Reserve Bank
of New Zealand
Te Pūtea Matua

Summary of submissions: Tightening Loan-to-Value Ratio Restrictions

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Background

1. Reserve Bank of New Zealand - Te Pūtea Matua analysis indicates that house prices are above their sustainable level[1], and the risks of a housing market correction are continuing to rise. This follows a rapid acceleration in the housing market over the past 12 months combined with increased lending to higher-risk borrowers at, high-Loan-to-Value Ratios (LVR) borrowers.

2. In March 2021, we reinstated LVR restrictions on both owner-occupiers and investors, and tightened LVR restrictions further on investors in May 2021. Despite this, house prices have continued to rise and we have seen a significant increase in higher risk lending to owner-occupiers.

3. To address this, in September 2021 we consulted on a proposal to tighten LVR restrictions on owner-occupiers.

4. After considering submissions and undertaking further analysis, published as part of our Regulatory Impact Statement (RIS), we have decided to implement Option A from the consultation document, tightening restrictions on owner-occupiers. However, we have delayed the implementation of the new restrictions from 1 October until 1 November.

5. Table 1 shows the new LVR settings to come into force from 1 November 2021. We believe that the proposed tightening of LVR restrictions will over time help reduce the number of highly leveraged borrowers and help to build resilience in the financial system.

Table 1 - LVR restrictions from 1 November 2021

	Current Settings	New settings from 1 November 2021
Owner-occupiers	Speed limit: 20% Threshold: 80%	Speed limit: 10% Threshold: 80%
Investors	Speed limit: 5% Threshold: 60%	Speed limit: 5% Threshold: 60%

6. This document outlines the feedback received and the key themes emerging from the consultation process to tighten the LVR restrictions on owner-occupiers. The accompanying RIS provides an assessment of the costs and benefits of the decision to tighten LVRs for owner-occupiers.

7. We will continue to monitor the situation closely and review whether the LVR settings remain appropriate.

[1] Our analysis of house price sustainability is set out in detail in the August Monetary Policy Statement (MPS) and the key findings are also summarised in this document. https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Monetary%20policy%20statements/2021/mpsaug21.pdf?revision=3627c6fa-6462-453a-af85-06e62f47705c

Consultation Process

8. The consultation on the Reserve Bank's proposal to reinstate LVR restrictions opened on 3 September 2021, and closed on 18 September 2021. We received 12 submissions to the consultation paper, comprising:

    - four submissions from industry – ANZ, ASB, Kiwibank and the New Zealand Bankers Association (NZBA); and,
    - eight submissions from members of the public.

9. These submissions have been anonymised and uploaded to the Reserve Bank website.

10. This document provides a summary of the submissions received in response to our consultation, as well as a brief response to those submissions. Here, we focus on the common themes and views raised in the submissions. This document is not intended to be an exhaustive summary and response to all points raised. We direct readers to the consultation document and regulatory impact statement (RIS) for our full analysis of the issues that led to the decision to tighten LVR restrictions for owner-occupiers.

Summary of Submissions

Industry respondents supported tightening LVR restrictions.

11. Industry respondents recognise the need for further tightening in order to help control house price inflation and mitigate potential risks to financial stability and they were comfortable with tightening LVR restrictions.

12. The submissions from the public were less supportive. Two of the submissions from the public supported tightening LVRs, and five opposed the tightening. The eighth public respondent did not oppose tightening LVRs, but did not think it would have much impact.

Respondents prefer Option A over Option B

13. All of the respondents that supported tightening LVR restrictions preferred Option A (the LVR threshold for owner-occupiers remains at 80 percent, but the speed limit reduces from 20 percent to 10 percent) over Option B (the LVR threshold for owner-occupiers reduces from 80 percent to 75 percent, but the speed limit remains at 20 percent).

14. A number of reasons were given for this, including:

    - Option A is better targeted in terms of reducing high-LVR lending as the speed limit would be reduced from 20 percent to 10 percent. Option B may not reduce the amount of lending over the 80 percent LVR band as the speed limit would remain at 20 percent – this mean that 20 percent of lending to owner-occupiers could still be at an LVR of above 75 percent.
    - Option B is likely to create quite a lot of complexity and would be difficult to implement. The Combined Collateral Exemption, staff training and

communications, customer education, internal processes and policies, and internal LVR modelling would be very difficult to adjust for a new LVR threshold, especially given the short time frames. Many approvals and pre-approvals are in the 75 percent to 80 percent LVR bucket, which exacerbates the issues that relate to managing the pre-approval pipeline.

- Option B would have a greater impact on first-home buyers than Option A as a lot of first-home buyers borrow in the 75 percent to 80 percent LVR bucket.

Implementation is very fast, so it would be difficult to manage the pipeline of existing pre-approvals

15. The banks felt that implementation from 1 October was very quick and would not give them long enough to adjust to any new restrictions. For example, pre-approvals last 90 days, so some banks may need to consider cancelling some existing pre-approvals to comply with any new restrictions.

