RESERVE BANK

OF NEW ZEALAND

TE PŪTEA MATUA

Summary of submissions and final policy position on the review of the asset class treatment of residential property investment loans in BS2A and BS2B

Please not that this is not a consultation document. However, the Reserve Bank invites any feedback on the proposed technical changes to BS2A and BS2B by 19 June 2015. Comments should be addressed to:

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Background

1. The Reserve Bank consulted on the second stage of its housing review from 20 September to 25 October 2013. As part of that consultation, the Reserve Bank proposed to amend the asset class treatment of loans to residential property investors within BS2B, the set of capital requirements that applies to banks operating on the internal ratings based approach. It was proposed that loans above a certain count-based threshold, initially set at four and then increased to five properties, should be grouped in an asset class other than the current retail residential mortgage asset class. The rationale is that the risk profile of loans to residential property investors differs from owner-occupiers and that the Basel II internal ratings based approach (IRB) guidelines recommend restricting the residential mortgage retail asset class to owner-occupiers, bar a few exceptions.

2. A summary of submissions and policy decisions on that consultation was released on 20 December 2013. Due to the technical nature of some of the changes required to the capital adequacy requirements to implement the policy decision, the Reserve Bank also consulted on an exposure draft of the new proposed wording between 28 March and 28 April 2014. Those further papers produced more detailed reactions from stakeholders to the Reserve Bank's proposal than were initially forthcoming. As a result, the Reserve Bank made some changes to the proposed policy such as increasing the count-based threshold from four to five properties. IRB banks, approved to operate under the BS2B framework, however, raised further implementation issues, which led the Reserve Bank to delay the introduction of the new asset class treatment and further to consider some technical detail associated with this policy.

3. The Reserve Bank reviewed the proposed policy and, between 5 March and 17 April 2015, consulted on a number of amendments to what had previously been consulted on. The Reserve Bank proposed that loans to residential property investors be treated separately from existing residential mortgage loans under BS2A and BS2B, meaning that all locally incorporated banks would need to comply with a new asset class treatment. Following the feedback from earlier consultations, this most recent consultation concerned new proposed definitions of residential property investment loans, the asset class treatment of residential property investment loans, and interim arrangements were a new asset class to be introduced.

4. Once a definition and new asset class are finalised, applying to all locally incorporated banks, the Reserve Bank will be able to implement macroprudential policies targeting this class of borrowers.

5. Separately, and unrelated to the second stage of the housing review, or to the asset class treatment of residential property investment loans, this most recent consultation also proposed changes to capital requirements for reverse mortgage loans, the removal of the qualifying revolving retail exposure (QRRE) option in BS2B, and the removal of the Foundational IRB approach in BS2B. These issues will be addressed at a later stage.

6. This document summarises the feedback that the Reserve Bank received on the asset class treatment of residential property investment loans in the March/April 2015 consultation, and the Reserve Bank's responses and policy decisions. The Reserve Bank received 26 submissions in total. Of those, 11 were from banks, 12 were from private individuals, and three from industry representatives.

Asset class treatment of residential property investment loans under BS2A and BS2B

1. The Reserve Bank considers that residential property investor loans have a different risk profile to owner-occupier residential property loans. The Basel II IRB approach recognises this in that the retail mortgage asset class is intended for, with a few exceptions, owner-occupier mortgage loans. The second stage of the housing review sought to establish a separate asset class for residential property investors in BS2B, to align with the Basel guidelines.

2. Under the Basel Standardised approach there is no such distinction between owner-occupier and investor mortgage lending, however the approach provides flexibility for regulators to diverge from the Basel recommendations for country-specific reasons. Aligning any new property investor asset class in BS2A and BS2B would facilitate, were it considered necessary, a macroprudential intervention on property investor lending, as it would capture all locally incorporated banks.

<u>Rationale and Policy Intent</u>

Question 1: Do you have any comments on this analysis or the Reserve Bank's rationale?

