Internal Models Based Approach)” (BS2B). IRB banks (those accredited to use their own internal credit-rating based approach to capital adequacy) use BS2B; other banks, including overseas bank branches for their required disclosure of LVR breakdown, use the definitions in BS2A.

19. The definitions in BS2B are looser and less precise than those in BS2A. (This difference derives from the respective approaches to definitions under the internal models based approach and the standardised approach in the Basel Committee’s capital adequacy framework.) Now, however, the Reserve Bank has work under way to better align definitions relating to LVR across all banks:

    - The Housing Review stage two is expected to improve the consistency of LVR definitions across standardised and IRB banks’ capital adequacy calculations.
    - The LVR data collection project will require banks to provide a breakdown of their residential mortgage lending by LVR bracket. Over time this will significantly improve the Reserve Bank’s ability to monitor systemic risk in the housing market, and assist in assessing regulatory impact and compliance monitoring should LVR restrictions one day be applied. The need for even-handed monitoring of high-LVR residential mortgage lending is expected to eventually result in a single common set of definitions. We anticipate that these might be similar to those currently in BS2A, but possibly with greater precision.

20. A consideration is that restrictions on high-LVR lending should apply as consistently as possible across all banks. Once we have completed the two projects referred to above, we expect each of the definitions used in the standard conditions of registration will be able to cross-refer to a common definition elsewhere in the Banking Supervision Handbook, where such a definition already exists, or will be given as a single definition in this policy document. As far as possible there should be a single definition applicable to all banks.

21. Given that the other work is still in progress, our approach in the draft BS19 is to cross-refer as far as possible to what banks are already using elsewhere: 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 more on whatever banks have chosen to do in their modelling approaches, within the parameters of BS2B.

22. One exception to using the BS2A definitions exactly is that we have removed the word “fully” from the BS2A definition of a “residential mortgage loan”. “Fully secured” indicates an LVR of 100 percent or less, but it is important that restrictions, along with reporting on the template, apply equally to any mortgage lending with LVRs over 100 percent. For

avoidance of doubt, with or without the word "fully" we do not intend to rule out cases where the loan may also be secured on additional assets.

23. One difference between BS2A and BS2B that creates possible confusion is that BS2A refers to "first ranking" mortgages while BS2B refers only to exposures secured by residential mortgages. Until we have completed further work, again we leave it to IRB banks to use whatever residential mortgage lending they capture within their own internal category for this, as a subset of the retail exposure class.

24. We expect as part of the Housing Review stage two work to tighten the definition of valuation, in particular what constitutes a "credit event" for determining the mortgage origination date. We will endeavour to reflect such definitional changes in the LVR restrictions framework, as and when they are finalised.

25. Neither BS2A nor BS2B provides a clear statement that we can draw on to specify the date on which an offer of a residential mortgage loan to a customer becomes a firm new commitment. The draft BS19 therefore includes a section spelling out what we intend by the term "new commitment".

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)?

Exemptions

26. We propose several standard exemptions to the LVR restrictions. These exemptions are intended to reduce the efficiency costs of imposing LVR restrictions without unduly undermining their effectiveness. When speed limits have been imposed on new lending in specified high-LVR buckets, loans falling within the exempt categories would be excluded from both the numerator and denominator, in calculating the percentages of new lending falling within those buckets.

27. We recognise that some of the following exemptions may be challenging for banks to implement. We have therefore expressed them in a permissive rather than a prescriptive way: a bank <u>may</u> exempt any given loan from the high-LVR restrictions if it can be certain that the loan meets one of the exemption criteria, but it is not <u>required</u> to identify every potentially exempt loan.

Housing NZ Mortgage Insurance Scheme

28. First, as already noted in the response to submissions on the macro-prudential framework, we propose to exempt lending under Housing New Zealand's Mortgage Insurance Scheme (MIS), including the Welcome Home Loan scheme and Kainga Whenua programme. MIS loans serve clear government housing policy objectives and present minimal risks to financial stability, as any bank losses are either underwritten or guaranteed by Housing New Zealand.

Refinancing and LVR portability

29. Second, we propose to exempt any new housing loan which replaces an existing housing loan to the same owner-occupier and which has a loan value and LVR no greater than those of the existing loan. Exempting such loans will not undermine the policy's objective of restricting the increase in the volume of new high-LVR lending.

30. Without this exemption, a homeowner who had already taken out a high-LVR mortgage before restrictions were imposed would be trapped with their existing loan. This could undesirably inhibit competition, as the borrower would not be able to refinance the mortgage on their current home on better terms with a different lender. It could also affect labour mobility, if the borrower wanted to move to a new part of the country to take up a new job, and the borrower had to find a substantially larger deposit to pay for a new house, as a result of the restrictions.

31. A borrower may not always be able to align the completion dates of the sale of their old home and purchase of the new home. The wording of the exemption therefore includes a three month period during which a person who has recently sold their home can carry their previous LVR over to a new home, as long as the loan amount is no bigger. We think this provides a reasonable trade-off between allowing those moving house to have some time to find a new one, and not allowing a large build-up of unused high-LVR capacity through this exemption.

