Westpac
Institutional Bank

Lowering the boom

RBNZ introduces restrictions on high loan-to-value ratio housing loans

- **The Reserve Bank has placed a limit on the proportion of home loans at high loan-to-value ratios, in an effort to lean against the hot housing market.**
- **There is likely to be some 'sticker shock' after the restrictions come into effect on 1 October, with a fall in house sales and a slower rate of growth for house prices and household credit.**
- **However, we expect only a modest impact on house prices over the medium term. We find that interest rates are the main determinant of the demand for houses. Loan restrictions affect who are able to buy houses, but have little impact on the price that a given buyer is willing to pay.**

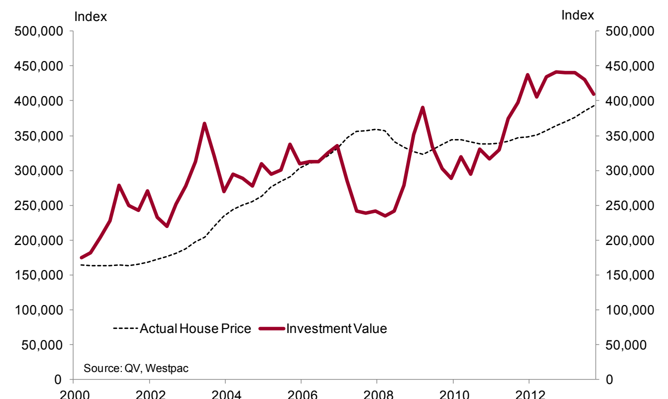
Today the Reserve Bank announced that loan-to-value ratio (LVR) restrictions on housing loans, its newly-minted macroprudential policy tool, will be brought into action.[1] We had expected an announcement sometime soon, with the framework for this policy tool having been finalised last week, and with the RBNZ making no bones about its discomfort with housing market trends.

LVR restrictions are expected to work by actively leaning against an upswing in asset prices and bank credit, whereas the other options in the RBNZ's macroprudential toolkit focus on increasing banks' safety buffers in a potential downturn. The fact that this tool has come into favour with the RBNZ in just the last few months suggests that the RBNZ is prepared to take a more activist approach to dealing with housing cycles.

From 1 October, banks will be required to restrict home loans that exceed 80% of the value of the house to no more than 10% of new lending (though with some exemptions, the share is expected to be closer to 15% in practice). Figures published by the RBNZ show that, as of February this year, high-LVR loans were estimated to make up about 30% of new lending, so these figures suggest there could be a sharp dropoff in house sales and household credit growth in the short term.

However, beyond this 'sticker shock' effect, we think that the long-term effect on the housing cycle will be limited. In our framework, house prices are determined by buyers' willingness to pay, which in turn depends on a range of financial factors, especially interest rates. LVR restrictions will affect the mix of potential buyers, but they don't affect a given person's willingness to pay. So we expect only a modest downward impact on house price inflation. This is not to say that LVR limits won't 'work'; in fact they could help to reduce the overall degree of household leverage, which is still beneficial from a financial stability point of view.

Investment value of housing



The Investment Value framework

We have used our Investment Value framework to analyse the New Zealand housing market since 2007.[2] The framework calculates a 'fair' price that an investor would be willing to pay, based on a range of financial factors such as interest rates, rental yields, maintenance costs, the tax treatment of property, inflation expectations, and long-run expected capital gains. This framework doesn't produce a forecast for house prices per se; instead, it identifies when there is a gap between current house values and the Investment Value, with the implication that the gap will need to be closed one way or another.

To understand our conclusions about the impact of LVR limits, it's important to first recognise the starting point for the housing market. We find that house prices are currently below the Investment Value, given current interest rates. That valuation gap has narrowed somewhat in recent times, as fixed-term mortgage rates have risen from their lows. (The last point in the chart is our estimate for the end of the current quarter.) But there is still scope for house prices to be bid higher from here; as a result, we've been forecasting house prices to rise further over this year and next year.

LVR restrictions

Restricting the number of high-LVR loans will shut some potential buyers out of the market, unless they can muster up a larger deposit. This means that less-leveraged buyers are more likely to be the successful bidders, and they will set the benchmark as to where house prices will gravitate. To put it another way: LVR limits will affect who gets the houses, but they do not affect what a given individual is willing to pay for a house.

1 For details see www.rbnz.govt.nz/news/2013/5406716.html
2 See www.westpac.co.nz/assets/Business/Economic-Updates/Archives-2012/BubbleSchmubble.pdf

This step alone suggests modestly lower house prices, relative to the baseline of no LVR limits. However, there is another step to consider in terms of the pricing of mortgages. We expect to see a bifurcation of mortgage pricing:

- *Higher* borrowing costs than otherwise for high-LVR loans, either in the form of higher carded interest rates or larger low-equity premiums. Lenders will need some basis for rationing the demand for high-LVR loans; prices are the most straightforward solution.
- *Lower* borrowing costs than otherwise for low-LVR loans. Banks are likely to compete more fiercely for the limited pool of borrowers that they are allowed to lend to. Also, the 'speed limit' design of the LVR limits means that the more low-LVR lending a bank does, the more high-LVR lending it can do.

This means that, for those who can stump up a deposit of 20% or more, their willingness to pay may actually *increase* as a result of LVR restrictions. As for who the successful bidders will be – we suspect that investors will have a greater capacity to muster up a large enough deposit, while first-home buyers are most likely to be excluded, and will be forced to rent instead. So on balance LVR restrictions are likely to be in the direction of modestly lower house prices, but higher rents and a lower rate of home ownership than otherwise.

Monetary policy implications

LVR restrictions are primarily about financial stability. they will have implications for monetary policy, but only to the extent that the housing market feeds into generalised inflation. Hence, the RBNZ notes, if LVR limits are successful in slowing the housing market, that could leave scope for lower interest rates than otherwise, in turn reducing the upward pressure on the exchange rate.

The counter to this argument, though, is that the RBNZ has not been a strong believer in the housing/inflation link in the first place. To date, the RBNZ has been assuming that households will be more cautious during this upswing compared to past cycles, given that they are carrying already-high levels of debt. In our view, that assumption is being steadily undermined by the economic data. But for the RBNZ to now acknowledge that housing matters for the inflation outlook, it would also have to acknowledge that there is more inflation pressure in the pipeline than it has previously admitted. This would be a hawkish shift, not a dovish one. Our view is that LVR restrictions won't obviate the need for OCR hikes from next year.

Conclusion

Our framework focuses on the demand side of the housing market, particularly on financial factors such as interest rates; we find that we don't have to resort to stories of irrationality to account for the path of house prices over the last two decades. LVR restrictions have a fairly limited impact on the financial factors within this framework, so we don't expect them to have much lasting effect on house prices.

It's very likely that there will be some 'sticker shock' in the housing market after the restrictions come into effect. The overseas experience has been that house sales fall sharply, and house prices and household credit rise at a slower pace, in the 3-6 months after LVR rules are tightened. We fully expect to see a similar slowdown in the months following the imposition of LVR limits here.

However, this short-term impact should not be taken as a sign that LVR limits can 'fix' the housing cycle. Overseas experience also suggests two other outcomes: that the impact of macroprudential tools tends to be short-lived, and that measures that affect the cost of buying a house tend to be more effective than restrictions on quantity. We'll delve into this in a forthcoming bulletin.

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