3. This part of the consultation received the most feedback. Overall, responses to this question were mixed. A majority of submissions did not support the Reserve Bank's rationale for creating a separate asset class for property investors, arguing that property investor status in and of itself did not contribute meaningfully to the riskiness of a residential mortgage loan, and that evidence presented on the performance of property investment loans in the UK and Ireland was not applicable in the New Zealand context. Many larger banks and property investors were the most critical of the Reserve Bank's rationale. However, some submissions, notably many standardised banks and other stakeholders, agreed with the Reserve Bank's rationale, saying that given the scale of property investment lending in New Zealand and differences in risk characteristics, it would be appropriate to segregate residential mortgage loans in the proposed manner.

4. A few submissions commented on the evidence cited by the Reserve Bank, specifically the studies referred to in paragraphs 11 and 12 of the consultation document. While, in aggregate, investor lending in the UK and Ireland performed relatively poorly in the 2008-2012 period, submitters argued that the studies cited demonstrated that, holding the LVR, servicing costs, and other factors constant, buy-to-let borrowers were only marginally riskier than other buyer types. As many buy-to-let loans were written when the level of house prices was already elevated, buy-to-let loans tended to have a higher average LVR than other loans, and hence the aggregate performance of buy-to-let loans was relatively poor during the period studied. In other words, the vintage of a loan was a more important determinant of its performance. However, after adjusting for the LVR, the buyer type was only marginally relevant in terms of explaining arrears behaviour.

5. Several submissions questioned the applicability of studies on investment lending performance from the UK and Ireland, where they argued lending standards were materially different from those in New Zealand, both in the years prior to 2008, and at

present. These submissions argued that the Australian and New Zealand banking industries were generally more conservative than their foreign counterparts, and several banks cited evidence from their own experiences during the 2008-2012 period, demonstrating that property investment lending had performed as well, and in one case better, than lending to owner-occupier borrowers. A few submissions noted that risk weights on housing loans in New Zealand were already high relative to comparable countries. In addition, some of these submissions argued that the existing LVR policy that the Reserve Bank had implemented had further improved the conservativeness of lending in New Zealand.

6. A few submissions disputed the Reserve Bank's proposition that property investment loans are more strongly correlated with systemic risk factors, and hence would require a higher correlation factor. These submissions argued that, due to the diversification of income streams, both labour and rental income, a typical property investor would be more able to service their loans in the event of a downturn than an owner-occupier who receives only labour income. Further, it was argued that buy-to-let lending in the UK and Ireland typically had no recourse to a borrower's other income, whereas in New Zealand, with with-recourse lending, and the cross-collateralisation practices of many banks, servicing of investment property lending is much more closely aligned to all of an investor's income sources. One of these submissions pointed to the relative stability of rental rates and vacancy rates in New Zealand, compared with the unemployment rate, which would not justify a higher correlation factor than for owner-occupier lending.

7. One submission disagreed with the Reserve Bank's proposal to increase the minimum LGDs for loans in the new asset class, arguing that there is no evidence that the cure rate for housing loans with an investment element would be lower during a downturn, and that there would be no significant difference in the costs of readying a property for the market (maintenance, repairs etc.).

8. Several submissions argued that further Reserve Bank intervention in lending behaviour could have unintended and undesirable consequences, including reducing the supply of rental properties, and more broadly, misallocating capital in the economy. A number of these submissions argued that the Reserve Bank should focus on neutral interventions such as higher overall capital requirements, i.e. capital ratios, or the use of the countercyclical capital buffer, if it believes property investment lending poses a threat to financial stability. One submission noted that housing loans have, as yet, seldom played a central role in financial crises, and that New Zealand banks have not suffered significant loan losses on property lending since the 1930s. Consequently, the submission argued that further intervention was unnecessary and could undermine the efficiency of the financial system.

9. Two submissions disputed the Reserve Bank's interpretation of the Basel Committee's recommendations for the asset class treatment of residential property investment. These argued that the wording of the Committee's recommendation to restrict the residential mortgage loan asset class to owner-occupied property loans was influenced by the form of the housing market in central Europe. These submitters interpreted the Basel II guidelines as saying that, in the New Zealand context,

property investors with small portfolios ought to be considered for the same asset class treatment as owner-occupied property loans[1].

