The Treasury

Loan-to-Value Restrictions
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To: Minister of Finance

Deadline: Wednesday 3 July

Aide Memoire: Briefing on Loan to Value Restrictions

This note updates you on work looking at ways to mitigate the possible adverse effects that the imposition of loan-to-value restrictions (LVRs) on new mortgages may have on first home buyers. We recommend that you read this note ahead of your discussions with the Governor of the Reserve Bank on Wednesday, 3 July.

Context

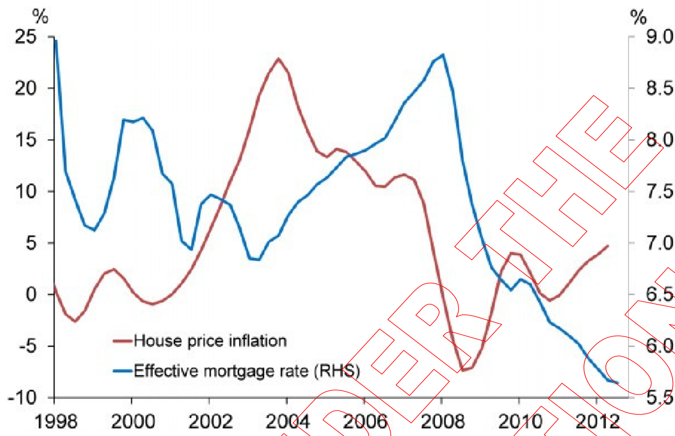
On 19 June the Reserve Bank signalled to you that it is investigating the establishment of restrictions on the issuance of new high loan-to-value (LTV) mortgages by commercial banks. In response to these developments, we have received a request from the office of the Prime Minister to provide advice on possible policy options for the Government to mitigate the impact that housing LVRs may have on first home buyers, without compromising the Reserve Bank's financial stability mandate.

Work in this area should be viewed in the broader context of the housing affordability work stream and overall macroeconomic management. The financial stability concerns identified by the Reserve Bank from current and prospective house price inflation have substantial overlap with the supply pressures that the housing affordability work stream is looking to address over the medium term. Drawing on the experience of the last house price cycle, these house price developments could also have implications for macroeconomic management.

Prices as a key driver

We share the Reserve Bank's view that house prices are high across a range of metrics, and are likely overvalued at current levels. Rising house prices together with overvaluation could have a negative impact on financial stability, macroeconomic management, the affordability of housing and the social outcomes that are associated with these factors. Additionally, high prices may also affect broader economic performance over time by diverting resources into sectors of the economy that tend to exhibit lower productivity.

Figure 1 - House price inflation and effective mortgage rate



Rising house prices in Auckland and Christchurch are a reflection of excess demand for housing, underpinned by obstacles to increasing housing supply. Historically low interest rates are also contributing to increasing housing demand.

Although an increase in residential investment is forecast over the medium term, any large increases in housing supply are unlikely to become available over the short term (1-2 years). The consequence of this lag is likely to be elevated levels of excess housing demand for some time. In the absence of Reserve Bank (OCR/macro-prudential) or government policy action to moderate demand, we are likely to see price growth remaining strong over the short term.

In a recent speech the Deputy Governor of the Reserve Bank, Grant Spencer, outlined the Bank's concerns with the housing market and its case for the use of LVRs. He also explained the Bank's reluctance to use the OCR to deal with what it sees as inflation that is isolated to one market. General (CPI) inflation is currently tracking below target, and unemployment is above trend. In addition, the exchange rate effects of an OCR increase are also seen as undesirable. With the new macro-prudential framework in place, the Bank believes that it can use a more specifically targeted instrument to help reduce pressure on the housing price-cycle. While both tools have dampening effects on demand in the economy, the Bank has taken a view that LVRs would do less harm to the wider economy than the OCR.