16. Respondents provided two main suggestions to address this:

    - Some respondents suggested that the initial compliance period be extended to five or six months (i.e. from 1 October 2021 to 31 March 2022). Others suggested that the initial compliance period be extended to five months from 1 October to 28 February, after which there would be rolling periods of three months.

    - One respondent suggested that the restrictions be applied in a stepped approach. For example, reducing the speed limit from 20 percent to 15 percent in the three months from October to December, then from 15 percent to 10 percent in the three months from January to March.

Reserve Bank response

17. We have decided to delay the implementation of the new LVR restrictions by one month, from 1 October to 1 November. This is due to the shorter than usual timeline for this consultation combined with the disruptions from heightened COVID-19 alert levels to customers and banks in managing or completing purchases associated with existing pre-approvals. The combined effects of the short timeline and COVID-19 restrictions would make it more difficult for banks to meet the new LVR restrictions if imposed on 1 October, risking a sharper than intended slowdown in lending and more abrupt impacts on approved borrowers.

18. Historically, we have given banks around three months from announcing a proposed LVR change to implementation, in order to give banks a chance to prepare their loan pipeline. Changing the implementation date to 1 November will give the banks nearly three months from when we first announced our proposed LVR change on 8 August.

Some respondents do not support tightening LVR restrictions.

19. Some respondents disagreed with our analysis and argued that we had not made the case for tightening LVR restrictions. Most of these respondents felt that the analysis, including the cost-benefit analysis, does not support a tightening of LVRs.

20. They argue that there is not an immediate concern to financial stability as existing borrowers have experienced a large equity gain over the last year. Furthermore, some respondents also point to the fact that the Reserve Bank's stress tests show that the banking system would remain stable and resilient even if house prices fell significantly.

21. This is because the Reserve Bank's argument for LVR restrictions depends, in part, on its data on the stock of lending by LVR, set out in Figure 5 of the consultation paper and used in the analysis presented in Figure 9. The Reserve Bank did not explain the source of the data, and in particular whether house values have been adjusted to market value.

Reserve Bank response

22. The respondent is correct that the data in Figure 5 of the consultation paper is the stock of lending by regulatory (i.e. origination valuation) LVR. As noted by the respondent, the regulatory LVR overstates the actual risk position when prices are rising.

23. To address this, Figure 9 of the consultation paper shows data which is based on an estimated "market value" or "dynamic" LVR, i.e. the LVR position of the lending updated to reflect the value of the property today, rather than the value at the time the loan was originated. This takes account of the new risk position of borrowers who have benefitted from further house price increases. It is different from Figure 5, which does not adjust for these further increases in a borrower's equity position. It might also have been unclear that the figure shows lending from the past year and not total lending. The Reserve Bank, therefore, stands by the estimate that a 20 percent fall in house prices could lead to 22 percent of recent high LVR borrowers being in negative equity.

24. With the estimated dynamic LVR data in Figure 9, the chart plots the percentage of lending from the past year which would be in negative equity, following a 30 percent price decline from the June 2021 price level.

Respondents argued that capital requirements are more efficient

25. Some respondents also argue that capital requirements are already sufficient to protect the financial system from 'bad loans', and that capital requirements are more efficient than LVR restrictions in addressing financial stability risks. Banks are required to hold a certain percentage of capital relative to their risk weighted assets. High-LVR loans have a higher risk weight, so banks are required to hold more capital as a result. Therefore, it is argued that the risk of high-LVR loans is already accounted for.

Reserve Bank response

26. We acknowledge that higher capital requirements partially offset the risks of higher-LVR loans. However, past Reserve Bank research[2] has found that the LVR restrictions have significantly improved the resilience of the banking system. The LVR policy has reduced the scale of mortgage defaults and credit losses that would occur in a housing downturn, due to a reduction in risky loans on bank balance sheets and the mitigation of a potential house price decline.

27. The resilience benefit has been partly offset by a fall in capital requirements that results from lower credit risk, reducing the banks' buffer for absorbing credit losses. Nevertheless, the LVR policy is estimated to have reduced mortgage losses – as a share of the capital banks hold against their housing loans – by 12 percentage points. The LVR policy is found to have mitigated about half of the deterioration in bank resilience from 2013 that would have occurred in the absence of the policy.

28. We also note that capital requirements are generally stable across the economic and financial cycle. By contrast, macroprudential tools such as LVR restrictions can be adjusted over time in response to changes in systemic risk ('leaning against the cycle'). As such, LVR restrictions are better suited to addressing boom/bust dynamics in the housing market.

Cost Benefit Analysis

29. Some respondents also argued that the cost-benefit analysis was incorrect. They argue that we had underestimated the efficiency losses from tightening LVR restrictions and that we had overestimated the financial stability and wider economic benefits that this proposal could have.