10. Conversely, several submissions agreed with the Reserve Bank's overall rationale for segregating owner-occupiers and property investors into different asset classes, saying that there were material differences in the risk profiles of these two groups of borrowers. One bank noted that it had already commenced a programme of work to identify investor lending within its portfolio, in order to monitor these differences.

Response

11. The Reserve Bank does not dispute the existence of differences in lending standards and the degree of conservativeness between banking industries in New Zealand and other countries, and agrees that New Zealand has not had a severe downturn in its housing market in recent decades. However, the Reserve Bank does not consider these arguments as sufficient reasons to disregard pertinent lessons from downturns in the housing markets of other countries, and the Basel Committee's recommendations, both of which suggest that property investors have a different risk profile to owner-occupiers in any given jurisdiction.

12. The empirical evidence that the Reserve Bank cited in its consultation paper shows that, even once the effects of LVR and servicing costs are accounted for, buyer type (that is, if a buyer is classified as buy-to-let) had a positive and statistically significant marginal effect on the likelihood of being in arrears[2]. This is incorporated, for instance, by adjustments for investor loans in ratings agencies' risk models for RMBS in Australia[3]. Moreover, the evidence from the UK and Ireland suggests that the vintage of a loan is a key determinant of its performance through a housing cycle. Buy-to-let buyers were disproportionately represented in borrower cohorts near the peak of the cycle, with subsequent higher realised rates of arrears. Further, as property investors are more likely to have interest-only mortgages, they tend to remain at the origination LVR where owner-occupiers reduce their LVR and hence risk through principal repayments. Combined, these factors point to a difference in the risk profile vis-à-vis other buyers, and to a higher correlation factor in the Basel capital equation.

13. The current lack of distinction between owner-occupier and non-owner-occupier residential mortgage lending in the retail asset class represents a deviation from the Basel Committee's guidelines. Although the Basel requirements are influenced by the structures of European and North American housing markets, where apartment-type rental accommodation is more common, it is the Reserve Bank's view that the Basel Committee expects that its intention, to restrict the residential mortgage category to owner-occupier mortgage loans, be applied regardless of the types of rental accommodation within a jurisdiction.

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[1] One of these submissions referred to the Basel II document wording concerning the retail asset class (http://www.bis.org/publ/bcbs107.pdf):
"Loans secured by a single or small number of condominium or co-operative residential housing units in a single building or complex also fall within the scope of the residential mortgage category. National supervisors may set limits on the maximum number of housing units per exposure."

[2] See, for instance, Lydon and McCarthy (2011), Table 7, and also Kelly (2012), Figure 3, or Palmer (2014).

[3] See for instance S&P, http://www.standardandpoors.com/spf/upload/Ratings_EMEA/2011-09-01_RMBSAustralianRMBSRatingMethodology.pdf

14. Indeed, in its most recent Regulatory Consistency Assessment Programme assessment of Basel III regulations in Australia, perhaps the most similar country to New Zealand in terms of the structure of the rental property market, the Basel Committee chided that country's prudential regulator for the way in which all mortgage loans are grouped in the same retail asset class. In its report, the Assessment Team noted[4]:

> Under APRA's IRB Prudential Standards, mortgage loans are eligible for retail treatment regardless of the occupancy status of the property which, in the Assessment Team's opinion, is a deviation from the Basel Framework. (…) However, it is not certain what the performance of these [non-owner occupied mortgage] loans would be during a significant economic downturn, such as that experienced in Australia during the early 1990s, or whether the risk characteristics of such loans would remain similar to those of owner-occupied loans in such a circumstance. Accordingly the likely potential risk for capital understatement that could result from APRA's current treatment of non-owner occupied mortgages was considered material. On this basis, the RCAP team views this deviation as potentially material.

15. While risk weights for residential mortgage loans are, in general, higher in New Zealand than comparable countries including Australia, the Reserve Bank does not see this as a reason to depart from the Basel Committee's recommendation to treat residential property investment loans in a separate asset class.