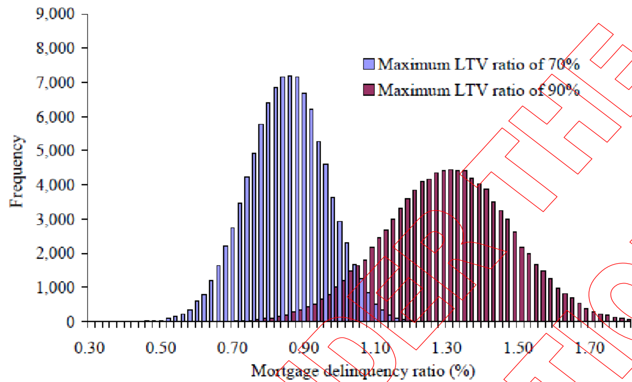
Evidence on the effectiveness of LVRs

There is currently a very limited understanding of how effective these tools would be in the New Zealand context as they are untested. There is, however, some international evidence that LVRs are an effective financial stability tool to deal with housing demand. There is reasonably strong evidence of the following:

- High LTV borrowers pose larger default risks
- Larger amounts of high-LTV lending increases the sensitivity of bank balance sheets to income shocks, and

- The use of LVRs increases the resilience of the financial system by decreasing the sensitivity of bank balance sheets to mortgage default. Figure 2 presents an estimate of this for Hong Kong.

Figure 2 - Simulated distribution of mortgage delinquency ratio for Hong Kong



Source: Wong, et. al. (2011) Hong Kong Monetary Authority Working Paper

In addition, there is also emerging (but limited) evidence from a small group of countries to suggest that LVRs can play a role in controlling house prices.

Evidence on the impact of LVRs

We currently do not have a good understanding of the distributional profile of high-LTV mortgage lending. While the Reserve Bank is working with commercial banks to collect and measure distributional data, it is unlikely that such information will become available before the Reserve Bank may wish to deploy restrictions on high-LTV lending.

Preliminary information based on discussions that the Reserve Bank has had with two commercial banks indicates the following:

- **Total value of lending**:
  - Around 20 percent of new mortgage lending is to first home buyers
  - Around 40 percent of new high-LTV lending is to first home buyers, and
  - Around 30 percent of all new lending is in the high-LTV category

- **Number of loans:**
  - Around 65 percent of first home buyers have high-LTV loans

Using this limited data, and assuming it roughly represents aggregate activity across all banks, we arrive at the following tentative inferences:

- About 12 percent of total new lending is to first home buyers on a high-LTV basis, and

- About 65 percent of first home buyers are borrowing on a high-LTV basis, but this represents only 60 percent of the **dollar value** of high-LTV lending to first home buyers. This could mean that low-LTV first home buyers are borrowing more on average than high-LTV first home buyers.

Dividing borrowers into equity and income categories, there are two groups of high-LVR borrowers:

- **Low-income / low equity**: Given New Zealand's relatively tight lending criteria, and the presence of the Welcome Home Loans scheme that offers mortgage insurance to banks lending in this segment, it is unlikely that there are many borrowers in this category receiving high-LTV loans. Those who do not meet the Welcome Home Loan criteria would be affected by the introduction of LVRs.

- **High-income / low equity**: These creditworthy but equity constrained borrowers would be affected by LVRs. International evidence suggests that this group contains the largest number of affected borrowers.

With limited data, it is difficult to get a definitive picture as to who would be most affected by the use of LVRs. However restrictions are unlikely to be absolute – the Reserve Bank has indicated that it would use a "speed limit" approach that would still allow a proportion of borrowers to receive high-LTV loans.

Possible options

We have been looking at possible ways to mitigate the effect of LVRs on first home buyers. In evaluating these options, we have made only one explicit judgement - that the current trend of housing price growth is undesirable for macroeconomic and financial stability, or the affordability of housing. We have not, however, made judgements around the utility derived from the equity value of home ownership. In addition, we have not been asked for advice on whether mitigating the effects of LVRs on first home buyers is a good policy option, but would be happy to do so.

Under the Memorandum of Understanding (MoU) that you signed with the Governor, the Reserve Bank would consult with you should they believe that the use of LVRs is warranted. While you do not have any formal overrides under the Reserve Bank Act, you would be able to provide your input into the Bank's decision-making process under the MoU. In view of this opportunity we have also examined some possible options that you may want to consider and discuss when responding to the Bank's formal consultation.

The enclosed table provides you with an overview of the options that could be considered further. The options are evaluated against the impact on: (i) financial stability, (ii) macro stability, and (iii) distributional/equity considerations. In all cases the principal transmission channel is the effect on house price growth. Of the full set of options available to the Government, only a small number are likely to be implementable and have an impact in the short term. We have also provided a number of other options that would require more lead time to design and implement, but may help alleviate excess housing demand over the longer term.

In your meeting with the Governor, you may want to discuss the possibility of the Bank using a targeted approach to LVRs based on specific pressure points in the housing market, or by geographical area. You may also want to ask the Governor for his input on how the government might use policy options to complement the Bank's use of LVRs.

