The Treasury

2015 Loan-to-Value Ratios/Macroprudential Policy Information Release

Release Document

June 2015

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: RBNZ Financial Stability Report, May 2015

Date:	12 May 2015	**Report No:**	T2015/993
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Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Note the major risks to financial stability identified in the RBNZ's May 2015 Financial Stability Report	13 May 2015

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Lucy Greig	Senior Analyst	04 917 6085 (wk)	[1]	✓
James Beard	Manager, Financial Markets and International	04 917 6161 (wk)	[1]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: No

Treasury Report: RBNZ Financial Stability Report, May 2015

Executive Summary

The RBNZ is releasing its *Financial Stability Report* (FSR) on 13 May 2015 at 9am. This note provides you with its main findings.

Overall, the RBNZ finds that the financial sector in New Zealand is relatively robust, with the banking system well capitalised, operating effectively and supporting growth. Nevertheless, financial risks have increased since the November FSR, with the key risks to resilience identified as:

- the probability of a sharp correction in house prices;
- the elevated debt levels of the dairy sector and decline in rural incomes;
- the extremely benign conditions in global financial markets that may not be sustained.

The FSR announces two policy developments:

- the consultation on changes to the RBNZ's macroprudential settings around LVR limits, restricting high loan-to-value lending to investors in the Auckland region, whilst relaxing the limit for residential lending outside of Auckland.
- the establishment of a new asset class for loans to residential property investors, which are given a higher risk weight than owner-occupier mortgages.

Recommended Action

We recommend that you:

a **note** the contents of the May 2015 *Financial Stability Report*

James Sargent

pp. James Beard
Manager, Financial Markets and International

Bill English

Hon Bill English
Minister of Finance

Treasury Report: RBNZ Financial Stability Report, May 2015

Purpose of Report

1. The RBNZ will be releasing its Financial Stability Report (FSR) on 13 May 2015 at 9am. This note provides you with the main findings.

   Overall, the FSR assessment is that the financial system in New Zealand is sound and operating effectively to support growth in New Zealand. Banks are well-capitalised with good asset quality and profitability. The business sector outlook is strong and improving, profitability remains strong and borrowing modest. Financial market infrastructure continues functioning satisfactorily.

2. Nevertheless, financial risks have increased since the November FSR, with the key risks to resilience identified as:

   - the probability of a sharp correction in house prices;
   - the elevated debt levels of the dairy sector and decline in rural incomes;
   - the extremely benign conditions in global financial markets that may not be sustained.

3. The key policy changes announced in the FSR are:

   - Changes to the current macroprudential settings, restricting high loan-to-value lending to investors in the Auckland region, whilst relaxing the limit for residential lending outside of Auckland.
   - Establishment of a new asset class for loans to residential property investors, which are given a higher risk weight than owner-occupier mortgages

Analysis

Housing market instability seen as a significant risk to ongoing stability, as a result of house price pressures in the Auckland region.

4. The RBNZ assesses that the LVR limits in place since October 2013 have limited the increase in financial system risk from the housing market at a national level. However, the FSR notes that housing market risk has increased over the past six months, centred in the Auckland region. These price rises have been driven by supply constraints, record net immigration and low long-term mortgage rates. The RBNZ's concerns are centred on a possible correction in house prices brought on by economic conditions reducing households' ability to repay their debt.

5. The FSR points out that household debt is high relative to incomes, one indicator of riskiness of lending. However, the RBNZ notes that the growth in net housing debt remains moderate due to households repaying existing debt, although gross housing debt is increasing. Falls in long term wholesale interest rates since November have supported the mortgage market, with for example five-year fixed mortgage rates being offered at historically low prices. This will have contributed to the increase in new mortgage lending, a key indicator of financial stability risk.

6. As a result, the FSR announces that the RBNZ will be undertaking a consultation on proposed changes to the current macroprudential settings. These involve a new restriction on loans to Auckland property investors, with almost zero lending at LVRs of greater than 70 percent. Investors account for around a third of new mortgage lending, and this proportion has increased strongly in Auckland since November. Investors are seen as more likely to default in a severe downturn, due to higher debt-to-income ratios than owner-occupiers and concentration in areas of high expected capital growth, and therefore the RBNZ suggests that this risk warrants a specific intervention.