16. The Reserve Bank agrees that diversification across income sources may insulate the serviceability of a given loan from economic (i.e. unemployment) shocks. However, at a given LVR, an investor will have multiple properties in addition to their own home, leading to a substantially higher gearing to their income than an owner-occupier with one home at the same LVR. If the investor's debt servicing is dependent on both their labour income and their rental income, they become in effect more exposed to systemic risk as they assume not only their own unemployment risk but that of their tenants.

17. The Reserve Bank believes that the effect of the creation of a new asset class for property investment would have limited effects on the rental market. If, for example, there is an increase in the proportion of houses that are owner-occupied, reducing the supply of rental houses, there would also be a reduction in the demand for rental houses due to owner-occupier home purchases.

[4] See the 2014 RCAP document http://www.bis.org/bcbs/implementation/l2_au.pdf, p. 16.

Definition of a residential property investor loan

> Question 2: What are the costs associated with each option, i.e. option 1, 2A and 2B, in terms of compliance costs and for the loans that would be affected? Please provide detailed information.
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> Question 3: Please describe the way in which you currently collect the information required to implement each of these options and any changes or additions you would have to make to your loan origination and information collection processes.
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> Question 4: Please provide your best estimate of how many loans would be captured under each of the three options?
>
> Question 5: Can you anticipate any implementation issues with these options? Please indicate how these issues could be overcome.
>
> Question 6: What are the benefits of each option overall as well as relative to the other options?
>
> Question 7: Do you have any suggestions as to how the proposed options could be improved or any other comments on the Reserve Bank's proposed definition?

18. Broadly, the three proposed options for the definition of a residential property investor loan were:
    - loans for non-owner occupier purposes (Option 1);
    - loans whose servicing costs are at least 50 percent dependent on rental income (Option 2A);
    - loans whose servicing costs are in any part dependent on rental income (Option 2B).

19. Banks' estimates of the total costs associated with the proposed changes ranged from $0.25m-0.5m for smaller banks, to $1.3m-$5m for larger banks, although in the latter figures, the costs of subsequent internal model development were included. Costs were a result of necessary changes to IT systems, staff training, the creation of new products within the new asset class, and changes to documentation and internal processes. Additionally, banks would need to assign staff and resources to the reclassification of existing loans during the transition period.

20. Most banks indicated that they already collected some form of information on the intended owner-occupancy status of houses used as security for loans. Accordingly, once a definition has been decided upon by the Reserve Bank, changes to loan origination and information collection processes would be minor.

21. While many banks were not able to provide estimates of how many loans would be captured under the options 2A and 2B due to insufficient data, under option 1 approximately 25 percent of the stock, and 30 percent of the flow of system lending would fall into the new asset class. Banks noted however, that these estimates can be subject to significant margins of error.

22. Several submitters suggested that the Reserve Bank allow banks to reclassify existing customers at credit or re-pricing events, rather than a defined reclassification period.

23. One bank queried how the segmentation of existing residential mortgage loans would impact on covered bond and residential mortgage backed securities programmes. The Reserve Bank will discuss this issue with affected banks.

24. Most submissions that commented on this section expressed a clear preference for Option 1, a definition based on owner-occupier status. Submissions argued that such a definition would be less onerous in terms of the data that banks would be required to collect and maintain, as well as being simpler to implement in bank IT systems and for training of staff. Several banks noted the difficulties that they would face in verifying rental incomes under options 2A and 2B. Only two submissions expressed no preference for any of the proposed options.

25. Two internal model banks suggested the use of a Pillar II overlay to make banks hold additional capital against new lending to property investors, or to use a counter cyclical buffer. These banks argued that new requirements that alter credit risk capital calculations are detailed and complex, and that to impose a capital overlay would be simpler and allow time for banks to develop and seek approval for a model for the new asset class. An overlay could be removed once an internal model is approved.

26. A few banks noted that it would be worthwhile to align the definition of property investment loans for the new asset class with the definition that the Reserve Bank uses in its new commitments by borrower type survey (table C31).

27. Several submissions noted the difficulties that could arise if the option 1 is defined too broadly, that is, if holiday homes and secondary residences are counted as investment properties.