A summary of short-term measures is presented below (Note: the impacts of these options are assessed relative to a baseline scenario where LVRs are implemented without further policy action):

Short Term Options	Impact on Financial Stability	Impact on Macro-stability	Equity Consider-ations	Summary
Targeted/Tiered LVRs	Uncertain	Likely positive	Likely positive	May be possible to implement
Subsidies/Kiwisaver/Welcome Home Loans	Likely negative	Likely negative	Positive	May offset gains of using LVRs
HNZC Discounted Sales	None	None	Positive	Under consideration as part of housing affordability work
Accelerating supply-side measures	Positive over time	Positive over time	Positive	Benefits accumulate over time; will require "skin in the game"

In addition, there are some longer term measures that could have an impact on housing demand but would require more detailed design and lead time to implement. The ones that we think might be feasible are:

- Incentivise first home buyers to build a bigger deposit
- Restrictions on overseas buyers
- Establishing a right-to-buy scheme for HNZC tenants
- The use of real interest mortgages
- Implementing the risk free return method on rental housing income
- Establishing a capital gains tax, and
- Levying a land tax on the value of unimproved land owned by the taxpayer

There are also some options that would not recommend:

- Recommending that the Reserve Bank does not use LVRs
- Alternative tools such as sectoral risk weights or OCR
- Mortgage interest levies
- Mortgage interest tax relief to first home buyers
- Non-resident withholding taxes on rental income, and
- Capital gains taxes for non-residents

Conclusion

We believe that the use of LVRs is likely to be the best available option in dealing with excess demand for housing in the short run, while broader policy to stimulate housing supply takes effect. While there are likely to be some negative effects on a proportion of first home buyers, they are likely to be smaller than the economy-wide impacts, including distributional effects of an increase in the OCR. While there may be ways to counter the impact of LVRs on the affected group of first home buyers, these measures are likely to diminish the effectiveness of LVRs, and there are likely to be fiscal costs associated with them.