7. The RBNZ is also proposing to relax the speed limit for all residential property lending outside of Auckland, allowing banks to make 15% of these loans at higher than 80% LVRs (up from 10% now). This is in part due to the LVR limits having improved overall stability in the rest of the country, although the FSR notes that the effect of the speed limit has weakened in the Auckland region.

8. The LVR policies improve household and bank resilience by reducing the proportion of borrowers with low equity buffers. However, concerns in Auckland are also around the debt relative to incomes of new buyers in Auckland, and the potential for higher default rates of this group during downturns.

9. Risks in the commercial property sector are assessed as largely contained, although there are pressures in Auckland in this market too.

Rural sector vulnerabilities remain a worry as dairy prices remain low amid a concentration of debt in some parts of the farming sector.

10. The dairy sector is currently experiencing a fall in incomes due to low international prices, and the FSR judges that these risks may materialise if these low prices are maintained. Global dairy prices fell by over 50% from peak to trough last year, due to increased supply, and reduced demand from China. Low prices reduce cash flows and may lead to falls in rural land prices. This would reduce the equity buffers available to farmers and potentially increase the number of loan defaults in this sector.

11. The FSR notes that Chinese milk demand has been relatively low due to the build-up in inventories in 2013, and that a recovery in this market could have a significant impact on milk prices. The RBNZ cites that the concentration of debt may be problematic – with around 11 percent of farm debt sitting with farmers who currently have negative cash flow and high LVRs combined.

Low global interest rates and loose financial conditions pose a risk to ongoing financial stability.

12. Low interest rates have encouraged a ‘search for yield’, driving investment towards riskier assets. In turn, this results in a reduction in credit spreads and lower market volatility, and pushes up prices on both financial and real assets. Monetary easing in Europe and Japan have been significant drivers of these loose financial conditions. This means offshore funding conditions for New Zealand banks remain favourable for the time being. However, these dynamics may prove an issue once interest rates revert to more usual levels, through elevated asset prices and the chance of a disorderly correction either in New Zealand itself, or a global correction that could indirectly harm New Zealand.

13. The insurance sector also faces challenges from the low interest rate environment, although reductions in reinsurance costs have benefited the industry. The estimated final cost of claims relating to the Canterbury earthquakes continues to be revised upwards.

14. New Zealand continues to maintain a high level of external debt, and therefore remains exposed to volatility in global funding markets. In recent years, banks have increased their deposit funding, resulting in a rise in the core funding ratio and a decline in rollover requirements. This means that their funding profile is less risky overall. However, a fall in export incomes may see net external debt rise over the near term.

15. A further global risk highlighted by the FSR is the potential for a sharp contraction in China, which could slow trade, disrupt capital markets and reduce export incomes in Australia and New Zealand.

16. Other key risks include weak growth in Europe, US monetary policy normalisation, and volatile global commodity markets.

Banking sector stability is considered strong, with high profitability and good capital adequacy. However, the FSR stresses that the vulnerabilities identified highlight the need for banks to maintain prudent lending standards and adequate financial buffers.

17. New Zealand banking sector capital and liquidity buffers have been rising over the last few years and exceed minimum regulatory requirements. Underlying profitability is strong and has increased over the past year, as a result of high asset quality, interest income growth and keeping costs low. This allows banks to use retained earnings as a source for building capital.

18. In order to support the maintenance of banking system stability, and following their recent consultation, the RBNZ is establishing a new asset class for bank loans to investors in residential property. These loans will be subject to a higher risk weighting than owner-occupier loans, reflecting the greater riskiness of this lending. This measure will be introduced from 1 October 2015.

19. The RBNZ additionally plans to review bank capital requirements in the context of the recent changes affecting the banking system both domestically and globally.

20. The RBNZ also notes that it is continuing with improvements on financial oversight, including on the stocktake of bank and non-bank regulations. Public consultation on specific proposals is planned for later in 2015. They also anticipate consulting with banks later this year on the practical implementation of stress tests.

Next Steps

21. The RBNZ's consultation on its proposed changes to the current macroprudential settings will be issued in late May to seek feedback from industry. Any changes will come into effect in early October.

22. The RBNZ measure establishing a new asset class for bank loans to investors in residential property will be introduced from 1 October 2015.

23. The RBNZ additionally plans to review bank capital requirements in the context of the recent changes affecting the banking system both domestically and globally.