30. As evidence of this, one respondent pointed to the fact that there has been less development of readily available alternative credit providers as a result of LVR restrictions than expected. This suggests that some potential purchasers have been forced out of the market as there are fewer options to borrow from alternative credit providers.

Reserve Bank response

31. Our view is that the potential allocative efficiency costs of tightening LVR restrictions further would be of a similar nature to those identified in previous rounds of tightening (i.e., restricting lending to otherwise creditworthy borrowers). The new LVR settings are in line with our previous tightest LVR settings from October 2016 to January 2018. Industry demonstrated during this period that they can still efficiently allocate credit despite the restrictions.

32. We can also ease restrictions once the financial stability risks decline, as we did in 2017-2019. Therefore, the efficiency costs are transitory and can decline as the risks decline.

[2] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Analytical%20notes/2019/an2019-07.pdf?revision=37bd70e8-aed6-4457-be16-fcbb95bf3727

Impacts of interest rate rises

33. A few respondents felt that the concerns about the impacts of increased serviceability stress (as a result of interest rate increases) on economic activity and consumption were misplaced. They state that interest rates increase, generally, because the Reserve Bank has increased the OCR in order to dampen inflationary pressures. Therefore, economic activity and consumption should fall as a result, which is arguably desirable if there are inflationary pressures.

Reserve Bank response

34. While this is correct, part of our concern is that the current large mortgages that new borrowers are taking out will lead to a more unequal impact of changes in monetary policy. Due to rapid house price appreciation and low interest rates, a recent borrower with the median new mortgage will need to cut back their spending more substantially in response to rising interest rates than was true 10 years ago.

Rising house prices are a concern, but a tighter LVR would not have much impact

35. Some respondents acknowledged the issue of rapidly rising house prices; however, they argued that tighter LVR restrictions would have very little impact and that other policies are better placed to dampen house price inflation.

36. Many of these policies are not within the Reserve Bank's control or mandate, including:

    - Changes to tax policy. This may include introducing a stamp duty or a form of transaction tax.
    - Supply side measures. For example, initiatives to free up land, simplification of the building consent process, and a greater ability to import skilled workers.

Reserve Bank response

37. Our main goal when implementing macroprudential policy is to promote the maintenance of a sound and efficient financial system. However, in February 2021, the Government issued a direction to require the Reserve Bank to have regard to "support[ing] more sustainable house prices, including by dampening investor demand for existing housing stock which would improve affordability for first home buyers" when setting financial stability policy. Having regard to house price sustainability aligns with our objective.

38. We acknowledged in the consultation paper that tightening LVR restrictions would only have a small impact on house prices. Based on past Reserve Bank research, we expect that tightening LVR restrictions will have a modest impact on house price inflation.[3] We also noted that the effect on house prices is likely to be short term (one year or less).

[3] https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Analytical%20notes/2013/an2013-05.pdf?revision=4c2d73ed-89d0-4d06-b77a-904380fc59c5

39. However, the short term price effect of LVRs will help improve financial stability by removing the riskiest borrowers from the market, and at the margin contribute towards more sustainable house prices.

40. The change also reflects the availability of macroprudential tools at this point in time. Debt serviceability restrictions are not currently a practical option but their availability in the future could have an impact on LVR settings. The Reserve Bank will consult on a framework for debt serviceability restrictions in the coming months.

A tighter LVR would impact first-home buyers the most

41. Most respondents felt that tightening LVRs would disproportionately impact first-home buyers. It was noted that many first-home buyers borrow at an LVR of greater than 80 percent and many are also borrow in the 75 percent to 80 percent LVR bucket. Therefore, a high proportion of first-home buyers would be impacted by either option. There is concern that the LVR would further 'tilt' the playing field away from first-home buyers.

Reserve Bank response

42. We acknowledged in the consultation document that first-home buyers would likely be the most impacted by this change. However, this is an unavoidable consequence of addressing the financial stability risks we are currently seeing in the market. We note that under the new settings, banks will still be able to make up to 10 percent of new lending to owner-occupiers at high-LVRs, and the majority of this will be to first-home buyers. In addition, the LVR exemption regime allows buyers who qualify for Kainga Ora First Home Loans, and those purchasing new build properties, to continue borrowing at higher LVRs

43. Moreover, Option B (reducing the LVR threshold to 75 percent) would have had a larger impact on first-home buyers. It would have likely stopped a larger number of first-home buyers from purchasing homes, and forced those that did buy to have larger deposits.

Next steps

44. Thank you to everyone who submitted on this proposal. The full list of submissions will be available on our website.

45. We will work with banks to implement the new tighter LVR restrictions restricting banks to no more than 10 percent of new lending to owner-occupiers at an LVR above 80 percent from 1 November 2021.

46. We also intend to consult in November on the introduction of debt serviceability restrictions.