

Economic Note

November FSR Review

29 November 2017

Easing restrictions

- The RBNZ has started to ease the Loan-to-Value Ratio (LVR) restrictions, effective from 1st January.
- Further easing will depend on financial stability risks remaining contained.
- Dairy sector risks continue to recede; funding and commercial property risks noted.

Summary

The relaxation of the residential Loan-to-Value Ratio (LVR) restrictions happened a little sooner than we had expected. The financial stability risks in housing have receded. However, given uncertainties around how temporarily the election impacted market activity and over when government tax/housing policies will take effect, we had expected the RBNZ would wait a little longer. But the shifts are modest.

All other things equal, the imminent relaxation of the restrictions will help put a floor under housing activity and prices. The nationwide investor LVR restriction of 60% (i.e. 40% deposit) did have a sustained impact on the composition of new residential lending.

This initial LVR easing is likely to contribute to a stabilising in 2018 of the mild price falls seen in Auckland and Christchurch, though we would still expect price growth in other regions to flatten off. We don't expect the eased restrictions to spark a return to strong house price growth.

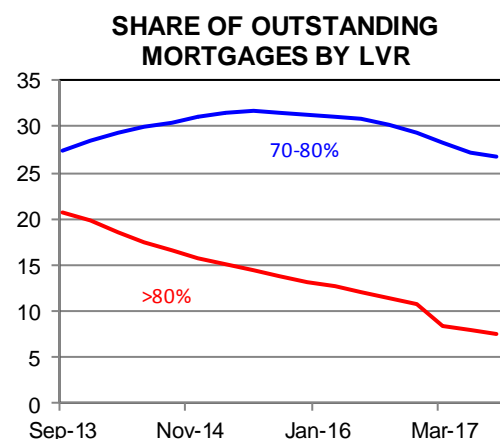
LVR easings

From January 1st the RBNZ will lift the share of lending banks can lend to owner-occupiers at a LVR above 80% (i.e. less than a 20% deposit) from 10% to 15%. This will make it slightly easier for first home buyers to purchase a house if they haven't got a 20% deposit.

On the investor side, the RBNZ will ease the LVR restriction to 65% from 60%, meaning that investors will be able to purchase property with a 35% deposit (previously 40%). Note that the 'speed limit' here is to remain fixed at 5%, meaning in effect few low-deposit investor loans.

The LVR path from here

Beyond the first easing of the restrictions, **further easing will depend on the RBNZ being comfortable that financial stability risks will remain contained.** That keeps the focus on the state of the housing market over the next year in particular. Signs that the market remains contained even in an environment of less LVR restraint would be an



important signal. The FSR suggests the RBNZ is quite confident the housing market will not rebound, though the RBNZ will be mindful the Auckland and Wellington markets are still quite supply-constrained. The quality of banks' residential lending portfolios will also be a consideration. Since LVR restrictions were introduced in 2013 there has been a marked reduction in high-LVR loans on banks' balance sheets. The RBNZ would want to see that share remaining low.

We would expect that any future LVR moves would follow the pattern of the first move, with incremental easing of the restrictions. The next obvious moment for a future RBNZ decision is the next FSR, in May next year. By that stage the RBNZ will have been able to assess how the housing market has behaved in the initial months after the January easing, as well as have a clearer idea of the Government's housing-related actions.

DTIs some way off (if ever)

On the debt-to-income (DTI) front, the RBNZ stated that following on from public submissions, the RBNZ and Treasury would discuss including DTIs in the Memorandum of Understanding with the Finance Minister during Phase Two of the Reserve Bank Act Review. The new Government, like the previous one, has expressed reluctance to endorse this additional tool.

Rural risks

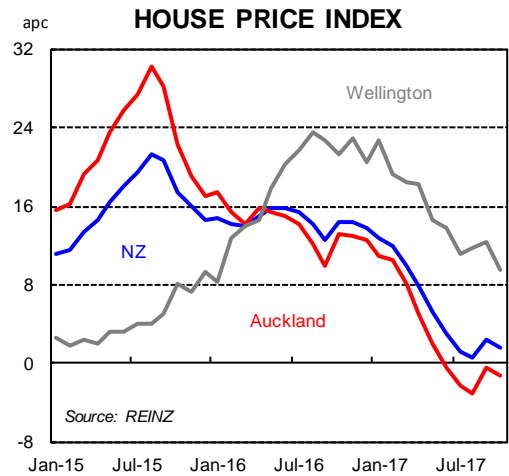
The RBNZ noted that **risks in the dairy sector have declined over the past six months** as higher dairy prices have improved sector profitability. For example, the Fonterra farm-gate milk price ended the 2016/17 season at \$6.12/kg of milk solids after starting the season at \$4.25/kg. Moreover, the number of non-performing loans in the sector has reduced, with the share of non-performing loans down to 1.6%, from 1.9% at the end of 2016.

Nonetheless, the RBNZ still notes that dairy sector debt levels remain high and, accordingly, the sector remains vulnerable to shocks. For example, debt in the dairy sector is estimated to be more than three times income, compared to a ratio of around two for the sheep and beef sector.

