Reserve Bank of New Zealand
Te Pūtea Matua

Policy options to support more sustainable house prices

Background

The Reserve Bank closely monitors the financial system to assess for emerging risks. These assessments include looking at the risk that a downturn in the housing market poses to those who are excessively leveraged – both borrowers and lenders. The results of these assessments factor into our financial policy settings aimed at both preventing boom-bust cycles, and building up financial system resilience.

In February 2021, the Minister of Finance asked us to have regard to house price sustainability into when making financial stability decisions. This is separate from the Monetary Policy Committee's monetary policy remit and generally aligns well with our current work, as unsustainable asset price growth can lead to a sharp correction in prices, which would have negative implications for the broader economy and financial stability. Housing makes up about half of households' net worth, and mortgage lending makes up more than 50 percent of total bank loans.

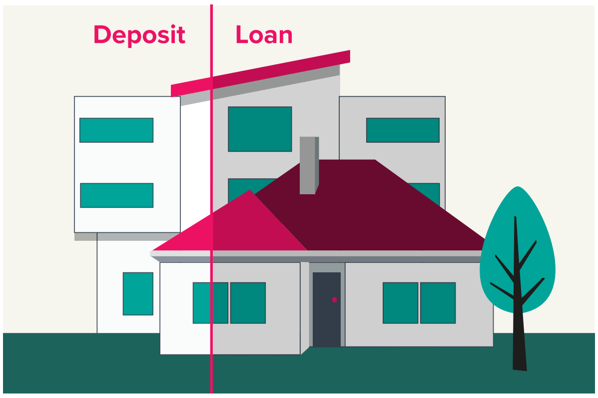
What is house price sustainability?

We believe that a 'sustainable house price' is the level that the price would be expected to move towards over several years, reflecting the underlying drivers of supply and demand for housing, including population growth, building costs, land supply, and interest rates. For more on this, see Why the Reserve Bank is concerned about New Zealand's rising house prices.

While financial stability tools can assist with the Government's housing policy objectives, the key drivers of house prices and housing affordability (such as population growth, land use constraints, infrastructure, building costs, and long-term trends in global interest rates) fall outside of our remit and require a broader public policy response.

The Government recently announced changes to housing and tax policies to support more sustainable house prices. The Reserve Bank also reintroduced restrictions on mortgage lending with high loan-to-value ratios (LVRs). Combined with low levels of immigration, the waning impact of past interest rate declines, and rising housing supply, we believe that these factors will dampen house price inflation over 2021 and 2022.

What are the current policy tools available to the Reserve Bank?

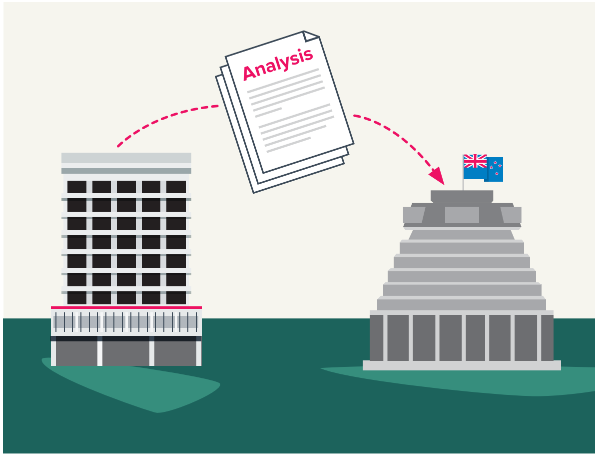


The main tool we use to respond to 'boom and bust' cycles and reduce risks to the financial system from unsustainable house prices is mortgage Loan-to-Value Ratio restrictions, or LVRs. LVRs are a measure of how much a bank lends against mortgaged property, compared to the value of that property. This tool is included in our current Memorandum of Understanding on macro-prudential policy with the Minister of Finance.

The Reserve Bank first used LVRs as a financial stability tool in 2013 and we have revised LVR settings over time. We typically review our financial stability tools when we produce our bi-annual *Financial Stability Reports*. LVRs were removed last year in response to the economic impact of the COVID-19 pandemic. They were reinstated in March, with a further tightening of the restrictions affecting property investors occurring in May.

Some other tools exist but are generally less effective. The Minister of Finance invited the Reserve Bank to advise on any other policy tools that could be worthwhile.

What we said to the Minister



In May we wrote back to the Minister outlining potential financial policy instruments that we could use to support more sustainable house prices. In our assessment, we detailed that debt serviceability restrictions would be the most effective tool to add to our toolkit to support financial stability and house price sustainability. The majority of our analysis focused on the option of Debt-To-Income (DTI) limits, but we noted that other debt serviceability tools are also in use internationally and could be considered as alternatives to DTI limits.

DTI limits are calculated by measuring the ratio of a borrower's total debt in proportion to their total income. As such, they can be an effective tool to ensure borrowers do not take on more debt than they can afford. Our analysis indicates that a DTI tool would primarily impact investors and higher-income owner occupiers, who borrow at higher DTI ratios on average, and the tool could be calibrated to exempt the large majority of first-home buyers. DTI limits could also benefit first-home buyers overall by supporting sustainable house prices and dampening investor demand.

Along with LVR restrictions, debt serviceability restrictions are commonly used internationally to address financial stability issues related to the housing market. We consider LVR restrictions and debt serviceability restrictions to be complementary tools as they address different dimensions of housing-related risk; DTIs reduce the likelihood of mortgage defaults while LVRs largely reduce losses to banks if borrowers default.

We also assessed the effectiveness of restricting interest-only lending and determined that currently, interest-only lending to investors (or other borrowers) does not pose financial stability risks, nor do they impact negatively on the Government's housing objectives. We also found that restricting interest-only lending would be challenging to implement and enforce.

In his response, the Minister has agreed to add debt serviceability restrictions to the MoU in principle, on the condition that any implementation is designed to avoid impact, as much as possible, to first home buyers.

Next steps

If a further tightening of policy settings is needed in the short term, the most straightforward response would be to tighten LVR restrictions further.

Over the coming months we will be discussing with industry the feasibility of implementing a DTI limit (or other debt serviceability tools) as part of our financial stability toolkit. This does not indicate that we have any immediate plans to implement the tool, rather it will allow us to further assess the tool's effectiveness. Any decision on implementing debt serviceability restrictions will be preceded by a full public consultation process, along with a Regulatory Impact Assessment.

We will also be continuing to publish our assessment on the sustainability of house prices and related financial stability risks every six months in our *Financial Stability Report* (FSR). Between FSRs we will monitor developments in the housing market, and will review our financial policy settings. The initial effects of the recent tightening of LVR settings and the Government's recently announced housing policy changes will become clearer over the coming months. If further action is required, we will determine the appropriate response based on the tools available to us.