28. Several submissions commented that the segmentation between asset classes should apply at the customer, rather than the specific loan level. If a customer was deemed to be a residential investor, then all of their loans with that bank would fall into the new asset class. This is because banks in New Zealand perform cross-collateralisation when calculating LVRs. To segment in this way would better reflect the underling nature of the risk, in that the probability of default is linked most closely to a customer than a particular loan.

<u>Response</u>

29. The Reserve Bank is conscious of the effects of its interventions on the efficiency of the financial system, and seeks to minimise where possible the costs it imposes on the public. In this case, it believes that the benefits of greater differentiation and visibility of credit risks within banks' systems exceed the costs of implementing the changes, and will allow the Reserve Bank to apply appropriate capital requirements for property investment loans and implement macroprudential policy.

30. The Reserve Bank appreciates that the required upgrades to systems are not simple, and has taken this into account in deciding on the timing of interim arrangements (see below).

31. The Reserve Bank acknowledges the issues that submitters raised with each of the proposed options, and has decided to implement Option 1.

32. The Reserve Bank does not agree with the suggestion that banks be allowed to reclassify their existing lending at credit events alone, rather than the proposed transition period. It is important that loans be correctly classified for capital purposes, and that a level playing field is maintained. However, the transition period will be extended to twelve months (see below).

34. Where cross-collateralisation takes place, the proposed definition in BS2A and BS2B allows banks to continue to take a customer level view where they do so already, that is, to treat all of a customer's loans as either non property-investment mortgage loans, or as property-investment mortgage loans, for capital purposes, provided the loan is correctly classified. Additionally, the definition allows banks to portion out a customer's loan(s) between the two categories for capital purposes, subject to the conditions for each category, if they wish to do so.

35. If a customer's loans are split into the two categories where securities are linked, this is to be done on a pro rata basis. For a loan secured over both owner-occupied and non owner-occupied properties, the portion of that loan that can be treated as a non property-investment residential mortgage loan must be not more than the total value of that borrower's loans secured by those residential properties multiplied by the proportion attributable to owner-occupied residential property. The proportion attributable to owner-occupied residential property is determined by the property value of owner-occupied residential property divided by the total property value of the property used as security. The following presents the proposed changes to BS2A and BS2B.

Proposed changes to BS2A / BS2B – Updated Paragraph 43(e) / Section 4.7A in highlight

"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 predominately used for farming or commercial activities. Without limitation, a property will be considered to be predominately 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.

A residential mortgage loan written on or after 1 October 2015, and from 1 October 2016 residential mortgage loans written before 1 October 2015, must be further sub-classified as either a:

(i) Non property-investment residential mortgage loan; or
(ii) Property-investment residential mortgage loan

All residential mortgage loans written before 1 October 2015 are classified as a non property-investment residential mortgage loans until 1 October 2016.

For the purposes of this section the following definitions apply:

Non property-investment residential mortgage loan
A non property-investment residential mortgage loan is eligible for retail treatment regardless of exposure size. A non property-investment residential mortgage loan is:

i. a residential mortgage loan secured only over owner-occupied residential property; or

ii. the portion of a residential mortgage loan secured over both owner-occupied residential property and property that is not owner-occupied residential property, provided that the amount treated as a non property-investment residential mortgage loan is not more than the:

   total value of loans to that customer secured by those residential properties multiplied by the proportion attributable to owner-occupied residential property.

The proportion to be attributed to each owner-occupied residential property must be calculated as the property value of the owner-occupied residential property divided by the total property value of the property used as security, where the property value is determined in accordance with paragraph 37 [BS2A] / 4.150A [BS2B][5]. For a borrower, the total proportion attributable to owner-occupied residential property is the sum of all proportions attributable to each owner-occupied residential property.

An owner-occupied residential property is a property that meets the following criteria:

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[5] Such proportions should be updated if there is a change in the property value as defined in paragraph [37/4.150A].

- a natural person or related party of a natural person owns the property and is the obligor under the residential mortgage loan;

- that natural person, or a related party of that natural person that meets the definition of related party in paragraph 43(e) / 4.7A(c), intends to occupy the property either as their principal or secondary residence (a secondary residence includes holiday homes or a second home where the natural person or related party spends significant time); and

- in respect of a secondary residence, no rental income is derived from that property, except to the extent that the rental income is minimal (e.g. a bach rented out for six weeks a year).

