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FINANCIAL STABILITY EXTRA | MAY 13 2015 | Confidential to HUGO members

Reserve Bank surprises with 30% LVR rule in Auckland

SUMMARY: The RBNZ is frustrated that government policy actions to ease pressure on Auckland housing prices have been inadequate and is taking a lead by undertaking an unexpectedly strong initiative, using the limited range of tools at its disposal. It knows LVR's can have short term impacts, which dissipate over time. The bank believes the latest move could reduce Auckland house price inflation by between 2 and 4% "or maybe even more than that." Its concerns about the potential for a disorderly unwinding of current benign global financial market conditions cannot be ignored, especially as New Zealand remains relatively heavily externally indebted and could experience difficulty funding debt rollovers, notwithstanding an increase in reliance on domestic funding sources since the GFC. Debt-exposed dairy farms are identified as a third source of significant risk.

COMMENTARY: The Reserve Bank has gone considerably further than expected in today's six monthly Financial Stability Report, with a new loan-to-valuation lending restriction inside the Auckland Council territorial boundary. It says Auckland house prices are "very stretched, increasing the risk of financial stability from a sharp correction in prices".

Its new policy, to operate formally from October 1 after consultation but effectively in place from today, will require a minimum 30% deposit, compared with the 20% requirement currently operating nationally, for house purchases in the AC area. Banks will be required "to observe the spirit of the restrictions and not seek to expand high-LVR investor lending in Auckland."

The so-called "speed limit" requiring banks to hold no more than 10% of their total loan book in high LVR loans will remain in place in Auckland, but will be relaxed to 15% in the rest of the country, where house price inflation is roughly in line with income growth and is not posing a concern. New house and apartment starts will be exempt from the new rule, to avoid exacerbating Auckland's housing supply shortage. The RBNZ reiterates that "policies to ease housing supply constraints in Auckland remain the key to addressing the region's housing imbalances over the long term."

As expected, banks will also be required to ring-fence a new class of residential property investment lending, which will be applied to "any retail mortgage secured on a residential property that is not owner-occupied".

Other key elements of the Financial Stability Report:

- "Many highly leveraged farms are facing negative cashflows and the risks will become more pronounced if low milk prices persist beyond the current season," the central bank says. ;
- The potential for a "disorderly" unwinding of "current benign conditions" in global financial markets is tied to potential disruptions to global capital flows in the event of a significant increase in US interest rates;
- Households are reducing mortgage debt faster than necessary, but residential property investors are proportionately more likely to borrow on interest-only terms, possibly reflecting the ability to offset interest payments against personal income tax. Around half of investor lending is at LVR's higher than 70%;
- The commercial property sector is sound, although increased international investment in New Zealand commercial property will contribute to a worsening current account deficit, which is expected to grow from 2.6% of GDP at present to a forecast 5.7% in 2017.
- The banking sector is sound. However, some legacy capital assets will no longer qualify as regulatory capital from 2016. New Basel III-compliant capital instruments will need not to reduce loss-absorbing capacity". "Investors will need to fully understand the risks associated with these."

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