Bridging loans

32. Third, the draft BS19 document includes a proposed exemption for bridging finance. If a home buyer plans to use the net sale proceeds of their existing house to help finance their new home, and the settlement date for the purchase of the new home is before that of the old home, that person will typically take out a bridging loan. If this is structured as a top-up on the mortgage loan on the existing home, it would typically carry an LVR of up to 100 percent and fall within the scope of the high-LVR restrictions. We intend to exempt a bridging loan of this sort. The relevant mortgage loan and LVR for the purpose of the restrictions are those on the new home once the old home has been sold and the bridging loan repaid.

33. We note that in the cases of LVR transferability for borrowers moving house, and bridging loans, we have drafted the exemptions with the intention that only owner-occupiers should benefit from them. We also recognise that the wording of these exemptions may not extend to more complex, but common cases such as joint ownership and ownership through a family trust, some of which it may be desirable to exempt. For instance, a joint loan to a married couple will become a sole loan after the death of one of them but we would not intend to restrict LVR portability on that basis.

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

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

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

Lower-ranking mortgage top-up loans

34. The additional standard conditions (2) and (3) in Appendix 1 of the draft BS19 are intended as far as possible to prevent lenders from undermining the effectiveness of the first condition. Lenders, which would most likely be entities outside the scope of the Reserve Bank's banking supervision regime but could potentially be registered banks, could undermine the effectiveness of the LVR tool by providing top-up loans secured by second or lower-ranking mortgages on residential property to borrowers who have taken out a first-ranking mortgage loan.

35. Condition (2) aims to ensure that a registered bank prevents any other lender from providing a top-up loan secured by a lower-ranking mortgage on a residential property on which the bank is making a first-ranking mortgage loan. An exception is provided for cases where the top-up loan would leave the borrower's total LVR below the lowest level at which LVR restrictions start to apply in the first condition. The condition, as currently drafted, requires banks to include terms within their standard loan conditions, that require the borrower to get the bank's permission before granting any additional encumbrance over the property.

36. Condition (3) aims to prevent registered banks themselves from providing top-up mortgage loans. Condition (2) already achieves this in the case where the first-ranking lender is another registered bank: the proposed condition (3) would close off the opportunity for a registered bank and a non-bank lender to make an arrangement whereby the non-bank lender provides a first mortgage loan secured on, say, 10 percent of the house value, while the bank provides the bulk of the finance via second mortgage to take the borrower's total LVR to 100 percent. We believe that this condition is necessary on initial implementation of the policy, because, as noted above, the present scope of the definitions does not clearly or comprehensively extend to banks' lower-ranking mortgage lending. Our understanding is that banks currently do little or no such lending, so our expectation is that complying with this condition would not be onerous.

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

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

Other features of BS19

Monitoring compliance and Reserve Bank expectations

37. The Reserve Bank is conscious that a narrowly-targeted restriction of this sort will create incentives for both registered banks and other financial firms to devise structures and products that fall outside the scope of the policy as worded, but which can profitably be sold to home buyers as ways to get around the restrictions.

38. The draft policy document BS19 sets out the Reserve Bank's expectations in this regard (see Section 6(8)). The key message is that we expect banks to comply with the spirit as well as the letter of the policy. Section 11 of BS19 notes the cases in which we would vary the LVR conditions of registration for an individual bank. In brief, this says that the standard conditions will normally apply to all registered banks without variation, but that we may vary the conditions or add an additional LVR condition for a particular bank (or take other action if need be) if we believe that that bank is acting against the spirit of the policy.

Disclosure and reporting

39. The draft policy document includes brief sections on disclosure requirements relating to LVRs under the Reserve Bank's disclosure regime, and on the proposed LVR reporting template which the Reserve Bank is currently developing in consultation with the banks. These sections are only intended to provide a convenient summary of LVR-related policy matters in one place: they refer to requirements which are imposed on registered banks separately from conditions of registration, and are (or will be) set out elsewhere.

Changes to BS1

40. The existing handbook document "Statement of Principles: Bank Registration and Supervision" (BS1) will also be updated. The Reserve Bank publishes BS1 to comply with the requirements of section 75 of the Reserve Bank of New Zealand Act 1989 ("the Act"). Among other things, BS1 sets out the principles on which the Reserve Bank acts in imposing, varying, removing, or adding to conditions of registration. The attached track-changed version of BS1 shows the proposed revisions. These changes are to add the proposed standard LVR conditions, and to note when they will be applied.

41. We are proposing to make other unrelated changes to BS1 at the same time, as follows:

    a. Changes to reflect the fact that the minimum Core Funding Ratio was increased to 75 percent from 1 January 2013;

    b. An addition to paragraph 110(1), to clarify that a registered bank does not have to publish its plans to restore its capital positions when it falls below its buffer ratio, only when it breaches one of it capital adequacy minimum requirements;

    c. Current paragraph 99 (concerning a bank's internal capital adequacy assessment process ("ICAAP")) has been moved to where it more logically fits, at new paragraph 102E.

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

Next steps

42. The consultation closes on 3 July 2013. We aim to publish the finalised versions of the new Handbook document BS19 and of BS1 by around mid-July.

Consultation questions

In addition to the consultation questions embedded in the main document, we welcome other feedback and questions.