Property-investment residential mortgage loan
A property-investment residential mortgage loan is a residential mortgage loan, or any part of a residential mortgage loan, that is not treated as a non property-investment residential mortgage loan.

Related party
For the purposes of this section, a person (A) is a related party of another person (B) if:

(a) A is the trustee of a trust and B is a beneficiary of the trust;
(b) A is a company or unincorporated entity and B is a shareholder of, or otherwise controls, A;
(c) A is the spouse, civil union or de facto partner of B; or
(d) A is the estate of the spouse, civil union or de facto partner of B.

Asset class treatment of residential property investment loans

Question 8: Are there any other asset class options the Reserve Bank should consider?

Question 9: What are the costs for your bank to migrate residential property investment loans to a new retail asset class?

Question 10: Do you have any comments on the Reserve Bank's preferred option of grouping residential property investment loans in a new retail asset class?

33. While two submissions commented that residential property investment loans could also be considered for treatment under a SME Retail-like asset class due to their business-like attributes, submissions on this section were generally supportive of the Reserve Bank's approach to place property investment loans in a new sub asset class within the retail asset class (Option C).

34. The costs of migrating residential property investment loans to a new retail asset class were incorporated in the estimates given in response to question two. Banks noted that the costs of reclassification resulted from changes to IT systems, changes to credit event reporting processes, data cleansing and management, and customer contact projects, among others. Many smaller banks indicated that reclassification costs would involve manual processing, and consequently, would be staff and resource intensive.

35. One bank disagreed with the proposition that internal model banks create a new property investment retail asset class, arguing that internal model banks could appropriately identify and capture risks relating to retail residential mortgage loans with an investment element within the existing grouping. However most banks supported the Reserve Bank's preferred option, to create a parallel retail asset class for property investor loans, with a few submissions noting that this would allow them to continue to portfolio-manage these loans and therefore reduce the burden of compliance.

<u>Response</u>

36. To maintain residential property investment loans within the existing asset class for internal model banks would not significantly reduce the opacity around whether residential property investment loans have a capital backing commensurate with their risk profile. Additionally, to do so would inhibit the ability of the Reserve Bank to implement macroprudential policies concerning residential property investment lending, where it deems it to be necessary.

37. The Reserve Bank will proceed as indicated in the consultation document. Residential property investment loans will be grouped in a new sub-asset class within the retail asset class.

38. In the consultation document, the Reserve Bank proposed calibrations for minimum LGDs and correlation factors for IRB banks for residential property investment loans. As noted above, several submissions disagreed with the proposed higher correlation factor and one with the proposed higher minimum LGDs for the new asset class. The evidence that the Reserve Bank has, for instance from the BRANZ 2010 House Condition Survey[6] which studied the quality of rental accommodation, is supportive of higher LGDs for loans on investor properties. Further, the Reserve Bank maintains that, in line with the Basel Committee's guidance, in the absence of New Zealand data on the performance of these loans during a severe downturn, relatively more conservative calibrations of correlation factors are appropriate.

39. To be clear, the Reserve Bank does not anticipate that PD estimates for loans in the new asset class would on average change significantly. However with higher correlation factors and minimum LGDs it is anticipated that risk weights for loans in the new asset class would rise under the changes to BS2B. The following tables present the proposed changes to BS2B.

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[6] See pp. 8-9, Beacon Resource: Performance of rental housing v3 (October 2014).

Proposed changes in BS2B – updated tables and definition

4.164A For the purpose of section 4.164 Correlation (R) is determined by the loan-to-value (LVR) of the residential mortgage loan in accordance with Table 4.11A.