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Options	Description	Impact on financial stability	Impact on macro-stability	Distributional / equity considerations	Other considerations	Initial assessment
Possible options for further consideration						
More targeted or "tiered" LVRs	RBNZ has currently designed LVRs with several exemptions (including for the Welcome Home Loans Scheme, the Kainga Whenua programme, certain bridging finance loans, and re-financing of existing home loans). Under this option, LVRS would be applied in a more targeted way. Possible options include: (1) Geographical LVRs (i.e. apply in Auckland) (2) Exempting first-home buyers, (3) Exempting houses below a certain value (4) LVR speed limits for investors in residential housing (i.e. non-owner occupied).	Could possibly reduce risks to financial stability, depending on the nature of the exemption. While Auckland is a strong driver of current house price inflation, the Reserve Bank continues to be concerned about the level of house prices in other parts of the country. There is also a risk that these pressures could be diverted from Auckland to other areas. First-home buyers comprise a significant proportion of new high LVR lending. There is some anecdotal comment that high income first-time buyers are a key driver of house price pressures. If this is the case, then an outright exemption would likely undermine the effectiveness of LVRs in reducing risks to fin. stability. But an exemption for houses under a certain value may still be effective.	Could be positive for macro-stability, depending on the nature of the exemption.	Applying geographical LVRs would have distributional impacts for different regions. May help improve housing affordability in the regions where LVRs are applied but this could be offset by house price increases in regions not applied. An outright exemption for first-home buyers would mean fewer distributional issues relative to the current design of LVRs. However, if first-home buyers are driving a significant amount of house price inflation, this type of LVR may also have limited impact on housing affordability. An exemption for homes under a certain value would impact more heavily on high-income individuals. If high-income individuals are a key driver of house price pressures, then this could have positive benefits for housing affordability.	Could possibly be achieved in the short term. Governor has final decision on macroprudential tools. Appetite of RBNZ to design more targeted LVRs is currently unclear. However, their consultation paper on high LVR lending is still out for consultation and they are yet to finalise their views on design.	Could be considered further Our initial view is that it may be possible to apply more targeted LVRs to address risks to financial stability (whilst avoiding some of the impacts on first-home buyers).
Subsidies for first-home buyers / **Kiwisaver Home Deposit Scheme /** **Welcome Home Loans**	This option would increase government assistance for first-home buyers. There are various design options. The Crown currently offers two products aimed at assisting people to buy homes (KiwiSaver Home Deposit Scheme and Welcome Home Loans). These schemes could be extended by lifting volume caps (WHL), increasing income thresholds or increasing deposit subsidy levels (KS). Designing a new subsidy or shared equity scheme is possible but unlikely to be delivered quickly.	Likely to reduce gains to financial stability from LVRs. The Kiwi Saver Home Deposit Scheme increases the cash available to homebuyers for deposits. Increasing eligibility may encourage buyers to take on more debt/seek more expensive houses. This could exacerbate house price pressures. WHL is a loan deposit scheme, which allows eligible people to borrow up to $200k without a deposit or up to $280/350k (depending on the region) with a deposit of 15% of the debt above $200k. Increasing price caps or income thresholds would encourage more borrowing. This may also exacerbate house price pressures.	Depending on how widely the schemes are extended, this could increase demand for housing and aggregate demand (through wealth effects on existing owners).	Would directly help first-time buyers onto the housing ladder. However, it could also push up property prices, possibly making houses even less affordable. Welcome Home Loans are targeted at lower-income groups and therefore have some progressive distributional impacts. The KiwiSaver scheme is targeted at first home-buyers and median-income groups ($100k for 1-2 borrowers; $140k for 3+). House price caps apply to both schemes. Lifting income caps could reduce the progressive distributional impacts of these two schemes.	Possibly some direct fiscal costs to Government from extension of the schemes. Also, the Government, as the mortgage insurance provider for Welcome Home Loans, would be bearing increased risk. Extending KiwiSaver withdrawals and/or the Welcome Home Loan scheme could potentially be done in a relatively short timeframe. Designing a new subsidy or shared equity scheme would likely take much longer.	Already being considered This option would directly address concerns about impact on first-home buyers. Designing this option as an extension of an existing scheme (such as Welcome Home Loans) could potentially be implemented in the short term. However, this option may partially offset financial stability gains from LVRs
HNZC discounted sales in certain regions	The Minister of Housing is currently exploring the option of HNZC selling surplus assets in the regions to low/median-income families, with some form of discount to the price (e.g. a 'gifted deposit')	Little/no impact on financial stability expected. Eligible families/buyers would still need to satisfy bank lending criteria, and volume of sales is expected to be low.	Little/no impact on macro-stability expected. Volume of houses likely to be sold under such a scheme would be small (e.g. in the hundreds of houses) and would not be in high demand areas.	Eligibility criteria currently under consideration by Minister of Housing would target first home buyers.	Discount to sales price would need to be relatively low (e.g. 10-15%) for HNZC to satisfy its legal obligation to manage its assets and liabilities efficiently.	Already being considered Unlikely to have a large impact but directly addresses concerns about first-home buyers without adversely affecting financial/macro-stability.
Restrictions on overseas buyers	This option would strengthen restrictions on overseas citizens buying residential property in NZ	Benefits for financial stability are likely to be limited. Current data suggests that non-residents and foreigners are not significantly contributing to house price inflation.	Benefits for macro-stability are likely to be limited.	This option would have distributional impacts as it would tilt home ownership towards residents and/or NZ citizens	Policy flexibility appears very limited in this area due to restrictions under our Free Trade Agreements	Could be considered further We are still to determine some more specific options that would be palatable under our Free-Trade Agreements.
Additional supply-side measures under housing affordability work	There is an existing work programme set up to increase the responsiveness of housing supply to demand in the long term. There may be some additional measures we could implement in the short term. For example, greater central direction through the planning process. Under this the government would provide a housing/urban development focused NPS, NPS/NES hybrid, or a specific module in the National Plan Template on housing/urban development.	Greater central direction through the planning process may not have a significant effect on short-term expectations of house buyers but may lower long-term expectations of land owners about the future path of house prices, potentially bringing forward supply.	Greater central direction, if it has the desired effect, would make supply more responsive – thus enhancing macro-stability.	Making supply more responsive should moderate house prices so there could be equity gains.	The cumulative impact of changes to the supply-side might be significant, but will take a long time to become material, in part because new housing comprises a small component of the overall housing market. In terms of providing greater central direction, there may be a limit to the amount of direction the Crown can provide given local context. May be perceived as cutting across local autonomy.	Could be considered further Will continue to progress the work programme. It is unlikely to address the short-term issues identified. Greater central direction is an additional measure that may have an impact in the short term and would make explicit the Government's expectations of local councils in terms of housing/urban development.