Economic Note

Preview of November 2018 Financial Stability Report

23 November 2018

LVRs: should they stay or should they go?

- The RBNZ Financial Stability Report will focus on housing and dairy risks, which are gradually easing.
- Housing developments suggest there is a case for easing the LVR restrictions.
- But, at the margin, we think the RBNZ will wait slightly longer, though easier owner-occupier LVRs are possible.

Summary

Should they stay or should they go now?
Should they stay or should they go now?
If they go, there could be trouble
And if they stay there'll be no bubble
So come on and let us know.

Whether the RBNZ's Loan-to-Value Ratio restrictions (LVRs) get relaxed at the (Financial Stability Report) FSR release will be the prime point of interest. As the Clash might sum it up, the decision is a pretty conflicted one. Key metrics the RBNZ focuses on all point to easing financial stability risks. But, taking a forward-looking viewpoint, there is some uncertainty about whether housing activity and debt levels will continue on their recent benign trends – implying little urgency to ease the lending restrictions now.

We think a shift in LVRs at this meeting is a lineball call, and that the RBNZ will judge it can afford to wait a little longer. But we can readily argue for both relaxing the restrictions and for leaving them as they are for a little while longer. So there is a distinct possibility of some relaxation. In the event there is, we highlight an easing of the owner-occupier restrictions as a step that is in keeping with the Government's broader housing policy objective of a tilt to owner-occupiers and away from property investors.

Same risk focus

The main risks the RBNZ will cover in the Financial Stability Report (FSR) remain the perennial ones: housing and dairy. On both fronts, we expect the RBNZ to devote considerable time to discussing the risks. We expect the RBNZ will assess that the financial risks in these areas as continuing to ease.

LVRs: if they go there could be trouble

Based on key criteria, there is every reason for expecting some form of relaxation of the LVRs. The risks to the financial system have reduced further since the RBNZ decided to ease the restrictions a year ago.

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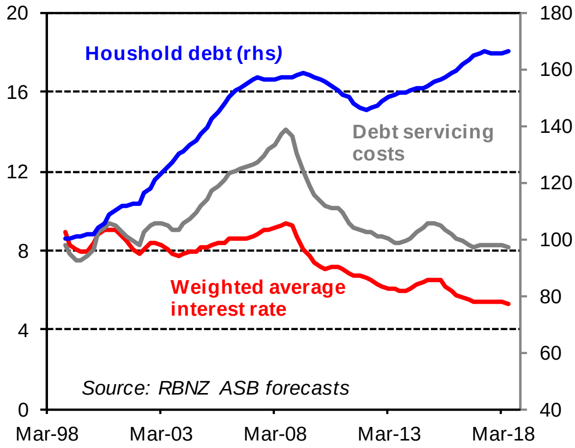
House price growth is moderating overall. And in Auckland, the region seen at most risk of a damaging housing correction, prices have been essentially flat for the past two years. There, further overheating seems unlikely, and a soft landing appears to be happening as the demand and supply sides both respond to changing drivers. The risk of a material fall in prices appears to have reduced, and house prices are less stretched compared to household incomes than they were back in 2016.

High LVR Lending (>80%), % of all mortgages		
	2018	Year ago
ASB[1]	7.6	8.8
ANZ[2]	5.2	6.2
BNZ[3]	6.3	7.5
Westpac[4]	9.4	9.5

[1] *ASB June year Annual Report*
[2] *ANZ June Interim Financial Statements*
[3] *BNZ March disclosure*
[4] *Westpac March disclosure*

The one caveat to overall modest house price growth and a stable Auckland market is the degree of heat still in some provincial centres. There is always the risk that easing lending restrictions further fuels price growth in these areas. But, relative to local incomes, prices in these areas are not as stretched as they are in Auckland.

HOUSEHOLD DEBT & INTEREST COST
(% of disposable income)



An unequivocal reduction in risk over the past year is the continued fall in the share of high-LVR loans on banks' balance sheets. Consequently, banks are in an even more resilient position to weather any loan defaults should there be a material decline in house prices.

Mortgage lending growth has also slowed further since the restrictions were last eased. Furthermore, it is running broadly in line with household income growth, meaning that debt relative to income has stabilised, albeit at a record level.

In a recent speech, Deputy Governor Geoff Bascand commented that bank lending standards have tightened.

If they stay there'll be no bubble

But there are good reasons for the RBNZ choosing to take its time, minimising the risk of the housing market regathering some pace in soft areas and fanning the flames in those areas that – if anything – already look like they have started to accelerate even further:

- The early 2018 relaxation of LVRs did see a pick-up in high-LVR lending, which no doubt contributed to the stabilising of mortgage credit growth in the first half of 2018 after a period of steady deceleration.
- Mortgage rates have dropped in recent months to record lows, and their impact is unclear at present.
- If credit growth did pick up again it might start to run ahead of household income growth, pushing debt vs. income to fresh records.
- Auckland's gradual adjustment to less-stretched valuations relative to incomes is occurring in a very orderly fashion, so why rock the boat?

There are a lot of moving parts in the housing market at the moment, with an early spring sales bounce (potentially boosted by a rush to beat the foreign buyer ban), strong provincial markets, and government policy changes occurring. But amidst this noise, the market isn't grinding to a halt.

Won't be here 'til the end of time

It is a lineball call in our view whether to ease the LVR restrictions at this point. We have come down on the side of no easing at this particular FSR announcement, given some conflicting signals about where the housing market and credit growth go from here. But we freely acknowledge an easing is readily justified by the overall reduction in risk metrics over the past year.

If the RBNZ was to ease the LVRs this month, we see a raising of the owner-occupier 'speed limit' as the more likely option (currently 15% of such new lending can be for 80+% LVR lending, the limit could be raised to 20%). In suggesting this we are to some extent playing the man, not the ball. Philosophically, easing owner-occupier restrictions sits very much with the Government's policy focus of enabling owner-occupiers (particularly first-home buyers) to purchase while also putting up added hurdles for residential property investors. In saying that, we do stress that there is no requirement for the RBNZ to support broader government policy objectives.

Whether there is some easing of the LVR restrictions or not this month, the longer-term question is when the restrictions will be removed? The RBNZ has indicated that the restrictions will always technically be in place and high-LVR loans actively reported on as they are now. But the RBNZ will move the settings to a point at which they are no longer restricting credit growth. As an example, setting the owner-occupier 'speed limit' at 30+% of new owner-occupier loans is unlikely to impact on borrowers' access to funds.

In his recent speech, Deputy Governor Geoff Bascand intimated that the RBNZ will gradually ease the LVR restrictions in "coming years" as long as conditions warrant it. So, regardless of whether there is any easing this month, we should expect that the RBNZ will gradually move the LVR restrictions to settings that no longer restrict borrowing capacity. After all, the LVR restrictions were supposed to be temporary, yet have been in place for 5 years and counting.

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