Table 4.11A: Correlation factors for residential mortgage loans

LVR	Correlation (R), non property-investment residential mortgage loan	Correlation (R), property-investment residential mortgage loan
Above 90 percent	0.21	0.24
80 to 90 percent	0.20	0.23
Below 80 percent	0.15	0.17

Table 4.11: Minimum LGDs for residential mortgage loans

LVR in %	LGD in %, non property-investment residential mortgage loans	LGD in %, property-investment residential mortgage loans
90-100	38	40
80-89	33.25	35.5
70-79	28.5	31
60-69	19	21.5
Under 60	10	12.5

40. In creating a new sub-asset class in BS2A the Reserve Bank is required to specify the risk weights that apply for banks under the Standardised approach. The Basel Committee arrived at a 35% risk weight for residential mortgage loans using an asset class definition that includes both owner occupier and rented property. The Reserve Bank currently prescribes higher risk weights than 35% where the LVR associated with a loan is greater than 80%. One submission argued that, were higher risk weights to apply to the new property investment asset class, the 35% average would dictate that the risk weights for non-property investment loans should fall. However, the Reserve Bank will proceed with the risk weights for property investment loans in BS2A as follows. At this time, the Reserve Bank considers the existing risk weights to be appropriate for owner occupier mortgage loans. The following table presents the proposed changes to BS2A.

Proposed changes in BS2A – updated table

Table 4.11: Risk weights for claims secured by first mortgages over residential property

Loan-to-value ratio	Risk weight in %			
	If there is lender's mortgage insurance that qualifies under section 38		If there is no lender's mortgage insurance or lender's mortgage insurance that does not qualify under section 38	
	Non property-investment	Property-investment	Non property-investment	Property-investment

	residential mortgage loans	residential mortgage loans	residential mortgage loans	residential mortgage loans
Does not exceed 80 %	35	40	35	40
81 to 90 %	35	50	50	70
91 to 100%	50	75	75	90
Exceeds 100%	100			

Interim arrangements

> Question 11: How long do you envisage it would take to implement the proposed new requirements?
>
> Question 12: Do you have any comments on the proposed interim arrangements?

41. In the consultation paper, the Reserve Bank proposed that the new asset class treatment of residential property investment loans take effect from 1st July 2015 for new lending, with a nine month transition period for the reclassification of existing lending. The majority of banks submitted that this timing was aggressive and that they would struggle to implement the required system changes before the 1st July 2015. Most banks indicated that they could implement the new requirements from between October and December 2015 for new lending if required. A number of banks suggested that the timeline for the implementation of the new asset class treatment be extended, from the proposed 9 month transition period for the reclassification of existing lending, to 18 months and beyond.

42. Several banks opposed the Reserve Bank's proposition that IRB banks operate under the same risk weight requirements as standardised banks until such a time as models for the new asset class have been developed and approved by the Reserve Bank. Several IRB banks indicated that there would be significant costs involved in modifying capital calculation engines to combine standardised and IRB model outcomes for housing loans. One submission noted that to do so would incentivise the building of a lower quality property investor model in order to limit the impost of increased capital under a standardised risk weight requirement. Another submission noted that to do so may cause reported risk weights to rise substantially until a model is developed, which may confuse market analysts. One bank suggested that the Reserve Bank allow internal models banks to continue to use existing PD and EAD models with the higher correlation factors and minimum LGDs in the consultation document.

<u>Response</u>

43. The Reserve Bank understands the practical and technical difficulties that banks may have in changing their systems to comply with the new asset class treatment, given that the final definition had been uncertain until now. Accordingly, the classification requirements for new lending will be delayed, to come into effect from the 1st October 2015. The Reserve Bank does not accept some of the longer timelines proposed for

the reclassification of existing lending, having indicated for some time its proposals to create a new asset class for residential property investment loans. Nonetheless, the Reserve Bank appreciates some of the difficulties that banks may face in reclassifying loans, and therefore will extend the proposed transition period to 12 months, that is, for existing lending to be reclassified before 1st October 2016.

44. The Reserve Bank accepts the suggestion that existing PD and EAD models continue to be used to calculate risk weights for loans in the new asset class, until new models are developed. Existing models would need to be updated with the above prescribed correlation factors and minimum LGDs for loans in the new asset class.

45. The Reserve Bank intends to review the calibrations for the new asset class (correlation factors, minimum LGDs in BS2B, and risk weights in BS2A) after one year.

References

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