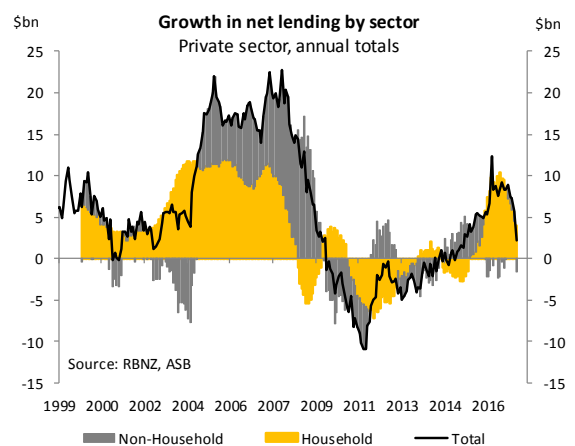
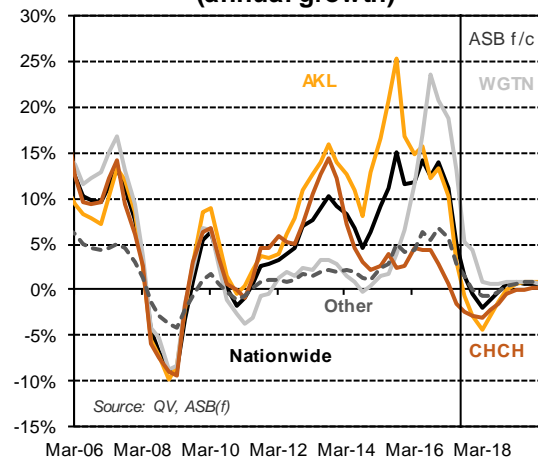
Other risks: Funding

The Banking system remains exposed to volatility in funding markets. The November FSR noted that banks have competed more aggressively for domestic deposit funding and have reduced credit growth. In turn this has helped to reduce offshore reliance on funding. As the RBNZ noted, there are a number of global risks that could flow through to NZ, including "unintended consequences" from the unwinding of unconventional monetary policies globally.

Our analysis suggests that system-wide net borrowing has moderated sharply since May, largely as a result of reduced household net borrowing. This, in turn, was drive by the deceleration in household credit growth, as the



REGIONAL HOUSE PRICE FORECASTS (annual growth)



housing market took an additional breather over the election period. Whether the housing market and household borrowing will remain as dormant over 2018 is an open question, though we expect some further moderation in household borrowing growth.

Other risks: Commercial property

The Bank is also closely monitoring the wider property market sector. Commercial property prices have risen strongly over the past few years, underpinned by strong owner-occupier and investor demand given the attractive yields on offer. Credit growth to the sector has also been relatively strong.

Of late, however, the Bank has detected a slowing in price growth over the last 6 months, with slowing particularly evident in the retail market. Major bank lending to the property development sector has declined slightly since the start of the year, with the RBNZ Credit Conditions Survey pointing to a further tightening in lending standards for commercial property in the next six months. **As the RBNZ notes, this tightening in lending standards appears to be a “prudent response to heightened risks” in the property development sector.** Vacancy rates in a number of sectors and regions remain low. However, commercial property development over the next few years is expected to be capped, given capacity pressures in the construction sector, tight access to development finance, stricter bank lending criteria to the commercial and residential property development and the shortage of available prime land.

November 2017 FSR media release

New Zealand’s financial system remains sound and risks to the system have reduced over the past six months, Reserve Bank Governor Grant Spencer said today when releasing the Bank’s November Financial Stability Report.

“Momentum in the global economy has continued to build over the past six months, reducing near-term risks to financial stability. However, the New Zealand financial system remains exposed to international risks related to elevated asset prices and high levels of debt in a number of countries.

“Domestically, LVR policies have been in place since 2013 to address financial stability risks arising from rapid house price inflation and increasing household debt. These policies have helped improve banking system resilience by substantially reducing the share of high-LVR loans. Over the past six months, pressures in the housing market have continued to moderate due to the tightening of LVR restrictions in October 2016, a more general firming of bank lending standards and an increase in mortgage interest rates in early 2017.

“Housing market policies announced by the Government are also expected to have a dampening effect on the housing market.

“In light of these developments, the Reserve Bank is undertaking a modest easing of the LVR restrictions. From 1 January 2018, the LVR restrictions will require that:

No more than 15 percent (currently 10 percent) of each bank’s new mortgage lending to owner occupiers can be at LVRs of more than 80 percent.

No more than 5 percent of each bank’s new mortgage lending to residential property investors can be at LVRs of more than 65 percent (currently 60 percent).

“The Bank will monitor the impact of these changes and will only make further LVR adjustments if financial stability risks remain contained. A cautious approach will reduce the risk of resurgence in the housing market or deterioration in lending standards.

Deputy Governor Geoff Bascand said “Looking at the financial system more broadly, the banking system maintains adequate buffers over minimum capital requirements and appears to be performing its financial intermediation role efficiently. The recovery in dairy commodity prices since mid-2016 has supported farm profitability and has helped to reduce bank non-performing loans in the sector. Recent stress tests suggest that banks are well positioned to withstand a severe economic downturn and operational risk events.

“The Bank has released two consultation papers on the review of bank capital requirements and a third paper on the measurement and aggregation of bank risk will be released shortly. The aim of the capital review is to ensure a very high level of confidence in the solvency of the banking system while minimising complexity and compliance costs.

“The Bank has also completed a review of the bank directors’ attestation regime and is making good progress in implementing a new dashboard approach to quarterly bank disclosures. This is expected to go live next May,” Mr Bascand said.

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